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# **PRE-INCORPORATION CONTRACTS AND THE LIABILITY OF THE PROMOTERS**

by

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## Declaration

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I, the undersigned, hereby declare that the work contained in this mini-dissertation is my own original work and that I have not previously, in its entirety or in part, submitted it at any other university in order to obtain an academic qualification.

Signature:.....

Date: 15 November 2010

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## Abstract

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Company law legislation has recently undergone changes with the enactment of the Companies Act 71 of 2008. The purpose of this new piece of legislation is, *inter alia*, to encourage entrepreneurship and enterprise efficiency, to create flexibility and simplicity in the formation and maintenance of companies, and to provide for the creation, role and use of companies in a manner that enhances the economic welfare of South Africa. This Act was signed into law on 8 April 2009 and is said to come into operation during April 2011. The Act furthermore introduces an extensive and renewed approach to the regulation of pre-incorporation contracts in an attempt to address the shortcomings of previous and current legislation on this topic. This study explores the impact and effect that the new Act will have on the conclusion of pre-incorporation contracts, and also identifies the possible shortcomings of the Act.

In order to determine what impact the new Act will have on pre-incorporation contracts, these contracts must first be placed in their historical context. This entails tracing the historical development of the common law rules relating to agency and ratification, and their impact on pre-incorporation contracts. Secondly this study attempts to determine whether the old and the current legislation regulating pre-incorporation contracts have been effective, and if so, to what extent. To establish this, the statutory arrangements that currently regulate pre-incorporation contracts require a grounded, solid and formulated basis, which is determined by an evaluation of the history of the different statutory sections on pre-incorporation contracts in these enactments. A significant part of this study will be devoted to the success, shortcomings and complications presented by the specific statutory arrangements. Fair consideration will be given to case law on these aspects. The South African courts have offered insight into the difficulties relating to the various statutory arrangements and explored alternative methods to supplement these statutory provisions.

The advantages, disadvantages and legal consequences of these alternative methods are also discussed and analysed in this study. Concepts that are dealt with in this regard includes shelf companies, an agreement for the benefit of a third party (the *stipulatio alteri*), and where promoters act as principals. This study also reveals that these alternative methods present their own complications.

The central theme of this study remains whether the new Companies Act provides adequate solutions to the problems that frequently arise from the conclusion of pre-incorporation contracts, and whether the shortcomings that exist in current and previous legislation have successfully been addressed by the new Act. To this end, the research reveals that section 21 of the new Act will succeed in equitably balancing the interests of third parties, companies and promoters, by providing clearly stipulated protection measures for all parties involved in the conclusion of pre-incorporation contracts. It has offered valuable improvements to previous statutes. The proposed reforms as introduced by section 21 are therefore welcomed.

The mere fact that the South African legislature has now made a conscious attempt to create reform on this subject shows that it acknowledges that pre-incorporation contracts will continue to play an important role in commercial dealings. However, questions still arise on the future role of the statutory arrangements in light of the various alternative methods available to promoters. Academic opinions have also been divided with regards to the future role of pre-incorporation contracts within changing commercial environments.

It is clear from the research presented in this study that pre-incorporation contracts have the potential to present a range of complex and challenging questions in practice. Therefore, this study seeks to provide sufficient guidelines to third parties and promoters who seek to acquire rights, duties, assets and benefits for a company prior to its incorporation, while protecting themselves against personal liability and associated litigation.

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## CHAPTER 1

### Introduction

‘The law of pre-incorporation contracts at first blush, may appear to be disarmingly simple, but which, after an examination of the common law, legal treatises and legislative attempts to find an equitable solution to a seemingly insoluble legal problem, is very complex.’<sup>1</sup>

#### 1.1 Background

A pre-incorporation contract is an 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.<sup>2</sup>

Persons who wish to form a company will have to give thought to the assets that are to be acquired by the company and the methods that are to be adopted to vest rights to those assets in the new company.<sup>3</sup> In practice, companies not yet in existence often experience the need to acquire certain rights and liabilities before incorporation (such as securing a lease contract or purchasing property/offices) to ensure that the company will effectively be able to commence business after its incorporation.<sup>4</sup> The problem that arises for unincorporated companies is that they do not yet have legal personality – as a result of their non-existence – and thus they cannot enter into any agreements themselves in an attempt to secure certain benefits. The most apparent solution would be for the company’s promoters or agents to contract in the company’s name or on behalf of the company in order to incur rights and liabilities for the company during the period before incorporation or registration.

However, the common law presents an obstacle to the individual who tries to contract as an agent for a principal that does not yet exist, in an attempt to obtain certain benefits for that principal. The common law principles flow from the understanding

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<sup>1</sup> As stated by Justice Borins of the Ontario Court of Appeal in *Sherwood Design Services Inc. v 872935 Ontario Limited* (1998), 39 O.R. (3d) 576.

<sup>2</sup> As defined in S 1 of Companies Act 71 of 2008 (hereafter ‘the 2008-Act’).

<sup>3</sup> Beuthin RC & Luiz SM *Beuthin’s Basic Company Law* 3<sup>rd</sup> ed (2000) Durban: Butterworths 35 (hereafter ‘Beuthin & Luiz’).

<sup>4</sup> Cilliers HS *et al Cilliers & Benade Korporatiewe Reg* 3<sup>rd</sup> ed (2000) par 5.01 (hereafter ‘Cilliers & Benade’).



that a company – prior to its incorporation – is not yet a legal entity and can therefore not perform juristic acts such as the conclusion of contracts. In the same vein, no person has the authority to act as an agent of a company that has not yet been established. Where an agent proceeds to contract on behalf of a non-existent principal, with the expectation that the principal will ratify the transaction upon incorporation, the common law rules of agency will preclude the ratification. These rules determine that a principal, not yet in existence at the time of the transaction, is not competent to ratify and hence there can be no representation of such a person.<sup>5</sup> Ratification has a retrospective effect and for this reason a person cannot act on behalf of a principal that does not yet exist. A company can thus not acquire rights nor incur liabilities in this manner.

The obstacle that has been created by the common law rule of no-ratification has since been remedied by the South African legislature.<sup>6</sup> South Africa was one of the first jurisdictions to provide a legislative solution to the multifaceted problems that can arise at the conclusion of a pre-incorporation contract.<sup>7</sup> The statutory solutions are however not without defects. Our courts have therefore tried to offer insight into the various statutory arrangements as well as suggest alternative methods to supplement the statutory provisions that regulate pre-incorporation contracts.

## 1.2 Purpose of the Study

This study focuses on the following issues:

- (1) Whether the current and previous statutes that regulate pre-incorporation contracts have been effective, and if so, to what extent.
- (2) The impact of the new Companies Act (71 of 2008) on pre-incorporation contracts. The issue remains whether this Act provides adequate solutions to the problems that frequently arise from the conclusion of pre-incorporation contracts. Also

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<sup>5</sup> Blackman MS “Companies” in *The Law of South Africa* Vol 4 Part 1 (1995) Durban: LexisNexis Butterworths par 60 (hereafter ‘Blackman LAWSA 4(1)’); *Kelner v Baxter* 1866 LR 2 CP 174; *McCulloch v Fernwood Estate Ltd* 1920 AD 204 207-208; *Peak Lode Gold Mining Co Ltd v Union Government* 1932 TPD 48 50-51; *Sentrale Kunsmis Korp (Edms) Bpk v NKP Kunsmisverspreiders (Edms) Bpk* 1970 3 SA 342 (A) 345; *Racec (Mooifontein) (Pty) Ltd v Devonport Investment Holding Co (Pty) Ltd* 1971 1 SA 299 (W) 303.

<sup>6</sup> In s 71 of Act 46 of 1926, s 35 of Act 61 of 1973 and s 21 of Act 71 of 2008.

<sup>7</sup> Cassim MF “Pre-Incorporation Contracts: The Reform of Section 35 of the Companies Act” 2007 124(2) *SALJ* 365 (hereafter ‘Cassim’).

whether the shortcomings that exist in current and previous legislation have successfully been addressed by the new Act.

- (3) Alternative methods (apart from the statutory provisions) that are available to promoters who wish to secure particular benefits for a company before its incorporation.
- (4) The consequences of and difficulties that arise from the statutory provisions, as well as those that arise from the application of the alternative methods.

The answers to these questions can be found in the various Companies Acts that have been drafted for and promulgated in South Africa.<sup>8</sup> Answers can be found not only in legislation, but also in our case law, common law (more specifically the law of contract) and in the opinions of legal writers. Pre-incorporation contracts have the potential to present a range of complex and challenging questions in practice. Therefore, promoters who aspire to procure the formation of a company, as well as third parties who are prepared to bind themselves in terms of pre-incorporation contracts to unincorporated entities, may find the answers to these questions useful.

Promoters will, under normal circumstances, not wish to incur any personal liability when contracting on behalf of an unincorporated company. If the promoter decides to abandon his venture at any given time, he would seemingly want to do so without liability. In return, third parties' interests need to be protected against the unforeseen conduct of the promoter and the unincorporated company in the event that the company fails to be successfully incorporated. This study is essential in providing sufficient guidelines to third parties and promoters who seek to acquire rights, duties, assets and benefits for a company prior to its incorporation, while protecting themselves against personal liability and associated litigation.

### **1.3 Methodology**

In this chapter the problem statement and focus of the dissertation is explained by providing background information on the issue of pre-incorporation contracts in the

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<sup>8</sup> *Supra* n 6.

South African law. It also contextualizes the purpose of the study, provides a brief outline of each chapter and indicates the delimitations of the study.

In chapter 2 that follows, the problem statements of the dissertation will be placed in their historical context. This entails tracing the historical development of the common law of agency and ratification, and the impact it has on pre-incorporation contracts as a separate legal subject. This chapter will also examine the case law that reflects the current common law position.

Chapter 3, which contains the most fundamental aspects of this study, examines the ways in which the South African legislature has opted to remedy the common law problem. The statutory arrangements require a grounded, solid and formulated historical context, which will be conducted by evaluating the history of the different sections that regulate pre-incorporation contracts in statutory enactments. A significant part of this chapter will be devoted to the impact, success and shortcomings of the specific statutory arrangements. Fair consideration will also be given to the difficulties that arose from previous and current legislation relating to pre-incorporation contracts and how the courts dealt with those difficulties. This chapter also deals extensively with the works of Cassim<sup>9</sup> and Ncube,<sup>10</sup> both of whom have made valuable recommendations regarding the transformation and reform of the statutory arrangements that regulate pre-incorporation contracts.

Company law legislation has recently undergone changes with the enactment of the Companies Act 71 of 2008. The purpose of this new piece of legislation is, *inter alia*, to encourage entrepreneurship and enterprise efficiency,<sup>11</sup> to create flexibility and simplicity in the formation and maintenance of companies,<sup>12</sup> and to provide for the creation, role and use of companies in a manner that enhances the economic welfare of South Africa.<sup>13</sup> This Act, although not yet in force, furthermore introduces an extensive and renewed approach to the regulation of pre-incorporation contracts in an attempt to address the shortcomings of older legislation. This chapter explores the

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<sup>9</sup> Professor Maleka Femida Cassim is currently a professor in Law at the University of the Witwatersrand, Johannesburg and also an attorney and Notary Public of the High Court of South Africa.

<sup>10</sup> Professor Caroline Ncube is currently a professor at the University of Cape Town.

<sup>11</sup> S 7(b)(i) of the 2008-Act.

<sup>12</sup> S 7(b)(ii) of the 2008-Act.

<sup>13</sup> S 7(e) of the 2008-Act.

impact, effect and possible shortcomings of the new Act on the conclusion of pre-incorporation contracts and the responsibilities of the promoters.

