

# PRE-INCORPORATION CONTRACTS: THE REFORM OF SECTION 35 OF THE COMPANIES ACT

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'The conundrum of the pre-incorporation contract has taxed some of the finest legal minds. If one should judge by results, it is probably true to say that it has defied them . . . courts in England and other Commonwealth countries have seemed to attach less importance to effecting justice and more to attempting to fit round pegs into square legal pigeon-holes, so that ultimately, in virtually all jurisdictions, it has been necessary to rescue the lawyers from the dilemma that their own fictions have created by having recourse to *legislative solutions*.'<sup>1</sup>

## INTRODUCTION

Section 35 of the Companies Act 61 of 1973 provides:

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

Section 35<sup>2</sup> is laudable to the extent that it overcomes the common-law hurdle<sup>3</sup> that a company cannot ratify a pre-incorporation contract<sup>4</sup> purportedly made by an agent<sup>5</sup> on behalf of the company prior to the formation of the company.<sup>6</sup> It certainly goes further than the equivalent statutory

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<sup>1</sup> A J Easson & D A Soberman 'Pre-incorporation contracts: Common law confusion and statutory complexity' (1992) 17 *Queen's LJ* 414 at 415, quoted with approval by Borins JA in *Sherwood Design Services Inc v 872935 Ontario Ltd* (1998) 158 DLR (4th) 440 (Ont C A) para 58. My emphasis.

<sup>2</sup> Like its predecessor s 71 of the Companies Act 46 of 1926.

<sup>3</sup> Laid down in *Kelner v Baxter* [1866] LR 2 CP 174, and accepted by the Appellate Division in *McCulloch v Fernwood Estate Ltd* 1920 AD 204.

<sup>4</sup> This article is confined to pre-incorporation contracts made in terms of s 35 and does not, save where directly relevant, cover pre-incorporation contracts made by way of the stipulatio alteri. The term 'pre-incorporation contract' is consequently used to refer to a s 35 contract.

<sup>5</sup> One cannot act as an 'agent' on behalf of a company which is not yet in existence. This should be borne in mind wherever the term 'agent' is used in this paper.

<sup>6</sup> At common law, a company cannot be a party to a contract prior to its incorporation since the company comes into existence only upon incorporation. Further, if an agent purports to enter into a contract on behalf of a company prior to the formation of the company, the company once formed cannot ratify the contract, as ratification operates retrospectively to the time that the agent entered into the contract and thus to a time at which the company was not yet in existence (*Kelner v Baxter* supra note 3; *McCulloch v Fernwood Estate* supra note 3 at 207–8). In addition, the agent may be held personally liable on the pre-incorporation contract. The purpose of s 35 is to put promoters, acting as agents, in a position to contract on behalf of a company even though the company does not yet exist (see e.g. *Build-a-Brick BK v*

provision in the United Kingdom which, surprisingly and despite widespread criticism,<sup>7</sup> has not mitigated<sup>8</sup> and does not propose to mitigate<sup>9</sup> the non-ratification rule at common law. But, although the South African legal principles relating to pre-incorporation contracts were historically progressive, since South Africa was one of the first jurisdictions to provide a 'legislative solution' to 'the conundrum of the pre-incorporation contract', the solution contained in s 35 has some thirty years later become outdated, too restrictive and out of step not only with modern trends but also with modern business practices. Section 35 is in dire need of a thorough overhaul. Clause 18 of the draft Companies Bill 2007, published after this article was written, seeks to do just that and it is hoped that the discussion below will be a useful contribution to its analysis and evaluation.<sup>10</sup>