Chapter 4 entails a study of the alternative methods that have been developed over the years to address this specific issue. Concepts that are dealt with in this chapter include shelf companies, an agreement for the benefit of a third party (the *stipulatio alteri*), and where promoters act as principals. As in the case of the statutory arrangements, the alternative methods also pose difficulties and/or complications. These problems will also be addressed in this chapter.

Finally, the conclusion to the preceding four chapters will be provided in the fifth chapter, which hopes to provide answers to the research questions by providing a broad conclusion and recommendations.

#### **1.4 Delimitation**

The scope of this study is partially limited in the following ways:

- (a) The term “promoter” will not be defined in detail, because company law legislation in South Africa contains no comprehensive definition of this term and the courts have refrained from formulating one. For the purposes of this study it will thus be accepted that a ‘promoter’ is any person who has taken part in the formation or promotion of a company.<sup>14</sup>
- (b) This study will also be limited to pre-incorporation contracts pertaining to companies only, as the discussion will not include Close Corporations<sup>15</sup> or any other business entities or associations.
- (c) By virtue of the fact that this study is a mini-dissertation I have also decided to chronologically limit the study to the early law of the twentieth century in an attempt to underscore the most important transformations of the South African company law to date.

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<sup>14</sup> As referred to in s 423 of Companies Act 61 of 1973 (hereafter ‘the 1973-Act’). In Chapter 14 of the 1973-Act (under the heading ‘liquidation of companies’) the Legislature tries to define a ‘promoter’ in relation to his civil and criminal liability in respect of any misconduct or offence. There is no other official definition of a promoter in any of South Africa’s Companies Acts. For more information on this subject see Blackman LAWSA 4(1) par 64.

<sup>15</sup> For a discussion on pre-incorporation contracts pertaining to Close Corporations see S 53 of the Close Corporations Act 69 of 1984; as well as Blackman MS “Companies ” in *The Law of South Africa* Vol 4 Part 3 (1995) Durban: LexisNexis Butterworths par 476-479.

## CHAPTER 2

### The Common Law Position

#### 2.1 General position on the law of agency and representation

Many contracts are concluded not by the principal parties themselves, but through their representatives or agents.<sup>16</sup> The term ‘agency’ enjoys a variety of meanings and frequently overlaps with the concept of representation.<sup>17</sup> For the purpose of this study it is necessary to clarify the primary difference between the two terms. In the event of agency, a principal authorises another person (the agent), to represent him or her in negotiating a contract with a third person. The agent then, acting on behalf of the principal, enters into negotiations with the third party. If a successful contract is concluded as a result of the negotiations, that contract comes into being between the principal and the third party.<sup>18</sup> The agent will not be a party to the contract, but will be bound to a separate contract with the principal governing his or her appointment as the principal’s agent. The term ‘agency’ in this instance signifies the contractual relationship between the agent and principal, or the agent’s representation of his principal, or both. Thus, it would seem that there can only be ‘agency’ where a person is contractually authorised by a principal to perform a juristic act and not where authority is derived from another source.

Representation is the phenomenon that occurs when one person (called the agent) concludes a juristic act on behalf of or in the name of another (called the principal).<sup>19</sup> In this case the term ‘agency’ is an instance of representation. Therefore, agents who act on behalf of others act as representatives. This can only occur when the representative has the necessary authority or power to represent the principal. The power to represent may be granted by law itself – usually where the principal is a

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<sup>16</sup> Hutchison D, Pretorius CJ *et al The Law of Contract in South Africa* 1<sup>st</sup> ed (2009) South Africa: Oxford University Press 221 (hereafter ‘Hutchison & Pretorius’).

<sup>17</sup> *Supra* n 16. See also Wanda BP “Agency and Representation” in *The Law of South Africa* 2<sup>nd</sup> ed Vol 1 (2003) Durban: LexisNexis Butterworths par 175 (hereafter ‘Wanda LAWSA (1)’).

<sup>18</sup> *Supra* n 16.

<sup>19</sup> Van der Merwe S *et al Contract General Principles* 3<sup>rd</sup> ed (2007) Cape Town: Juta and Company Ltd 251 (hereafter ‘Van der Merwe’); *Joel Melamed & Hurwitz v Cleveland Estates (Pty) Ltd*; *Joel Melamed & Hurwitz v Vorner Investments (Pty) Ltd* 1984 (3) SA 155 (A) 166C-D; *Totalisator Agency Board OFS v Livanos* 1987 (3) SA 283 (W) 291.

juristic person (such as a director for a company) or if someone is incapable of managing his or her own affairs (where a guardian acts for a minor).

The purpose of representation is to bring about the legal consequences that would have resulted if the particular juristic act had been concluded by the principal himself.<sup>20</sup> Where a representative thus concludes a contract on behalf of his principal, the principal and not the representative is regarded as the contracting party. As a result the rights and duties arising from that contract ascribes to the principal and not to the representative. It is important to note that the representative is not a party to the obligations flowing from that contract and that the resulting obligations are only established between the principal and the third party.

Representation will only be possible if the following requirements for representation are met:

- (i) The representative and the third party must have the intentions that the legal consequences of their conduct shall ascribe to the principal and not the representative. Not only the representative, but also the third party must therefore intend that their conduct will create, alter or extinguish legal relationships for the principal.<sup>21</sup>
- (ii) The principal must exist at the time when the representative purported to act on his behalf. There can be no representation of a non-existent person.
- (iii) In order to conclude juristic acts on behalf of another, the representative requires the necessary authority to act on behalf of another.

For the purpose of the discussion, this study will refer to the term ‘agent’ as an instance of representation, as the person who purports to conclude a pre-incorporation contract will do so in the name of, or on behalf of, the unincorporated company and the power to represent has been granted to that person by law.<sup>22</sup>

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<sup>20</sup> Van der Merwe 251.

<sup>21</sup> *Supra* n 20; *Nordis Construction Co (Pty) Ltd v Theron, Burke & Isaac* 1972 (2) All SA 261 (D) 271.

<sup>22</sup> *Supra* n 6.

## 2.2 General position on ratification

The common law rules on ratification determine that where a person professes to act on behalf of another person without the necessary authority, the latter may adopt or ratify the act.<sup>23</sup> Ratification is therefore a unilateral juristic act by which a person adopts an unauthorised act as valid and binding.<sup>24</sup> Like any other expression of will, ratification can be made expressly or by conduct.<sup>25</sup> The effect of a valid ratification is that the unauthorised act is assumed to have been duly authorised when it was concluded.<sup>26</sup> Ratification is therefore retroactive in effect.

However, certain limitations are also placed on ratification. For the purpose of this study, the following limitation (often known as the ‘no-ratification rule’) is underscored. A contract made on behalf of a principal who is not in existence at the time when a contract is entered into by a person professing to contract on behalf of such a principal cannot be ratified or adopted by the principal upon his incorporation.<sup>27</sup> The agent is therefore deemed to have contracted on his own behalf and is held personally liable. As one cannot represent a person that is not yet in existence, there can be no ratification of an act concluded on behalf of such a non-existent person even if he or it should come into existence subsequently. This particular limitation creates various obstacles for the conclusion of pre-incorporation contracts.

## 2.3 Obstacles that the no-ratification rule create for pre-incorporation contracts

Requirements (ii) and (iii) as listed in subparagraph 2.1 above, make it impossible for a promoter to conclude a pre-incorporation contract on behalf of an unincorporated company. This is based on the presumption that the corporation has not yet been established at the time the promoter purported to act on its behalf. The corporation would subsequently not be able to provide the promoter with the necessary authority to act on its behalf, because the corporation does not yet exist and can therefore not

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<sup>23</sup> *Mort NO v Henry Shields-Chiat* 2000 JOL 6502 (C) 15.

<sup>24</sup> *Reid and Others v Warner* 1907 TS 961 971-2.

<sup>25</sup> *Reid and Others v Warner* 973-4; *Wilmot Motors (Pty) Ltd v Tucker’s Fresh Meat Supply Ltd* 1969 4 All SA 395 (T) 399.

<sup>26</sup> *Wanda LAWSA* (1) par 200.

<sup>27</sup> *Supra* n 5.

provide authorisation.<sup>28</sup> Even if that principal subsequently came into existence, the entity would not be able to ratify what purports to have been done on its behalf.<sup>29</sup>

The common law position creates a risk for the promoter, the company and the third party in that there would be no enforceable contract between the third party and the company, or between the third party and the promoter.<sup>30</sup> To deal with the risk of a potentially unenforceable contract, parties in the past had to take precautions to ensure that the corporation had in fact been incorporated.<sup>31</sup> However, this created unnecessary costs and delays and prevented the company from benefiting from business opportunities that presented itself prior to the incorporation of the company.<sup>32</sup>

#### **2.4 A brief overview of historical case law on pre-incorporation contracts**

In 1866, in the case of *Kelner v Baxter*,<sup>33</sup> the Court of Common Pleas in England for the first time confirmed that where a contract was signed by one who professed to be signing ‘as agent’ but who had no principal existing at the time, the contract would be wholly inoperative unless binding upon the person who signed it. He was personally liable and a stranger could not by a subsequent ratification relieve him from that liability.

The court held that the ratification that was attempted in this case was not valid on the basis that the company was not in existence at the time the promoters purported to act on its behalf. The court nonetheless felt there was clearly an intended contract and the only way in which there could have been a valid contract was if the plaintiff (the third party) and the defendants (the promoters) were the respective contracting parties. The court was of the opinion that the apparent intention of the parties was that the company when formed should receive the benefit of the contract; notwithstanding the fact that if the company failed to come into existence by that time, the plaintiff should

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<sup>28</sup> Gillen M “*Notes on Business Associations*” (2002) [Online] [www.law.uvic.ca/mgillen/315/documents/Ch15Pre-IncContracts.pdf](http://www.law.uvic.ca/mgillen/315/documents/Ch15Pre-IncContracts.pdf) 189 (accessed on 15/06/2010) (hereafter ‘Gillen’).

<sup>29</sup> *Supra* n 5.

<sup>30</sup> Gillen 194.

<sup>31</sup> *Supra* n 30.

<sup>32</sup> Lost opportunities such as the purchase or lease of property, offices and equipment or securing employment contracts with prospective employees.

<sup>33</sup> 1866 L.R. 2 C.P. 174.



still have been paid. The agreement would be a mere nullity unless it was construed as the personal undertaking of those who signed it. Therefore, there was a strong reason for construing it *ut res magis valeat quam pereat*.<sup>34</sup> In order to give the contract any operation at all, the promoter must be personally liable.

This case confirmed that there could be no ratification by a principal who was not in existence at the time that the contract was entered into on his behalf. A new agreement on identical lines was necessary to establish a valid contract between the third party and the company, after its incorporation. This doctrine was confirmed in our law in 1920 by the Appellate Division of South Africa in the case of *McCulloch v Fernwood Estate*,<sup>35</sup> and also later followed in other South African cases.<sup>36</sup>

The judgement in *McCulloch* further attempted to highlight the way in which the South African law of contract, based on Roman-Dutch law principles, differed from the English law. The English law is different as it does not recognise an agreement for the benefit of a third party i.e. a *stipulatio alteri*. In South African law it is possible to contract independently for the benefit of a third party, but it is not necessary to do so as agent. Such a contract, when duly accepted by the person for whose benefit it was made, then becomes enforceable.

The judgement in *McCulloch* and the many judgements that followed,<sup>37</sup> established that where a person contracts individually, i.e. as principal, for the benefit of a third person, and that third person is a company to be formed, a valid contract will result when the company is formed and duly adopts the contract, thereby accepting its benefits and binding itself to its obligations.<sup>38</sup> However, where that same person purports to act as an agent of a company to be formed and not as principal, the doctrine as laid down in *Kelner v Baxter* will prevail – the contract will be

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<sup>34</sup> That the construction should be interpreted to be operative rather than inoperative.

<sup>35</sup> 1920 AD 204.

<sup>36</sup> See Wanda LAWSA (1) par 185.

<sup>37</sup> Such as *Peak Lode Gold Mining Co Ltd v Union Government* 1932 TPD 48; *Ex Parte Vickerman* 1935 CPD 429; *Sentrale Kunsmis Korp (Edms) Bpk v NKP Kunsmisverspreiders (Edms) Bpk* 1970 3 SA 342 (A); *Racec (Mooifontein) (Pty) Ltd v Devonport Investment Holding Co (Pty) Ltd* 1971 1 SA 299 (W); *Nordis Construction Co (Pty) Ltd v Theron, Burke and Isaac* 1972 (2) SA 535 (N); *Trever Investments (Pty) Ltd v Friedhelm Investments (Pty) Ltd* 1982 (1) SA 7 (A); *Nine Hundred Umgeni Road Road (Pty) Ltd v Bali* 1986 (1) SA 1 (A); *Gray v Waterfront Auctioneers and Another (Pty) Ltd* 1997 JOL 246 (W).

<sup>38</sup> Swart JD “Pre-incorporation contracts” 1977 *SACLJ* F-36 F-39.

unenforceable due to the fact that the individual purported to act as an agent for a non-existent principal.

This was the position under our law until the passing of Companies Act 46 of 1926.<sup>39</sup> Section 71 of this Act (of which section 35 of Companies Act 61 of 1973<sup>40</sup> and section 21 of Companies Act 71 of 2008<sup>41</sup> are the counterparts) created an exception to the rules that were established in the abovementioned cases. The South African legislative authority now allows for the subsequent ratification of a contract concluded by an agent on behalf of a company still to be formed. The statutory arrangements with regards to this process will be explored in detail in the following chapter.

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<sup>39</sup> Hereafter the 1926-Act.

<sup>40</sup> Hereafter the 1973-Act.

<sup>41</sup> Hereafter the 2008-Act.

## CHAPTER 3

### Solutions to the ‘no-ratification rule’

#### 3. Statutory arrangements

The first Companies Act for South Africa was passed in 1926, the second in 1973 and the third and also most recent, Companies Act 71 of 2008. The 1926 Act remained the basis of South Africa’s company law for almost half a century, although there were a few significant Amendment Acts<sup>42</sup> since then which sought to correspond with developments in Britain.<sup>43</sup> In 1963, the South African government appointed the Van Wyk de Vries Commission to examine the 1926-Act, which had never been consolidated with its Amendment Acts and was therefore in urgent need of reform.<sup>44</sup> As a result of the recommendations made in the Commission’s report a Companies Bill<sup>45</sup> was promulgated in 1973. This legislation not only consolidated the earlier legislation but also introduced important changes to the law.<sup>46</sup> Every year since 1973, amendments have been made to the 1973-Act, some of the changes more significant than others. These amendments tried to ensure that South African company law remained in step with changing business and international developments and trends.<sup>47</sup>

Since 1973 there have also been significant political changes in South Africa, such as the transition to a democratic form of government and the adoption of a new Constitution.<sup>48</sup> This encouraged a complete overhaul of many Acts in South Africa, bearing in mind the spirit, purpose and objects of the Constitution. As a result, Companies Act 71 of 2008 was signed into law on 8 April 2009 and will become effective on a date yet to be determined by the President, by proclamation in the Government Gazette.<sup>49</sup>

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<sup>42</sup> Companies Amendment Act 23 of 1939 and Companies Amendment Act 46 of 1952.

<sup>43</sup> Davis D *et al Companies and Other Business Structures in South Africa* 1<sup>st</sup> ed (2009) Cape Town: Oxford University Press Southern Africa par 1.2 (hereafter ‘Davis’).

<sup>44</sup> Davis par 1.2.

<sup>45</sup> 61 of 1973.

<sup>46</sup> *Supra* n 43.

<sup>47</sup> Davis par 1.1.

<sup>48</sup> The Constitution of the Republic of South Africa 1996.

<sup>49</sup> The Act was published for information on 9 April 2009 (GN 421 GG 32121 of 9 April 2009). S 225 of the Act provides that the Act will come into force on a date fixed by the President by proclamation in the Gazette, which may not have been earlier than 9 April 2010 (one year following the date on which the President has

This Chapter seeks to explore and analyse the history and development of the statutory rules that regulate pre-incorporation contracts in South Africa by emphasizing the most important and relevant sections in all three Acts. Substantial developments have also occurred in case law, which facilitated the transformation of the country's law on this subject. These developments will be discussed in detail in this chapter.

### **3.1 Section 71 of Companies Act 46 of 1926**

According to this section, “any contract made in writing by a person professing to act as agent or trustee for a company not yet formed, incorporated or registered shall be capable of being ratified or adopted by or otherwise made binding upon and enforceable by such company after it has been duly registered as if it had been duly formed, incorporated and registered at the time when the contract was made, and such contract has been made without its authority: *provided that the memorandum of the company contains as one of the objects of such company the adoption or ratification of or the acquisition of rights and obligations in respect of such contract.*”

#### **3.1.1 Initial requirements for a binding pre-incorporation contract**

In terms of section 71 a pre-incorporation contract can effectively be ratified/adopted by a company, after its incorporation, provided that the following requirements are met:

- a.) the contract was made in writing;<sup>50</sup> and
- b.) the person who concluded it professed to act as agent or trustee for a company not yet incorporated;
- c.) the memorandum of association of the company contained as an object of the company the adoption or ratification of or the acquisition of rights and obligations in respect of such contract.

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signed/assented to the Act). The Minister of Trade and Industry recently announced in parliament, that it is anticipated that the new Companies Act shall come into operation during April 2011.

<sup>50</sup> For the sake of certainty a pre-incorporation contract must be reduced to writing before it is susceptible to ratification. A written contract is an important component of a company's records and makes it possible for the board of directors to receive full disclosure of the terms of the pre-incorporation before ratification. This seems to be an efficient way of ensuring full disclosure of the terms of the contract, which is essential for the protection of all the parties to the contract.

Such a pre-incorporation contract can then become enforceable on registration of the principal under the provisions of the Companies Act and upon compliance by the principal with the formalities prescribed by this section.<sup>51</sup>

### The Memorandum

The most pertinent requirement appears to be that the memorandum of the company must contain, as one of its objects, the adoption or ratification of the contract by the company. This serves as important protection to outsiders (potential creditors or investors) who may wish to extend credit to or invest in the company.<sup>52</sup> Outsiders who intend to do business with a particular company can now determine its pre-incorporation commercial activities by examining the company's memorandum.<sup>53</sup> Subsequently, this information will enable them to make informed decisions with regards to that specific company.

This, however, raises an important question: whether it is necessary for the memorandum to contain the required object at the time of the company's registration, or would it be acceptable if the object is only absorbed into the memorandum after the registration of the company. Is it possible to remedy the defect by altering the company's object clause after its incorporation? According to the section's plain language, all that is required is that the memorandum must contain that object at the time of the ratification or adoption of the contract, which is *after*<sup>54</sup> the company's registration.<sup>55</sup>

### Ratification

The interpretation of section 71 has proven to be problematic in more than one aspect. Section 71 does not prescribe a specific time period in which the company is compelled to ratify or adopt the pre-incorporation contract, neither does it prescribe a manner (explicit or implied) in which ratification should take place. Generally, a

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<sup>51</sup> *Racec (Mooifontein) (Pty) Ltd v Devonport Investment Holding Co (Pty) Ltd* 303.

<sup>52</sup> Ncube CB "Pre-Incorporation Contracts: Statutory Reform" 2009 126(2) *SALJ* 255 260 (hereafter 'Ncube').

<sup>53</sup> Ncube 260.

<sup>54</sup> Author's emphasis.

<sup>55</sup> *Sentrale Kunsmis Korp (Edms) Bpk v NKP Kunsmisverspreiders (Edms) Bpk* 359.

company is compelled to ratify contracts within the time agreed upon in the contract,<sup>56</sup> or, in the absence of such an agreement within a reasonable time.<sup>57</sup> However, the determination of a reasonable time is ultimately made by our courts and will depend on the facts of each case. As a result, third parties who are parties to a pre-incorporation contract, which does not stipulate a time period for ratification, may find their rights and obligations delayed for extended periods of time while waiting for the company to decide whether to ratify the pre-incorporation contract in question or not.<sup>58</sup> Furthermore, the parties may have had to resort to litigation to compel a company to make the decision to ratify or reject the contract.<sup>59</sup>

### Liability

Section 71 also sought to protect the promoter by providing a statutory mechanism (through section 71) to avoid personal liability on a pre-incorporation contract. This protection came at the expense of the third party who had to bear the risk of non-ratification by the company. This section left third parties vulnerable because it did not make provision for any personal liability of the promoter during the interim period (i.e. between the conclusion of the pre-incorporation contract and ratification or adoption of the contract by the company). It also did not take into account any liability upon non-ratification due to the fact that the company was never incorporated, or the fact that it refused to ratify the contract after incorporation.

As a result the third party found itself without remedy, because the company could not be held liable since it was not yet incorporated or because the company was incorporated but neglected to adopt or ratify the contract. In the latter event, the contract merely lapsed and the company did not receive any resulting rights or duties from that contract. The promoter could also not be held liable in these circumstances, because he did not contract as the principal and the third party presumably knew that the promoter was acting on behalf of a non-existent company. Ncube<sup>60</sup> is of the

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<sup>56</sup> *Sentrale Kunsmis Korp (Edms) Bpk v NKP Kunsmisverspreiders (Edms) Bpk* 359; *Racec (Mooifontein) (Pty) Ltd v Devonport Investment Holding Co (Pty) Ltd* 303; Kerr AJ *The Law of Agency* 3<sup>rd</sup> ed (1991) Durban: Butterworths 104.

<sup>57</sup> *Peak Lode Gold Mining Co Ltd v Union Government* 52; *Sentrale Kunsmis Korp (Edms) Bpk v NKP Kunsmisverspreiders (Edms) Bpk* 359; *Racec (Mooifontein) (Pty) Ltd v Devonport Investment Holding Co (Pty) Ltd* 303.

<sup>58</sup> Ncube 264.

<sup>59</sup> *Supra* n 58.

<sup>60</sup> *Supra* n 10; Ncube 258.

opinion that while section 71 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 should serve to encourage third parties to negotiate with promoters and thereby secure liability of the promoter should the company fail to be incorporated or refuse to ratify the contract. Third parties can therefore be better positioned if they clearly stipulate their protection in the contract that they conclude with the promoter to make provision for the above-mentioned circumstances. The counter argument to this statement is that inexperienced third parties or contractants do not ordinarily have the necessary knowledge to sufficiently protect their interests against experienced agents/promoters when negotiating the terms of a contract. Therefore, Ncube suggests that a policy shift is necessary to achieve a more balanced treatment of promoters and third parties.

### 3.1.2 Case law on the 1926-Act

Difficulties arising from section 71 were also reflected in South Africa’s case law. In 1932 Greenberg J confirmed in the case of *Peak Lode Gold Mining Co Ltd v Union Government*<sup>61</sup> that section 71 enabled a company, after its incorporation, to ratify or adopt a contract made before its incorporation by an agent professing to act on its behalf. It seemed to follow that the position of an unauthorised agent was now the same whether the alleged principal was or was not in existence at the time of the contract and that such an agent was not liable as a party to the contract, nor was he liable under a warranty of authority if the other contracting party knew at the time of the contract that he had no authority. In his judgement, Greenberg J also referred to the case of *McCulloch v Fernwood Estate Ltd*<sup>62</sup> where the court held that in case of doubt of liability, one should construe a transaction *ut res magis valeat quam pereat*.<sup>63</sup> But for the reasons mentioned, Judge Greenberg felt that the latter position was now being altered by section 71.

Before the enactment, because there could be no ratification by a principal not in existence at the date of the transaction, the Court was inclined to lean towards a

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<sup>61</sup> 1932 TPD 48.