Reform is essential not only of the fundamental underlying policy of s 35, but also to provide a complete, modern and comprehensive solution to the multitude of practical problems to which this section has given rise. First, regarding the underlying policy of s 35 — while it 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 imposition of personal liability on the agent of the pre-incorporation contract), s 35 fails to have sufficient regard for the position of the third party (that is, the party with whom the agent purported to contract on behalf of the company) and often operates to the detriment of the third party. For instance, 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,<sup>11</sup> who is consequently burdened with the risk of non-ratification. While this may have been justifiable in the business environment at the time of the enactment of s 35 and its predecessor, s 71 of the Companies Act 46 of 1926, on the basis that the third party voluntarily and knowingly undertook the risk of the company's non-incorporation or non-ratification and could have protected himself by appropriate safeguards in the contract, in the modern corporate context such a policy is unfair to the third party and out of line with global trends.<sup>12</sup> Part I of this article proposes a statutory solution for

*Eskom* 1996 (1) SA 115 (O)). Section 35 does not overrule *Kelner v Baxter* as it is logically impossible for a person to act as an agent for a non-existent company.

<sup>7</sup> See e.g. Jenkins Committee U K House of Lords *Report of the Company Law Committee* Cmnd 1749 (1962) paras 44 and 54(b).

<sup>8</sup> Section 36C of the Companies Act, 1985 fails to enable a company to ratify a contract purportedly made on its behalf before its formation and instead requires a novation. Unlike ratification, which is a unilateral act, novation requires the consent of the third party, that is, the person with whom the agent purported to contract on behalf of the company.

<sup>9</sup> See the Company Law Reform Bill [HL] Bill 24, cl 52, which merely re-enacts s 36C of the Companies Act, 1985.

<sup>10</sup> GN 166 in GG 29630 of 12 Feb 2007.

<sup>11</sup> H S Cilliers & M L Benade *Corporate Law* 3 ed (2000) 60.

<sup>12</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 (hereafter 'the Company Law Policy Paper') at 30–1, the harmonization of South African company law with the company laws of other jurisdictions, particularly with that of its trading partners, is a major theme of the new company law legislation.

balancing the conflicting rights and liabilities of the company, the agent and the third party, centred on a statutorily implied dual warranty by the agent that the company will not only be incorporated but will also will ratify the pre-incorporation contract — referred to hereafter as the ‘Liability Proposal’. The Liability Proposal is based on Australian<sup>13</sup> and New Zealand<sup>14</sup> corporate law, which, it will be argued, provide the best and most comprehensive models in this area of corporate law. The remainder of the article (particularly Part III on the interim position and Part V on the scope of s 35) proceeds on the premise that the Liability Proposal (or a substantially similar solution) is adopted in a new reformed and overhauled s 35.

Secondly, turning to the lacunae in s 35, there has been much disagreement and debate over the rights of the parties in the interval between the execution of a pre-incorporation contract by the agent and the third party and the ratification by the company of the pre-incorporation contract (referred to hereafter as the ‘interim period’). Indeed, this gap is also encountered in the equivalent statutory provisions in Australia and New Zealand. In view of the practical problems to which this gives rise and in the interests of certainty, efficiency<sup>15</sup> and the creation of a comprehensive statutory solution, the parties’ position during the interim period must be clarified by appropriate provisions in a new s 35. Part III of this article deals with the interim period and canvasses questions such as the unilateral withdrawal by the third party prior to ratification of the contract and mutual cancellation by the agent and third party. The submissions made in relation to the interim period are integrated with those on the Liability Proposal, to provide what is hoped to be a comprehensive proposal.

Other aspects of s 35 requiring attention are issues arising from the ratification of the contract by the company, including its retrospective effect (Part II below) and whether the four peremptory formalities<sup>16</sup> stipulated in s 35 are not too over-formalistic and burdensome and whether they ought to be abolished (Part IV below).

Regarding the scope of s 35, its limitation to pre-incorporation contracts made by a promoter acting in the capacity of an ‘agent’ on behalf of a company to be formed, and consequent inapplicability to pre-incorporation contracts entered into by way of a stipulatio alteri for the benefit of the company, should be retained.<sup>17</sup> The stipulatio alteri is an excellent device

<sup>13</sup> Australian Corporations Act 2001 (Cth), ss 131–3.