<sup>62</sup> 1920 AD 204.

<sup>63</sup> *Supra* n 34.

construction of the document that would deem the contracting party to be a trustee rather than an agent, and so enable the company, when it came into existence, to adopt the contract. Greenberg J said that under the law before this Act was passed, it was held by *McCulloch v Fernwood Estate Ltd*<sup>64</sup> that difficulties were likely to arise as to whether a person who purchased property, which was to be taken over by a company about to be formed, was acting as an agent or a trustee. In the present case there was no doubt that the vendors (third party) knew that the agent had no authority from the non-existent company since the agreement showed that the company was not yet registered. The agent was not liable under the agreement under any warranty of authority. He would not be deemed to have entered into the contract of sale on his own behalf and was therefore not liable under the contract as a purchaser.

The binding force of the agreement was conditional upon its adoption by the company after its incorporation. The effect of the agreement was thus that the company, within a reasonable time after its incorporation, and after receipt of the certificate of incorporation, was entitled to adopt the contract which, until that date, merely had the effect of granting an option to the company. The company would not be liable until it was incorporated and adopted the contract. If the company had not adopted the contract, the agent would also not have been liable in any way, either on the contract or on a breach of warranty of authority. The original contract was merely a contract by the third party to enter into a contract with the company to be formed.

The court further held that under section 71 of the 1926-Act, the adoption of a pre-incorporation contract, by a company after incorporation, was not retroactive in its effect. The court was of the opinion that the contract could only operate from the date of its ratification or adoption, and not retrospectively. However, it was submitted in *Beuthin's Basic Company Law*<sup>65</sup> that in fact it does – the words used in section 71 clearly seem to reflect the normal rule that ratification operates with retroactive effect.<sup>66</sup> Therefore, pre-incorporation contracts ought to have retrospective effect

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<sup>64</sup> *Supra* n 35.

<sup>65</sup> Beuthin & Luiz 37.

<sup>66</sup> *Supra* n 65.



unless the parties agree otherwise – to argue otherwise would result in inconsistency between section 71 and ratification at common law.<sup>67</sup>

### 3.1.3 Subsequent statutory amendments to the 1926-Act

In 1952, the following words were added to the provisions of section 71 by section 50 of the Companies Amendment Act 46 of 1952: ...“*and that a copy of such contract has been lodged with the Registrar together with the application for registration of the company*”. Eleven years later section 9 of the Companies Amendment Act 14 of 1963 amended section 71 of the principal Act yet again by adding the following provisions: ...“*and that two copies of such contract, one of which shall be certified by a notary public or by a subscriber to the memorandum, have been lodged with the Registrar together with the application for registration of the company*”. In light of the experience gained since 1926 about the operation of section 71, the legislature might have thought it essential that, before the adoption or ratification of such a contract by the company, a copy of it (and after 1963 a certified copy of it) should be made available in the Companies’ Registry for any interested person to inspect or obtain a copy. The Registry would thus be an alternative place for inspection and a place moreover where a copy of the contract could be obtained.<sup>68</sup>

The disadvantage of this requirement is evidently that the content of the contract between the contracting parties will be open for public inspection. It is clear that this requirement can also be detrimental to the confidentiality of the company’s pre-incorporation dealings.

#### Application of section 71 after the Amendments

In the case of *Sentrale Kunsmis Korp (Edms) Bpk v NKP Kunsmisverspreiders (Edms) Bpk*<sup>69</sup> Trollip J -- in his minority judgement -- was of the opinion that the language of section 71 created a strong *prima facie* impression that it was intended to apply not only to a contract concluded by an agent, but also to a *stipulatio alteri*, for it also refers to a contract made by “a person professing to act as a trustee” and to it being “adopted by or otherwise made binding upon and enforceable by” the company.

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<sup>67</sup> Ncube 266.

<sup>68</sup> *Sentrale Kunsmis Korp (Edms) Bpk v NKP Kunsmisverspreiders (Edms) Bpk* 358.

<sup>69</sup> 1970 3 SA 342 (A).

However, subsequent cases in the Provincial Divisions, such as *Ex parte Vickerman and Others*<sup>70</sup> held that section 71 only applied to a pre-incorporation contract made by an agent and not one made as a *stipulatio alteri*, for the intention was not to curtail the company's common law right of adopting the latter but merely to remedy its common law inability of ratifying the former. That shows that section 71 was only meant to apply to a pre-incorporation contract made by a person acting as an agent for the company, whether he calls himself an agent or a trustee. The reference later in the section to the binding effect of the company ratifying the contract supports that conclusion: “[it] is to be as binding as if the company had existed at the time the contract was made and such contract had been made without its authority”.<sup>71</sup> That provision points clearly to the postulated contract being one by an agent. If it is a contract made by an agent, then the requirements of section 71 must be fulfilled before it can be ratified by the company, as otherwise, as far as the company is concerned, it remains a nullity according to the common law, which has not been altered in that respect by section 71.

If, on the other hand it is a *stipulatio alteri*, it can be adopted by the company even if those requirements have not been complied with.<sup>72</sup> In this case the question was also raised whether failure to lodge two copies of the contract, one being certified, invalidates the contract. The majority of the court held that this requirement was merely directory.<sup>73</sup> It was held that if only one copy is lodged the omission will not be incurable, for the other one may be lodged at a later date. Trollip J, however dissented, holding that the failure to lodge two copies was fatal to the contract.<sup>74</sup>

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<sup>70</sup> 1935 C.P.D. 429, 430. See also *Ex parte Elands Properties (Pty.) Ltd.* 1945 T.P.D. 37, 40; as well as *Martian Entertainments (Pty.) Ltd. v Berger* 1949 (4) S.A. 583 (E) 590-591.

<sup>71</sup> *Sentrale Kunsmis Korp (Edms) Bpk v NKP Kunsmisverspreiders (Edms) Bpk* 358.

<sup>72</sup> *Sentrale Kunsmis Korp (Edms) Bpk v NKP Kunsmisverspreiders (Edms) Bpk* 359.

<sup>73</sup> *Sentrale Kunsmis Korp (Edms) Bpk v NKP Kunsmisverspreiders (Edms) Bpk* 351.

<sup>74</sup> See *Sentrale Kunsmis Korp (Edms) Bpk v NKP Kunsmisverspreiders (Edms) Bpk* 362-364. The language used in section 71 compelled Trollip J to conclude that the lodging of the requisite copies of the contract before its ratification or adoption is imperative for the validity thereof. Whether the requirement for lodging the two copies with the Registrar before the contract is ratified or adopted is imperative or merely directory, depended on the intention of the legislature as evinced by the language it has used. The legislature intended by section 71 that the company can nevertheless ratify it and render it enforceable “provided” that, *inter alia*, the requirement just mentioned is fulfilled. The ordinary meaning of “provided” in that context is “if” or “on condition that”, i.e., its fulfilment is thereby made a condition precedent to the ratification and enforceability of the otherwise null contract. That that was the legislature's intention also appears, firstly, from the use of the past tense, “have been lodged”, connoting that the lodging of the copies must already have taken place before the contract can be ratified or adopted, and, secondly, from the conjoining of that requirement in the same clause with the first proviso which is admittedly a condition precedent. By making the fulfilment of the

In the case of *Kelner v Baxter*<sup>75</sup> the contract was so worded that on the ordinary rules of construction the personal liability of the agent would have been excluded, since the purchase agreement specifically spoke of the agent, as acting ‘on behalf of’ the principal. The Court, realising that to adopt the ordinary rule of construction would result in the contract being a nullity, departed from it and held that in spite of the use of the words ‘on behalf of’, the contract as a matter of construction was one establishing the personal liability of the agent. It also disallowed parol evidence to show that such was not the real intention of the parties. This was done expressly in accordance with the maxim *ut res magis valeat quam pereat*. Therefore, in order to make a contract operative if possible by applying this maxim, the Courts in applying the principle in *Kelner v Baxter*, have held the supposed agent to be liable as the principal.<sup>76</sup>

The court in *Nordis Construction Co (Pty) Ltd v Theron, Burke & Isaac*<sup>77</sup> respectfully disagreed with the contention in *Kelner v Baxter* and was of the opinion that the question seems to be one of construction rather than one of ‘intendment of law’.<sup>78</sup> It follows that the Court cannot, in order to obtain validity to the agreement between the parties, create a contract between them which obviously from the agreement they never intended. In the present case the common intention of the parties which appears from the contract, was to contract with a company already in existence. The parties were ignorant of the company’s non-existence and it was their intention that the defendant was acting ‘as an agent’ for such a company.

In this regard it was clear from the evidence that the parties believed that the defendant was acting on behalf of an existing company, and that only the company would be bound by the contract and not the agent. To hold the defendant personally liable upon such a contract would have been to make a new contract for the parties, which neither of them ever intended. There can be no justification for construing the agreement in such a way. The court was of the opinion that whatever the precise limits of the *Kelner v Baxter* principle may be, it had no application to the *Nordis* case.

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requirement a condition precedent, the legislature used the clearest manner of expressing its intention that it was to be imperative and not directory.

<sup>75</sup> *Supra* n 33.

<sup>76</sup> *Nordis Construction Co (Pty) Ltd v Theron, Burke & Isaac* 270.

<sup>77</sup> 1972 2 All SA 261 (D) 272.

<sup>78</sup> *Nordis Construction Co (Pty) Ltd v Theron, Burke & Isaac* 271-272.

## 3.2 Section 35 of Companies Act 61 of 1973

Pre-incorporation contracts are currently regulated by section 35 of Act 61 of 1973. It provides that “[a]ny 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 two copies of such contract, one of which shall be certified by a notary public, have been lodged with the Registrar together with the lodgement for registration of the memorandum and articles of the company.”

It is clear from the discussion of section 71 of the 1926-Act that a policy shift was necessary to achieve a more balanced treatment of promoters and third parties who enter into pre-incorporation contracts. It is evident that section 35 does not reflect significant modifications made to its predecessor (section 71 of the 1926-Act). Trivial changes, such as the words ‘*on its registration*’<sup>79</sup> were inserted in section 35 of the 1973-Act, following the decision reached in *Sentrale Kunsmis v NKP Kunsmisverspreiders*.<sup>80</sup> The memorandum must now ‘*on its registration*’ contain as an object of such company the ratification or adoption of rights and obligations in respect of a pre-incorporation contract. These words were included in the section to prevent subsequent insertion of the object into the company’s memorandum after its registration. The question that arose in the *Sentrale Kunsmis* case with regards to the exact time when the object must be absorbed into the memorandum has therefore been remedied by section 35.

### 3.2.1 Remaining Controversies

Controversy, with regards to section 35, nevertheless continued to arise in our courts. In *Pledge Investments (Pty) Ltd v Kramer, NO: In re Estate Selesnik*<sup>81</sup> the Appellate

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<sup>79</sup> Author’s emphasis.

<sup>80</sup> See discussion of this case on page 14 and 18 of this dissertation.

<sup>81</sup> 1975 4 All SA 1 (A).

Division had to deal with difficulties arising from a public auction. An auctioneer knocked down property to a purchaser for R40 000. The court found that this conduct in itself resulted in an oral contract. Thereupon, a document headed ‘Conditions of Sale’ was completed and signed by the auctioneer and the purchaser. The signatures of the purchaser and auctioneer were then appended, the former signing ‘as agent for a company to be formed’. Trollip J held that reading the document as a whole, he had no doubt that the word ‘sold’ in the Conditions of Sale meant that the described property was sold by public auction on the stated terms and conditions for the mentioned amount to the named purchaser as agent for a company to be formed. The manifest purpose of so completing and signing the document was therefore to record and have certainty of the oral contract and its contents, as concluded by the auction sale, and to ensure that the auctioneer and purchaser were bound thereto by reason of their signatures. The judge proceeded by saying that such a signed written record of an oral contract was sufficient compliance with the requirement in section 71 of the 1926-Act of a “contract made in writing by a person professing to act as an agent for a company to be formed”.<sup>82</sup>

The purpose of the formality of writing is merely to ensure that the contents of the contract is certain and readily ascertainable, and that it be registered with the memorandum in the Companies’ Registry. The expression “contract made in writing” therefore covers not only a written contract, but also an oral contract which is subsequently reduced to writing. The word “made” carries a sufficiently wide connotation in the context to embrace both kinds of contracts.<sup>83</sup> Although the purchaser here professed to act for an agent for a company to be formed, the parties, by so recording the oral contract, rendered it effective and capable of ratification by the company.

In *Akromed Products Pty Ltd v Suliman*<sup>84</sup> the court applied the principles as laid down in *Nordis Construction*. In the present case, the issue arose on whether the plaintiff contracted with the defendant in the latter’s personal capacity, or with a company that was de-registered at the time of the conclusion of the contracts. The defendant denied

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<sup>82</sup> *Pledge Investments (Pty) Ltd v Kramer, NO: In re Estate Selesnik* 6.

<sup>83</sup> *Supra* n 76.

<sup>84</sup> 1994 1 SA 673 (T).

that he had contracted with the plaintiff in the former's personal capacity. Under cross-examination he admitted that he, in his capacity as director of the company, had concluded the alleged agreements with the plaintiff. De Villiers J held that it was clear on the evidence that the plaintiff intended contracting with the company. This was not a case where both contracting parties were aware that the principal did not exist. To hold that the defendant was personally liable or took the place of the named principal as a party thereto, would have been to make a new contract which neither of the parties contemplated.

### 3.2.2 Further Developments

In 2006, the South African legislature promulgated the Corporate Laws Amendment Act.<sup>85</sup> Section 8 of the CLAA amended section 35 with effect from 14 December 2007. Prior to 14 December 2007, the submission of two copies of the pre-incorporation contract, one of them notarized, was required. The implementation of section 8 of the CLAA removed the formal requirement that two copies of the contract be lodged as well as the requirement for the lodgement of a notarised copy thereof. Companies now only have to lodge 'the contract'. Although section 8 of the CLAA does not say so expressly, it seems that one uncertified copy of the relevant pre-incorporation contract would now suffice. This amendment by the CLAA appears to revert back to the original position as determined by section 50 of the Companies Amendment Act 46 of 1952, because section 50 also required that only 'a copy of such contract' be lodged with the Registrar.<sup>86</sup>

### 3.2.3 Cassim's Proposal

Cassim is of the opinion that the statutory solution contained in section 35 has over the years become 'outdated, too restrictive and out of step with modern trends and business practices'.<sup>87</sup> According to Cassim the underlying policy of section 35 serves to protect the company's position (by permitting the company to ratify a pre-incorporation contract) and the agent's position (by overcoming the common-law

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<sup>85</sup> 24 of 2006 (hereafter referred to as 'the CLAA').

<sup>86</sup> See page 18 of this dissertation for a discussion of s 50 of Act 46/1952.

<sup>87</sup> *Supra* n 9; Cassim 365.

imposition of personal liability on the agent of the pre-incorporation contract). However, it still fails to have sufficient regard for the position of the third party because it failed to address the problems that previously arose from section 71. As previously highlighted,<sup>88</sup> if the company decides not to ratify the pre-incorporation contract, the contract simply lapses and the agent incurs no liability to the third party, which means that the third party is still burdened with the risk of non-ratification. Therefore, section 35 aims to protect the interests of the company and the agent, but leaves the third party unprotected and without a remedy should the incorporation of the company and/or ratification by the company of the pre-incorporation contract fail. It would clearly be inequitable to saddle the third party with the full risk of non-ratification.

### The Liability Proposal

According to Cassim, balancing the interests of the agent, the company, and the third party so that a greater share of the risk of non-incorporation or non-ratification falls on the agent or the promoter would be a better approach for the legislature to adopt.<sup>89</sup> She proposes a statutory solution for balancing the conflicting rights and liabilities of the company, the agent and the third party, centered on a “statutorily implied dual warranty” by the agent that the company will not only be incorporated but will also ratify the pre-incorporation contract.<sup>90</sup> This will be referred to hereinafter as the ‘liability proposal’. Cassim suggests that third-party protection can best be implemented by holding the agent liable for damages for breach of a statutorily implied warranty that the company will be incorporated within a reasonable (or agreed) time, and that it will within a reasonable (or agreed) time after incorporation ratify the pre-incorporation contract. This is the approach followed in Australia and New Zealand.<sup>91</sup>

The content of the proposed statutory warranty, the time period for its fulfilment, and the quantum of damages for breach thereof still have to be considered. The warranty evidently cannot be a warranty of the agent’s authority, as the agent under section 35

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<sup>88</sup> On page 15 of this dissertation.

<sup>89</sup> Cassim 368.

<sup>90</sup> Cassim 366.

<sup>91</sup> The Liability Proposal is based on s 131-3 of the Australian Corporations Act of 2001, and s 182-4 of the New Zealand Companies Act of 1993, which the author argues provides the best and most comprehensive models in this area of corporate law.

‘professes’ to act for a company not yet incorporated, and therefore cannot be said to provide an implied warranty that he has authority to act for the company.<sup>92</sup>

Accordingly, the statutory warranty should comprise two separate elements, namely that the company will be incorporated *and* that the company will on incorporation ratify the pre-incorporation contract, failing *either* of which the agent will incur liability for damages. Cassim suggests that these warranties should, in terms of section 35, be deemed to form part of all pre-incorporation contracts made by agents, but they should also be subject to express exclusion in the contract.

In order to be effective, the dual statutory warranty of incorporation and ratification would require time limits within which these events must take place. At present, the principle is that a principal must ratify acts done by an agent on its behalf within the time agreed upon by the parties or, failing such agreement, within a reasonable time.<sup>93</sup> It would be appropriate to extend this principle to the promoter’s dual warranty of incorporation and ratification by the company. The determination of a ‘reasonable’ time would, of course, depend on the facts and circumstances of each case. This would include the type of contract in question, the obligations of the parties under the contract and the nature of the goods or services involved.

The measure of damages for breach of the agent’s dual warranty of incorporation and ratification should yield an amount that would place the third party in the position he would have been in had the company been incorporated and bound by the contract as warranted. This would simply be an extension of the common law principles on breach of an unauthorized agent’s residual warranty of authority as laid down in *Blower v Van Noorden*,<sup>94</sup> that was extended to the agent acting on behalf of a non-existent principal in *Peak Lode Gold Mining v Union Government*.<sup>95</sup> In other words, the agent does not warrant that his principal will carry out the contract but only that it will be bound by it. The agent is therefore not held liable on the contract itself but is instead liable on the basis of a breach of warranty. This precludes the third party from claiming from the agent the full damages flowing from the breach of the pre-incorporation contract.

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<sup>92</sup> *Peak Lode Gold Mining Co Ltd v Union Government* 51.

<sup>93</sup> *Supra* n 56, n 57.

<sup>94</sup> 1909 TS 890.

<sup>95</sup> *Supra* n 61.



Furthermore, Cassim argues that it would also be appropriate in certain circumstances for the company to be held liable on a pre-incorporation contract, which it did not in fact ratify, while in other circumstances the agent should be held liable for the company's breach of a ratified contract. The statutory provisions on pre-incorporation contracts must allow the court a wide discretion to apportion liability between the company and the agent. This will be where it is just and equitable to do so by imposing secondary liability on the company for all or part of the damages for which the agent is liable to the third party for the agent's breach of the dual statutory warranty, or by imposing secondary liability on the agent to compensate the third party for the company's breach of the contract.

The practical implications of the statutory warranty approach require close and thoughtful consideration, particularly in respect of the interim period before ratification. If the agent is not personally liable on the contract during the interim period, there is in effect no contract during this period. Accordingly, the parties' position during the interim period must be clarified by legislation if the implied warranty approach were to be adopted. Particular attention should be paid as to whether and how the agent can prevent the third party from unilaterally withdrawing from the agreement pending ratification by the company, and whether the agent and the third party are able to cancel a pre-incorporation contract by agreement prior to its ratification by the company.

Cassim concludes by highlighting that South Africa's current legislation fails to afford justice to the third party under a pre-incorporation contract.<sup>96</sup> The underlying policy basis of section 35 is therefore 'skewed' in favour of the company and the agent acting of behalf of that non-existent company. Such a policy is no longer desirable and is, furthermore, out of step with modern global trends.

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<sup>96</sup> Cassim 398.

### 3.3 Section 21 of Companies Act 71 of 2008

It appears evident from this discussion that there was a fair amount of pressure on the legislature to improve or reform the current and previous legislation on pre-incorporation contracts. In an attempt to address the various problems that arose from section 71 and section 35, not only in our case law, but also issues that were given due consideration by academics, the legislature drafted and incorporated section 21 into the new Companies Act 71 of 2008. Arguably, section 21 completely and successfully attempts to reform any and all previous legislation regulating pre-incorporation contracts.

#### Defining a pre-incorporation contract

Section 1 of the 2008-Act begins the reform of section 35 by providing for the first time a clear definition of a ‘pre-incorporation contract’. It states that a pre-incorporation contract is “an 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”. In the case of *Sentrale Kunsmis Korp (Edms) Bpk v NKP Kunsmisverspreiders (Edms) Bpk* it was still disputed whether section 35 applied to agency situations alone or also to those situations where a promoter ‘professes to act as a trustee’ (*stipulatio alteri* scenarios). The phrase ‘professing to act as an agent or trustee’ in section 35 has therefore proven to be problematic. Section 1 of the 2008-Act attempts to provide certainty on this aspect. Instead of using the phrase ‘professing to act as agent or trustee’, section 1 now only refers to a person who ‘purports to act in the name of or on behalf of, a company’. This definition clearly indicates that section 21, read in conjunction with section 1 of the Act, now only applies in those cases where a promoter purports to act as an agent and not as a trustee (acting as a principal), when concluding a pre-incorporation contract on behalf of an unincorporated company. A trustee does not act ‘in the name of, or on behalf of’ another – a trustee contracts as principal in his own name.

#### Liability

A very long and detailed section 21 now determines that 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 the Act, but does not yet exist at the time.<sup>97</sup> Such a person (for example a promoter) will then be held jointly and severally liable with any other such persons for liabilities created as provided for in the pre-incorporation contract while so acting, if the contemplated entity is not subsequently incorporated or after being incorporated, the company rejects any part of such an agreement or action.<sup>98</sup> If, after its incorporation, a company enters into an agreement on the same terms as, or in substitution for, the original agreement between the promoter and the third party, the liability of such a person (promoter) in respect of the substituted agreement is discharged.<sup>99</sup>

### Ratification

Within three months after the date on which a company was incorporated the board of that company may completely, partially or conditionally ratify or reject any pre-incorporation contract or other action purported to have been made or done in its name or on its behalf.<sup>100</sup> If, within three months after the date on which a company was incorporated the board has neither ratified nor rejected a particular pre-incorporation contract, or other action purported to have been made or done in the name of the company or on its behalf, the company will be regarded to have ratified that agreement or action.<sup>101</sup>

To the extent that a pre-incorporation contract or action has been ratified or regarded to have been ratified, the agreement is as enforceable against the company as if the company had been a party to the agreement when it was made and the liability of such a person (the promoter) in respect of the ratified agreement or action is discharged.<sup>102</sup> If a company rejects the agreement or action, the person who bears the liability for that rejected agreement or action may assert a claim against the company for any benefit it has received, or is entitled to receive in terms of the agreement or action.<sup>103</sup>

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<sup>97</sup> S 21(1) of the 2008-Act.