<sup>14</sup> New Zealand Companies Act 1993, ss 182–4.

<sup>15</sup> And the avoidance of legal costs in determining these matters, all of which are objectives of the Company Law Policy Paper supra note 12.

<sup>16</sup> Or alternatively three of the four formalities (see the majority judgment in *Sentrale Kunsmis Korporasie (Edms) Bpk v NKP Kunsmisverspreiders (Edms) Bpk* 1970 (3) SA 367 (A) 386 which dealt with s 71 of the Companies Act, 1926.

<sup>17</sup> Although the current wording of s 35 is ambiguous on whether it encompasses the stipulatio alteri, since it refers to ‘a person professing to act as agent or trustee’ (see *ibid* at 397 which clarified this phrase) and to a contract ‘ratified or adopted by or otherwise made binding upon and enforceable by such company’

developed in Roman-Dutch law,<sup>18</sup> and its application to pre-incorporation contracts will without doubt continue to be beneficial.<sup>19</sup> In order to eliminate all uncertainty, the wording of s 35 ought to be clarified to state that s 35 applies only where the promoter has acted in the capacity of an ‘agent’ for a company to be formed, whether he calls himself an agent, trustee, nominee or otherwise. A second issue concerning the scope of s 35 is whether, in the event that the Liability Proposal is adopted, the scope of s 35 ought to be extended beyond the situation where both the agent and the third party are aware of the company’s non-existence,<sup>20</sup> to scenarios where only one or neither of them is aware of this fact. This is analysed in Part V.

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 enable promoters to simply acquire a company off the shelf and to thereafter contract in its name without the need for a pre-incorporation contract.<sup>21</sup> The expected improvements to company registration processes at the Companies Office, including expedited registrations and electronic filing processes, is another reason perhaps for doubting the importance of pre-incorporation contracts.<sup>22</sup> Despite these possibilities, pre-incorporation contracts will continue to play an important role in the corporate world. This is evidenced by the attention that other jurisdictions have continued to lavish on pre-incorporation contracts, both by way of legislative amendment<sup>23</sup> and academic writings, despite the easy and convenient availability of shelf companies and expedited registration of companies in those jurisdictions. Companies are often formed for a specific purpose in order to acquire specific assets or benefits, and promoters consequently desire the assurance, prior to incurring the costs of incorporating the company, that the company will indeed be able to reap those benefits or acquire those assets upon its incorporation. This is particularly so in the current business environment in South Africa where many new and unsophisticated entrepreneurs wishing to set up small businesses may require

(*ibid*), it has been held that the s 35 applies only where the promoter acts in the capacity of an ‘agent’ (*Ex parte Vickerman* 1935 CPD 429, followed by other cases since).

<sup>18</sup> *McCulloch v Fernwood Estate* *supra* note 3 at 215.

<sup>19</sup> This will, however, mean that difficulties will still be encountered in determining whether a promoter intended to act as an agent or as a principal in relation to a pre-incorporation contract, due to the unsatisfactory determinative criteria. However, this issue is beyond the scope of this paper.

<sup>20</sup> In this regard s 35 only applies where the agent ‘professes’ to be acting on behalf of a company to be formed — this means that both the agent and the third party must be aware of the company’s non-existence for s 35 to apply.

<sup>21</sup> See e.g. *Oshkosh B’Gosh Inc v Dan Marbell Inc Ltd* [1989] BCLC 507 (CA); *Badgerhill v Cottrell* [1991] BCLC 805 (CA).

<sup>22</sup> In Australian law even if an agent enters into a contract on behalf of a company before acquiring a shelf company, he may escape the equivalent statutory provisions on pre-incorporation contracts, provided that the shelf company in question was in fact incorporated before the date the contract was entered into. See *Commonwealth Bank of Australia v Australian Solar Information Pty Ltd* (1986) 11 ACLR 380.