<sup>98</sup> S 21(2)(a)+(b) of the Act.

<sup>99</sup> S 21(3) of the Act.

<sup>100</sup> S 21(4) of the Act.

<sup>101</sup> S 21(5) of the Act.

<sup>102</sup> S 21(6)(a)+(b) of the Act.

<sup>103</sup> S 21(7) of the Act.

### Formal Requirements

The most apparent amendment to the law regulating pre-incorporation contracts is that section 21 removed the section 35 requirements that the memorandum of the company must contain as one of its objects the adoption or ratification of the contract by the company, and that two copies of such a contract, one of which must be certified, must be lodged with the Registrar together with the application for registration of the company. These requirements provided protection to third parties who desired to contract with the company. It provided them with a sense of security and certainty to know that one of the company's objects was to adopt or ratify the contract. As noted earlier, this requirement also provided information to outsiders who opted to extend credit to or invest in the company, because these investors could determine the company's pre-incorporation commercial activities from the company's memorandum. The requirement to lodge copies of the pre-incorporation contract was on the other hand detrimental to companies, because it robbed companies and their contractual partners of confidentiality of their agreements, and possibly exposed them to unfair practices such as undercutting by competitors.

Ncube<sup>104</sup> is of the opinion that by choosing to remove this requirement, it may appear that the legislature has decided that the company's privacy in its pre-incorporation dealings outweighs consumer protection to third parties. This decision is justifiable when one considers the possibility that consumer protection can be achieved by other means. For example, the financial status of some companies may be ascertained through their annual financial statements, which are accessible at the offices of the Registrar of Companies' upon payment of the prescribed fees. Verification of a company's liquidity and solvency or an overview of its commercial undertakings can also 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.

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<sup>104</sup> Ncube 260-261.

### 3.3.1 An evaluation of section 21

Ncube<sup>105</sup> argues that a company currently has limited capacity and can only validly do what its memorandum's objects clause permits it to. Section 19(1)(b) of the 2008-Act 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. 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. Cassim<sup>106</sup> submits that the abolition of this requirement would be consistent with the proposals in the Company Law Policy Document<sup>107</sup> on the purpose and stated objects of companies. This advocates that a company should be required merely to have a broad purpose and that stated objects should be entirely voluntary. Promoters would, however, be advised to continue to include the ratification of pre-incorporation contracts as an object of the company, as it may be wise to ensure that a certain amount of publicity and disclosure is made to investors.

The main criticism that was levelled against section 35 was that it failed to provide for promoter liability and provide sufficient third party protection. Section 21 sought to address this problem by firstly inserting the provision that stipulates that any person who enters into a pre-incorporation contract, in the name of or on behalf of an entity that is not yet incorporated, is jointly and severally liable for liabilities created in the pre-incorporation contract, if the contemplated entity is not subsequently incorporated or after being incorporated, the company rejects any part of that agreement.<sup>108</sup> The promoter will therefore be personally liable in the above mentioned circumstances. However, it is still possible for the promoter to expressly contract out of the liability that is imposed on him through section 21(2)(a) and (b). Waiver of this liability is therefore possible in the contract itself if the other party to the contract also consents thereto.

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<sup>105</sup> Ncube 260.

<sup>106</sup> Cassim 394.

<sup>107</sup> As stated in *South African Company Law for the 21st Century: Guidelines for Corporate Law Reform* GN 1183 GG 26493 of 23 June 2004 (also referred to as 'the Company Law Policy Paper') at 33.

<sup>108</sup> *Supra* n 98.

Section 21(2)(a) and (b) primarily strives to afford protection to third parties who were previously left without a remedy in the event of non-ratification or -incorporation. Other than contracting himself out of liability, the promoter is also provided with an additional remedy through section 21(7). This section stipulates that the person who bears the liability for the rejected agreement or action by the company may assert a claim against the company for any benefit the company has received or is entitled to receive in terms of the agreement.

Secondly, section 21 also makes provision for a specific period within which companies are to decide whether to ratify a pre-incorporation contract. This provision is in the interests of both third parties and companies. It affords the company a fair amount of time in which to apply its attention and reach a decision with regards to the pre-incorporation contract before liability is imposed on it. In the same vein, third parties will only have to wait a maximum of three months for the company's decision in this regard. They will therefore not be subjected to long, unnecessary delays. Importantly, section 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'. A company's failure to act within the three-month period will therefore lead to deemed ratification after the expiry of that period.

This provision can prove to be problematic where a promoter contracts on behalf of the unincorporated company, and then fails to inform the board of directors of the existence of the contract. This will result in the company being bound by a contract that they had no knowledge of and consequently never had the choice to ratify or reject the contract. The promoter will be freed from liability once the company is deemed to have ratified the pre-incorporation contract.<sup>109</sup> Subsequently the company becomes liable to the third party. Failure to make a decision timeously can therefore not be accredited to any fault on the part of the promoter.

The possibility does still exist that section 21(6) can be abused by promoters. Where the contract is no longer beneficial to a promoter he might incorporate the entity but fail to put any assets in the corporation. He could then have the corporation ratify the

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<sup>109</sup> S 21(6)(b) of the Act.

contract relieving the promoter of liability and leaving the third party with an action against an insolvent corporation. This would give the promoters the opportunity to gain on a contract if it continued to be beneficial to them but avoid liability on the contract if it was not beneficial to them. They would thus be speculating at the expense of the third party. Under these circumstances the recommendations made by Cassim may prove to be valuable. She suggested that the statutory provisions on pre-incorporation contracts must give the court a wide discretion to apportion liability between the company and the agent where it is just and equitable to do so, by imposing secondary liability on the company or the agent (to compensate the third party for the company's breach of the contract).<sup>110</sup>

Section 21 also attempts to provide clarity on the debate whether the ratification of a pre-incorporation is retroactive in its effect. This debate started in 1932 in the case of *Peak Lode Gold Mining v Union Government*. In this case the court held that under section 71 of the 1926-Act, the adoption by a company after incorporation, of a contract entered into by a person for and on its behalf before incorporation is not retroactive in its effect. Other academics argued that such ratification had to have a retroactive effect, for it to be consistent with ratification at common law.<sup>111</sup> Section 21(6) now clearly stipulates that 'to the extent that a pre-incorporation contract or action is ratified, the agreement is as enforceable against the company as if the company had been a party to the agreement when it was made'. This section implies that the ratification of a pre-incorporation contract operates retrospectively. It is still being debated whether this stipulation means that ratified pre-incorporation contracts are retrospective to the date of their conclusion or if they are retrospective to the date of the company's incorporation. Section 21 does however not provide for the manner of ratification or rejection of the contract. This leads us to assume that it is entirely up to a company to determine the manner of ratification or rejection. An express provision for the manner of ratification would have been desirable because it would increase the level of certainty for all parties involved.<sup>112</sup>

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<sup>110</sup> Cassim 379.

<sup>111</sup> Such as Beuthin & Luiz as well as Ncube.

<sup>112</sup> Ncube 264.

### 3.3.2 Conclusion

Overall, it appears that section 21 will succeed in equitably balancing the interests of third parties, companies and promoters, by providing clearly stipulated protection measures for all parties involved. It will produce valuable improvements on the previous and current legislation that regulate pre-incorporation contracts.

The proposed reforms do however suffer from some defects. The rights and liabilities of the company, the agent, and the third party during the interim period (i.e. between the conclusion of the pre-incorporation contract and ratification or adoption of the contract by the company) are still left unsettled. The Act does not expressly stipulate that the promoter will be liable in terms of the pre-incorporation contract before the corporation is formed. Section 21 does also not prohibit the third party from unilaterally withdrawing from the agreement pending ratification by the company. It is also not clear whether the agent and the third party are able to cancel a pre-incorporation contract by agreement prior to its ratification by the company. Failure to make provision for the above mentioned circumstances, leads us to believe that these aspects are left to be regulated by the parties' intentions when they conclude the contract. It is therefore recommended that the contracting parties should address or attempt to make provision for these circumstances in the pre-incorporation contract itself.



## CHAPTER 4

### Alternative Methods

Sections 71<sup>113</sup>, 35<sup>114</sup> and 21<sup>115</sup> of the respective Companies Acts are permissive and not preemptory.<sup>116</sup> They were not introduced to serve as codification of the law relating to pre-incorporation contracts.<sup>117</sup> Therefore, promoters are allowed to use other alternative methods in an attempt to acquire rights, obligations and benefits for a company without having to comply with the statutory arrangements. These alternatives are presented in order to explore the advantages and disadvantages of such alternatives as well as to explain the issues and legal consequences pertaining to such alternatives.

#### 4.1 Shelf Companies

If the promoters have no immediate special requirements regarding the company's name or memorandum of association, and want their business to be incorporated as rapidly as possible, an alternative to registering a new company is to buy one 'off-the-shelf' from an agency that provides this service.<sup>118</sup> The purchase of so-called 'shelf companies' from agencies that provide this service has become a regular feature of commercial activities. The demand for shelf companies has grown, not only because it is more cost effective, but also because it offers a speedier alternative.<sup>119</sup> The documents of a shelf company typically comprise a certificate of incorporation, a one page memorandum of association, and a page recording that the table B articles of association (with minor amendments) are applicable.<sup>120</sup> The shareholder and director of the shelf company will typically be an employee of the agency that registered the company.<sup>121</sup> The shares are subsequently transferred to the purchaser (promoter) who 'buys' the company. That purchaser or its nominee is then appointed as director of the

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<sup>113</sup> Of the 1926-Act.

<sup>114</sup> Of the 1973-Act.

<sup>115</sup> Of the 2008-Act.

<sup>116</sup> Blackman LAWSA 4(3) par 480; Cilliers HS & Benade ML *Introduction to Company Law* (1985) Durban: Butterworths 34.

<sup>117</sup> *Supra* n 116.

<sup>118</sup> Davies PL *Gower and Davies' Principles of Modern Company Law* 7<sup>th</sup> ed (2003) London: Sweet & Maxwell P.80 (hereafter 'Davies').

<sup>119</sup> Green R "Land buying blues" (2006) January/February *De Rebus* 24.

<sup>120</sup> *Supra* n 118.

<sup>121</sup> *Supra* n 118.

company.<sup>122</sup> Therefore, the only thing that the purchasers have to do is to pay the agency and take transfer of the subscribers' shares and custody of the company's registers.<sup>123</sup> They will, of course, have to send the Registrar of Companies notices of the change of directors and of the position regarding the registered offices of the company.<sup>124</sup> Any other changes, for example alterations to the articles or a change of name, can be effected at leisure.<sup>125</sup> The main disadvantage is that until these changes are made, the company's name is unlikely to bear any relationship to the purchasers or to the business being carried on.<sup>126</sup>

Cassim is of the opinion that the question inevitably arises whether reform of the law relating to pre-incorporation contracts is necessary or worthwhile in light of the ready availability of shelf companies, which enables promoters to simply acquire a company off the shelf and thereafter to contract in its name without the need for a pre-incorporation contract.<sup>127</sup> The expected improvements to company registration processes at the Companies Registry's office, including expedited registrations and electronic filing processes, may provide additional reasons for doubting the importance of pre-incorporation contracts.<sup>128</sup> Despite these possibilities, the author still supports the view that pre-incorporation contracts will continue to play an important role in the corporate world.

## 4.2 Agreement for the benefit of a third party (the *stipulatio alteri*)

### 4.2.1 Nature of the *stipulatio alteri*

The South African courts have confirmed that it is possible for two parties to conclude a valid contract for the benefit of a third person, who is not a party to the contract, and who at the stage of contracting need not even exist.<sup>129</sup> One party (called the *stipulans*)

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<sup>122</sup> *Supra* n 118.

<sup>123</sup> Davies 81.

<sup>124</sup> *Supra* n 123.

<sup>125</sup> *Supra* n 123.

<sup>126</sup> *Supra* n 123.

<sup>127</sup> Cassim 367.

<sup>128</sup> *Supra* n 127.

<sup>129</sup> *Hutchison & Pretorius* 225; See eg *Mutual Life Insurance Co of New York v Hotz* 1911 AD 556 567; *Van der Plank v Otto* 1912 AD 353 362; *Brown's Executrix v McAdams, Masterpiece Gold Mining Co Ltd v Brown's Executrix* 1914 AD 231 235; *McCullogh v Fernwood Estate Ltd* 1920 AD 204 206 215; *Commissioner of Inland Revenue v Estate Crewe* 1943 AD 656; *Crookes v Watson* 1956 (1) SA 277 (A).

stipulates the benefit that he or she wishes the other party (called the *promittens*) to confer upon the third person. The *stipulans* extracts a promise from the *promittens* that he will confer that benefit on the third party, or at least offer that benefit to the third party, which the latter can accept or reject.<sup>130</sup> The mere conferring of a benefit is not enough. To constitute a valid *stipulatio alteri*, it is required that the *stipulans* and the *promittens* should intend to create an enforceable obligation in favour of the third person, obliging the *promittens* to make a performance to the third person, giving the third person an independent right to demand/enforce that performance upon acceptance.<sup>131</sup> The rights that the original contracting parties wish to create for the third party only becomes vested when the third party accepts and notifies the *promittens* of his acceptance of the benefit.<sup>132</sup> For acceptance to be valid, the third party must inform the *promittens* of his acceptance.<sup>133</sup> Before such acceptance, the *stipulans* and *promittens* may validly agree to alter or cancel their contract without the third party's consent.<sup>134</sup> The *stipulans* may therefore release the *promittens* from the obligation to confer the benefit upon the third party at any time prior to acceptance of the benefit by the third party.<sup>135</sup> If the benefit is rejected by the third party, the stipulation will also come to an end.<sup>136</sup> The exact nature of the rights and duties between the various parties and the duration of their relationships will depend upon a proper construction of the terms of the contract, as well as the intention of the parties, and not merely upon the rules of law.<sup>137</sup>

#### 4.2.2 Effect of the Companies Acts on the *stipulatio alteri*

A *stipulatio alteri* is unaffected by the provisions of the Companies Acts with regards to pre-incorporation contracts. In the event of a *stipulatio* the promoter contracts in his

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<sup>130</sup> Wanda LAWSA (1) par 177.

<sup>131</sup> Hutchison & Pretorius 225; *Crookes v Watson* 1956 (1) SA 277 (A) 291; *Joel Melamed & Hurwitz v Cleveland Estates (Pty) Ltd*; *Joel Melamed & Hurwitz v Vornor Investments (Pty) Ltd* 1984 (3) SA 155 (A) 172; *Total SA (Pty) Ltd v Bekker* 1992 (1) SA 617 (A) 625; *Pieterse v Shroobree NO*; *Shroobree NO v Love* 2005 (1) SA 309 (SCA) 313; *JR 209 Investments and another v Pine Villa Estates* 2009 (3) All SA 32 (SCA) 37.

<sup>132</sup> *Van der Merwe* 266; *Mutual Life Insurance Co of New York v Hotz* 556 567; *Botes v Afrikaanse Lewensversekeringsmaatskappy Bpk* 1967 (3) SA 19 (W) 23.

<sup>133</sup> *Supra* n 132.

<sup>134</sup> *Hofer v Kevitt NO* 1998 (1) SA 382 (SCA) 387.

<sup>135</sup> *McCulloch v Fernwood Estate Ltd* 215; *Mutual Life Insurance Co of New York v Hotz* 567; *Commissioner of Inland Revenue v Estate Crewe* 674, 683; *Crookes v Watson* 287-8, 306.

<sup>136</sup> *Mutual Life Insurance Co of New York v Hotz* 583.

<sup>137</sup> *Hutchison & Pretorius* 226; *Van der Merwe* 268.

own name as principal or *stipulans*, and not as agent in the name of or on behalf of an unincorporated company. Since the third party need not exist at the time of the conclusion of the agreement, a *stipulatio alteri* is an ideal construction to be used in the case of a company yet to be formed.<sup>138</sup> The intention of the *promittens* and the *stipulans* (in this case the promoter) is to bind themselves to each other in such a way as to confer some benefit or advantage to another (in this case the unincorporated company), who at that stage is not yet a party to their contract or not yet in existence.<sup>139</sup> The contract between the *promittens* and the promoter gives rise to an offer which the company can choose to accept or not once it is incorporated. If the company accepts the offer, it accepts all the terms and conditions which the benefit embraces. It cannot partially accept the benefit.<sup>140</sup> Until the company actually accepts the offer, the promoter and the *promittens* may by mutual consent withdraw the offer. The promoter may not unilaterally release the *promittens* and so render it impossible for the company to accept the offer.<sup>141</sup> If the *promittens* repudiates the contract in any way, it is the promoter who may elect to cancel the contract and sue for damages if any was suffered.<sup>142</sup> Alternatively, he may hold the *promittens* to their agreement pending the decision of the company, and may by interdict prevent him from doing anything which would have the effect of nullifying his undertaking.<sup>143</sup> He cannot on his own compel performance by the *promittens* to the company – this is something only the company itself is able to do upon acceptance.<sup>144</sup> Until the company is incorporated and accepts the offer, it acquires no rights or duties from the agreement between the promoter and *promittens*, as the promoter and *promittens* are the only persons bound by any contractual obligation.<sup>145</sup>

At present, a promoter who is negotiating a contract for an unincorporated company must follow the procedure that is prescribed in section 35 of the 1973-Act if he wishes to act as an agent for that company.<sup>146</sup> He may, however, choose not to do so in order to avoid the formal requirements and publicity which the statutory provisions entail.

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<sup>138</sup> *Supra* n 116.

<sup>139</sup> Beuthin & Luiz 39.

<sup>140</sup> *Supra* n 139.

<sup>141</sup> *Supra* n 135.

<sup>142</sup> *Supra* n 139.

<sup>143</sup> Beuthin & Luiz 40.

<sup>144</sup> *Supra* n 143. See also *JR 209 Investments and another v Pine Villa Estates* 37.

<sup>145</sup> *Supra* n 139, n 143.

<sup>146</sup> See Chapter 3 above.

The *stipulatio alteri* therefore offers a promoter the opportunity to achieve the same result, without having to comply with any prescribed statutory requirements.

### 4.2.3 Liability of the promoter

As with the statutory arrangements, similar questions arise regarding the liability of the *stipulans* (promoter) within the context of a contract for the benefit of a third person. Will the promoter incur liability if the company fails to accept the benefit on or before the time agreed upon by the promoter and the *promittens*? Also, what would the position be if the company rejected the benefit – will the promoter be able to replace the company as benefitting party under the agreement? These questions were answered by the two cases that follow.

The first case is that of *Nine Hundred Umgeni Road (Pty) Ltd v Bali*<sup>147</sup> where the agreement sued upon was a contract for the benefit of a third party. In terms of a written lease agreement, the appellant as the lessor, let (certain premises in Durban) to the respondent, “in his capacity as trustee for a company to be formed (‘the lessee’)”. The lease was signed by the respondent “for and on behalf of the lessee” on 5 June 1978 and by a director of the appellant on behalf of the appellant on 6 July 1978. The company contemplated by the respondent, Optima Motors (Proprietary) Limited (hereinafter referred to as the company), was incorporated on 27 June 1978. It is common cause that the premises were made available and that the lease commenced on 1 July 1978. An amount of R1 590 was allegedly due to the appellant in respect of arrear rental payable for the month of July 1979. The court assumed, without deciding, that the company did in fact not accept the benefit of the stipulation, and therefore never became a party to the lease contract. The question subsequently arose whether, as a matter of construction of the contract, the respondent in his capacity as trustee for the company to be formed was personally liable for the outstanding rental amount.

It was submitted on behalf of the appellant that the respondent contracted with the appellant as a ‘principal’, and that consequently the respondent was *prima facie* (unless as a matter of interpretation of the contract the parties intended otherwise)

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<sup>147</sup> 1986 (1) SA 1 (A).

personally liable for the performance of the obligations, and entitled to the rights of the lessee flowing from the contract. The court was of the opinion that the contract was a perfectly straightforward one that contained standard clauses. In the court's view, the description of the lessee as the trustee for a company to be formed is no indication, *per se*, that the trustee would be personally liable in terms of the contract (prior to the acceptance by the company of the benefit stipulated in its favour).

Reliance was also placed in this decision on the matter of *Gardner v Richardt*,<sup>148</sup> where Friedman J said: "It seems to me that the question whether and the circumstances under which a person contracting as a trustee for a company in the course of formation has the right to sue for specific performance of the contract, must be answered by reference to the terms of the particular contract under consideration; it is essentially a question of construction".<sup>149</sup> The Appellate Division in *Nine Hundred Umgeni Road* respectfully agreed with this contention. The Court stated that the trustee in the present case was not personally entitled to enforce or obliged to render the performance which is stipulated for the third party unless the contract so provided. A problem might arise if pending the formation of the company and its acceptance of the benefit, performance by the lessee of the terms of the contract, which does not also provide for the personal liability of the trustee, falls due. In such case, in order to stave off cancellation and preserve the benefit for the company, the trustee or somebody else would be compelled to perform. But by doing so, he would not personally incur any liability under the contract.

Failing performance of the lessee's obligations pending acceptance by the company, the *promittens* can do nothing but on account of such non-performance, resile from the contract. He would not even be able to successfully claim damages from any person unless he had taken the precaution to provide, as was done in the present case, for the company's directors to be personally liable by guaranteeing all the obligations of the lessee in terms of the lease. An important aspect of this case was that the contract in question did indeed contain a clause holding the trustee personally liable to the contract if the company did not adopt the contract on or before a certain date. An

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<sup>148</sup> 1974 (3) SA 768 (C) 770.

<sup>149</sup> *Supra* n 148 at 770E.

interpretation of the construction of the contract subsequently led to the personal liability of the trustee.

The second case is that of *Gray v Waterfront Auctioneers and Another (Pty) Ltd.*<sup>150</sup> On 14 December 1994 the second respondent entered into a lease with the applicant (for a period of three years from 1 March 1995), acting as trustee for a company to be formed. Clause 10.9 of the lease provided that the applicant warranted to the lessor that the company for which she acted as trustee would be formed, adopt, ratify and confirm the agreement (within 60 days from the date of the agreement), and take all other steps necessary to render the agreement binding on it. Clause 10.9.2 specifically provided that until the company has become the lessee under the lease agreement, “the trustee(s) in his/her/their personal capacity(ies) shall be liable for all the obligations imposed on the lessee”.<sup>151</sup>

From time to time extensions were granted to the applicant for her to fulfill the warranty. It is common cause that the applicant did not fulfill her warranty because the necessary steps for the company to become the lessee were not completed within 60 days from the date of the agreement or within the extended period agreed to. The company only took the necessary steps to become the lessee after the expiry of the last extension. The court felt that the deadline date was relevant only to the extent that the applicant warranted to the second respondent that the company would take the necessary steps by that date. The lease did not stipulate that if the beneficiary company had not become the lessee by the stipulated date i.e. where the applicant breached her warranty, the trustee would be regarded as the lessee under the lease agreement. Clause 10.9.2 only stated that until the necessary steps were taken to establish the company as the lessee under the lease, the applicant herself would be liable for all the obligations imposed on the lessee. The lease agreement did not provide for the applicant to substitute the company as lessee under the agreement. It simply provided that until such time as the company had become the lessee she was liable for the lessee's obligations. It was not open to any party to contend that the applicant had become lessee of the premises by reason of the warranty clause in the agreement.

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<sup>150</sup> 1997 JOL 246 (W).