<sup>23</sup> For example, Australian Corporations Act 2001 (Cth), s 131; New Zealand Companies Act 1993, ss 182–4; Jersey Companies Law 1991, Cap 13.125, art 21(1); Bahamas Companies Act 18 of 1992, s 22(1); Guernsey Companies Law No XXIII of 1994, art 15(1); Canada Business Corporations Act, R.S.C. 1985 c C-44, s 14; British Columbia Business Corporations Act [SBC 2002] s 20; Nigerian Companies and Allied Matters Act 1990, s 72.

assured arrangements prior to expending funds on forming and registering a company. Investors are also more comfortable with investing in a venture where the promoter has already made the necessary legal arrangements to acquire the assets or benefits for which the company is formed.<sup>24</sup> Promoters tend, in practice, to regard the incorporation of a company as one of the last formalities in a promotion.<sup>25</sup>

## I. BALANCING THE CONFLICTING INTERESTS OF THE AGENT, THE COMPANY AND THE THIRD PARTY — *THE LIABILITY PROPOSAL*

### (1) *The policy underlying s 35*

Section 35 protects 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 is inequitable to saddle the third party with the full risk of non-ratification. 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.

This suggestion is supported by a number of considerations. The promoter, because of his role in incorporating the company, is in a better position than the third party to predict the likelihood of the incorporation of the company and also of the ratification of the pre-incorporation contract.<sup>26</sup> This 'information asymmetry'<sup>27</sup> makes it equitable and efficient to place the burden of non-incorporation or non-ratification on the promoter. The promoter, moreover, often has a significant influence on whether or not the pre-incorporation contract is subsequently ratified by the company; indeed where the proposed company is a small private company of which the promoter is to become the sole or majority director and/or shareholder, the promoter is manifestly in a position to control both the incorporation and ratification. The need for a reallocation of the burden is made even more compelling if (as is proposed below) s 35 precludes the third party from unilaterally withdrawing from the pre-incorporation contract in the interim period prior to ratification by the company.<sup>28</sup>

The policy of placing the burden of non-incorporation or non-ratification on the promoter has, in fact, been adopted by the majority of leading

<sup>24</sup> *Sentrale Kumsnis* supra note 16 at 396.

<sup>25</sup> Paul J Omar 'Crossing time's boundaries: A comparative review of legal responses to the pre-incorporation contract' 2005 *Singapore Journal of Legal Studies* 76 at 76–7.

<sup>26</sup> *Westcom Radio Group Ltd v Maclsaac* (1989) 63 D L R (4th) 433 (Ont Div Crt)

<sup>27</sup> So labelled by Michael J Whincop *An Economic and Jurisprudential Genealogy of Corporate Law* (2001) 63–4 (as cited in Omar op cit note 25 at 91).

<sup>28</sup> It is debatable whether s 35 currently precludes a unilateral withdrawal, but the better view is that it does. It is submitted in Part II that s 35 ought to definitively preclude the third party's unilateral withdrawal.

jurisdictions, albeit through varying means. In Canada,<sup>29</sup> for example, the agent is personally liable on a pre-incorporation contract unless or until it is ratified by the company, while Australian and New Zealand law<sup>30</sup> hold the agent liable for damages for breach of a warranty of the company's incorporation and ratification of the pre-incorporation contract.<sup>31</sup> The United Kingdom, both at present and under its proposed legislation,<sup>32</sup> even goes so far as to impose personal liability on the promoter failing a novation or an express exclusion of liability.<sup>33</sup> This may be harsh on the company and the promoter, but it is nonetheless motivated by a real need to protect the interests of the third party.<sup>34</sup>

Consequently, s 35 should be amended so that a promoter acting as agent for a yet-to-be formed company is held liable to the third party in the event that the company is not incorporated or, if incorporated, does not ratify the pre-incorporation contract.