<sup>151</sup> *Gray v Waterfront Auctioneers and Another (Pty) Ltd.* 1997 JOL 246 (W) 252.

As in the first case, this court also relied on the construction of the contract to determine the exact liability of the trustee. On the basis of these two cases it seems likely that the courts will only impose liability on the trustees (promoters) if it was clear from the contract between the parties that it was their intention.

### 4.3 Promoter as principal

The statutory arrangements also do not apply if a promoter contracts in his personal capacity i.e. in his own name before the incorporation of the company, and then after its incorporation cedes his rights<sup>152</sup> under the contract. This also applies where he transfers the assets<sup>153</sup> he acquired for the company to the company. The promoter can also stipulate the right to nominate the company as purchaser.<sup>154</sup> The promoter can persuade the third person to make his offer to either the promoter or his nominee, the promoter having the right to name his nominee within a certain period – his nominee then being the company. The promoter can also cede rights which he acquired in terms of an option.<sup>155</sup> The promoter could obtain an option to acquire the benefit and agree with the third person, where necessary, that the option could be ceded by him to the company if he so desires.<sup>156</sup> Neither the company, nor the promoter would be bound to accept the benefit to which the option related, but the third person would nevertheless be obliged to keep his offer (in terms of the option) open.

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<sup>152</sup> Beuthin & Luiz 36; Cilliers HS & Benade ML *Introduction to Company Law* (1985) Durban: Butterworths 35.

<sup>153</sup> *Supra* n 152.

<sup>154</sup> *Supra* n 152; *Scheepers v Strydom* 1988 2 SA 778 (NC) 779C; *Commissioner for Inland Revenue v Collins* 1992 3 SA 698 (A) 700; *Botha v Van Niekerk* 1983 (3) SA 513 (W) 526-527.

<sup>155</sup> *Supra* n 116.

<sup>156</sup> *Supra* n 152; *Trever Investments v Friedhelm Investments* 1982 (1) SA 7 (A) 16.



## CHAPTER 5

### Conclusion

It is clear from this study that the common law rules of agency and ratification have made it impossible for an individual to conclude a contract for or on behalf of an unincorporated entity, based on the requirement that a principal must exist at the time when its agent professed to act on its behalf. In the same vein, a contract made on behalf of a principal who is not in existence at the time when the contract is entered into by a person professing to contract on its behalf, can also not be ratified or adopted by that principal.<sup>157</sup>

This was the position under the South African law until the passing of Companies Act 46 of 1926. The South African legislature acknowledged the problems that the common law rules were causing and subsequently decided to create an exception to the rules by absorbing provisions (specifically section 71 of the 1926-Act) into statute. This exception allowed a person to contract on behalf of a non-existent principal and for that principal to ratify or adopt such a contract once it comes into being. Although these provisions were welcomed, they were not without complications. The difficulties that arose from the interpretation of the provisions of the 1926-Act were underscored in cases such as *Sentrale Kunsmis Korp (Edms) Bpk v NKP Kunsmisverspreiders (Edms) Bpk*,<sup>158</sup> *Peak Lode Gold Mining Co Ltd v Union Government*<sup>159</sup> and *Nordis Construction Co (Pty) Ltd v Theron, Burke & Isaac*.<sup>160</sup>

The legislature amended section 71 in 1952 and 1963 without addressing the difficulties that were highlighted by the South African courts. These amendments merely increased the formal requirements that were essential for the conclusion of a pre-incorporation contract. To date, the essential problems with these provisions were that it did not make sufficient provision for the personal liability of the promoter in the event that the company fails to be incorporated or refuses to ratify the contract after its incorporation. The publicity requirements, i.e. the requirement that provides that the memorandum on its registration, must contain as an object of such company the ratification or adoption of the contract, and that two copies of the contract, one of which should be certified by a notary public, has to be lodged with the Registrar before the adoption or ratification of the contract, also proved to be problematic.

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<sup>157</sup> *Supra* n 5.

<sup>158</sup> *Supra* n 69 at 351, 359, 362-363.

<sup>159</sup> *Supra* n 61.

<sup>160</sup> *Supra* n 77 at 270-272.

In 1973 a new Companies Act was introduced which created the opportunity for innovative and improved provisions with regards to the regulation and conclusion of pre-incorporation contracts. However, section 35 of the 1973-Act did not introduce any significant improvements to its predecessor (section 71 of the 1926-Act). All that can be said about section 35 is that it successfully addressed the problem with regards to the object of the memorandum that was stressed by the court in the case of *Sentrale Kunsmis Korp (Edms) Bpk v NKP Kunsmisverspreiders (Edms) Bpk*.<sup>161</sup> Due to the lack of improvements in section 35 of the 1973-Act controversy continued to arise in our courts with regards to the interpretation of the statutory provisions. These problems were highlighted in cases such as *Pledge Investments (Pty) Ltd v Kramer, NO: In re Estate Selesnik*,<sup>162</sup> *Indrieri v Du Preez*<sup>163</sup> and *Akromed Products Pty Ltd v Suliman*.<sup>164</sup>

In 2006, section 8 of the Corporate Laws Amendment Act 24 of 2006 amended section 35 of the 1973 Companies Act with the intention of reducing some of the formal requirements which section 35 imposed. This amendment was also welcomed. Nevertheless, section 35 was still scrutinized by academic writers such as Cassim and Ncube.<sup>165</sup> They held the opinion that the statutory solution contained in section 35 has over the years become “outdated, too restrictive and out of step with modern trends and business practices”, that our law was in dire need of reform on this matter, and that a policy shift was necessary to achieve a more balanced treatment of the various parties involved in such a contract.

It is evident from the previous discussion that there was a fair amount of pressure on the legislature to improve or reform the current and previous legislation on pre-incorporation contracts. In 2008 the South African legislature finally decided to address all the concerns that were expressed over the years with regards to section 71 of the 1926-Act, as well as its counterpart section 35 of the 1973-Act. Therefore, the legislature drafted and incorporated a very detailed section 21 into the 2008-Act. As already alluded to in Chapter 3, it appears that section 21 has succeeded in equitably balancing the interests of third parties, companies and promoters, by providing clearly stipulated protection for all parties involved. It therefore produces valuable improvements on the previous and current legislation that regulate pre-

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<sup>161</sup> *Supra* n 55.

<sup>162</sup> *Supra* n 81 at 6.

<sup>163</sup> 1989 (2) SA 721 (C).

<sup>164</sup> *Supra* n 84.

<sup>165</sup> *Supra* n 9, n 10.

incorporation contracts. The main criticism that was leveled against section 35 was that it failed to provide for promoter liability and sufficient third party protection. Section 21 sought to address this problem by imposing joint and sever liability on promoters for the liabilities created in the pre-incorporation contract, in the event that the company is not subsequently incorporated or rejects any part of the agreement after its incorporation.<sup>166</sup> Section 21 also affords promoters protection by stipulating that the person who bears the liability for the rejected agreement or action by the company may assert a claim against the company for any benefit the company has received or is entitled to receive in terms of the agreement.<sup>167</sup>

The most apparent amendment to the law has however been the fact that section 21 removed the formal and publicity requirements contained in section 35. The memorandum of a company does not have to contain as one of its objects the adoption or ratification of the contract by the company and no copies of the contract have to be certified or lodged with the Registrar. This has afforded companies more privacy in their commercial transactions with outsiders. One can only speculate whether the legislature intended to abolish these formal requirements in an attempt to encourage people to make use of the statutory arrangements when concluding pre-incorporation contracts. Less formal requirements will automatically result in a more rapid process.

The full effect and impact of the 2008-Act on pre-incorporation contracts is still to be seen when it comes into force during April 2011. On the face of it, it appears that the solutions that the 2008-Act provides are adequate and will successfully address the shortcomings that exist in current and previous legislation on this subject. This statement will only be confirmed once we observe how these new provisions are applied in practice, interpreted, and enforced by the South African courts. The mere fact that the South African legislature has now made a conscious attempt to create reform on this subject shows that it acknowledges that pre-incorporation contracts will continue to play an important role in commercial dealings.

However, a key question arises around the future role of the statutory arrangements in light of the various alternative methods available to promoters, as discussed in chapter 4. Shelf companies have shown to play a more vital and convenient role in commercial dealings. The purchase of a shelf company does not only afford promoters the opportunity to quickly

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<sup>166</sup> *Supra* n 98.

<sup>167</sup> *Supra* n 103.

acquire an already incorporated company, but also to circumvent all the problems that can arise from concluding a contract on behalf of an unincorporated entity. In some instances it might also seem more convenient for a promoter to follow the *stipulatio alteri* route, because it does not require that one has to comply with any formal statutory requirements as set out in section 35 of the 1973-Act that is currently in force. However, in this context it is important for third parties to note that section 21 of the 2008-Act seeks to introduce better protection for third parties who enter into pre-incorporation contracts, through the promoter's personal liability and the company's deemed ratification provisions.<sup>168</sup> Section 21 does not however apply to promoters acting as principals in terms of a *stipulatio alteri* and thus denies third parties who contract with such promoters the benefit of the protection it offers.<sup>169</sup> It is evident from this study that neither the statutory solutions nor the alternative methods are without defects. Therefore it is suggested that parties enquire about the difficulties and consequences that can flow from the conclusion of a pre-incorporation contract as well as the alternative methods before they attempt to conclude a contract on behalf of an unincorporated entity.

Academics have been divided with regards to the role and future of pre-incorporation contracts within changing commercial environments. Ivamy is of the opinion that as a consequence of the difficulties that can arise from pre-incorporation contracts, the more usual practice is not to conclude any contract before the company has been incorporated, but rather to agree to a draft contract that can be entered into between the other party and the company after its incorporation.<sup>170</sup> Cilliers & Benade acknowledges that the disadvantage of section 35 is that copies of the contract must be lodged with the Registrar and that the contents are then open for public inspection, but they still advocate that from a practical point of view, the procedure laid down by section 35 is the safest to follow.<sup>171</sup> Pennington is in support of Ivamy's view. He is of the opinion that it is purposeless and even dangerous to conclude contracts on behalf of a company who is still in the course of its formation.<sup>172</sup> He suggests that the simplest way of avoiding the difficulties created by pre-incorporation contracts is to incorporate the company first, and then have it enter into the contract. If it is essential that the third party should be contractually bound before incorporation, the promoters should rather contract with the third party personally and then assign the benefit of the contract to the

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<sup>168</sup> Ncube 269.

<sup>169</sup> *Supra* n 158.

<sup>170</sup> Ivamy ERH *Topham and Ivamy's Company Law* 16<sup>th</sup> ed (1978) London: Butterworths 40.

<sup>171</sup> Cilliers HS & Benade ML *Introduction to Company Law* (1985) Durban: Butterworths 35.

<sup>172</sup> Pennington RR *Company Law* 6<sup>th</sup> ed (1990) London, Dublin and Edinburgh: Butterworths 90.

company after its incorporation.<sup>173</sup> Gillen acknowledges that with the statutory provisions there are risks associated with pre-incorporation contracts for both the promoters and third parties.<sup>174</sup> He suggests that these risks merely require some practical solicitor's advice: First, promoters who have approached an agency, attorney or any other solicitor to incorporate a company should be warned and made aware of the risks associated with pre-incorporation contracts for both the promoters and third parties. They should be instructed, if they want to enter into contracts on behalf of an unincorporated corporation, to do so within the ambit of the provisions of the applicable Companies Act. Their attention should also be drawn to the risk of personal liability. Second, if one is acting for a third party in any significant transaction, unless one is intimately familiar with the client's corporate status, it is always a good idea or good practice to continuously check the Companies Registry to confirm what the company's status is. One can do a check of the registry to confirm that a certificate of incorporation has been issued for that company and that the company is still in good standing.

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<sup>173</sup> *Supra* n 172.

<sup>174</sup> Gillen 202.

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