(2) *The optimal means of third-party protection — Personal liability or statutory warranty?*

Third-party protection can be implemented in a number of ways. One option is to render the agent personally liable on a pre-incorporation contract pending ratification by the company (as is done in Canada, Ghana, Nigeria and Malaysia).<sup>35</sup> Another is to hold 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, which is the approach in Australia and New Zealand.

The second of these would be the better route for South African law to follow. The personal liability approach amounts to constructing a new contract between the agent and the third party when the third party had no express intention of contracting with the agent but wished instead to contract with the company. This offends the basic and fundamental contractual principle that a contract is based on a meeting of minds or the intention of the parties. It is for this reason that Australian law has preferred the statutory warranty over the personal liability approach.<sup>36</sup> Furthermore,

<sup>29</sup> Supra note 23.

<sup>30</sup> Ibid.

<sup>31</sup> See further Part II(2) below.

<sup>32</sup> Supra notes 8 and 9.

<sup>33</sup> The UK legislation thus institutes the strict rule-of-law approach to *Kelner v Baxter* supra note 3 as opposed to the rule-of-construction approach where the personal liability of the promoter depends on the parties' intention (John H Farrar, Nigel E Furey & Brenda M Hannigan *Farrar's Company Law* 3 ed (1991) 60).

<sup>34</sup> See further Part II(2) below.

<sup>35</sup> See Canada Business Corporations Act, R.S.C. 1985 c C-44, s 14; Ghana Companies Code, Act 179 of 1963; Nigeria Companies and Allied Matters Act 1990, s 72; Malaysia Companies Act 125 of 1965.

<sup>36</sup> H A J Ford & R P Austin *Ford's Principles of Corporations Law* 6 ed (1991) para 549. However, Canadian law justifies its position on the basis that, as a matter of business reality, the promoter is usually in charge of the pre-incorporation and immediate post-incorporation process and is able to protect himself: R W V Dickerson, J L Howard & L Getz *Proposals for a New Business Corporations Law for Canada* vol 1 *Commentary* paras 68 to 73 as cited in Jacob S Ziegel 'Promoter's liability and pre-incorporation contracts: *Westcom Radio*

where personal liability is imposed on the agent, the agent is generally regarded as stepping into the shoes of the company with the result that the agent is by the same token entitled to enforce the contract personally against the third party.<sup>37</sup> Such enforcement by the agent would, in many circumstances, instead of serving to protect the third party's interests, be prejudicial to the third party, who intended to contract with the company and had no intention of contracting with the agent. This is particularly so where the contract in question contains important personal considerations for the third party, such as a contract for the employment of the third party or one for the extension of credit.<sup>38</sup>

Moreover, South African common law offers promoters wishing to enter into pre-incorporation contracts the further option of contracting as a *principal* by using the *stipulatio alteri*. One of the factors distinguishing s 35 and the *stipulatio alteri* is the promoter's personal liability under the *stipulatio alteri* (although this has been blurred to some extent); in this regard, promoters relying on a *stipulatio alteri* have personal rights and obligations in respect of the third party.<sup>39</sup> If s 35 also were to impose personal liability on the agent, this would blur even further the distinction between s 35 and the *stipulatio alteri*. It would be neater and logically more consistent if the promoter's personal liability were to be confined to the *stipulatio alteri* where the promoter acts as a principal while s 35, where the promoter acts as an agent, steers clear of personal liability. The rejection of the agent's personal liability under s 35 also accords with agency principles at common law. A further consideration is that adoption of the personal liability approach in s 35 would produce the paradoxical result that the *agent's* personal liability under s 35 would go further than the *principal's* personal liability under the *stipulatio alteri*! A promoter using a *stipulatio alteri* does not generally

*Group Ltd. v MacIsaac* (1990) 16 *Canadian Business Law Journal* 341, 342. This ignores the real possibility that a promoter might for various reasons not be in such a position of influence.

<sup>37</sup> See *Braymist Ltd v Wise Finance Co Ltd* [2002] Ch 273 which is authority for the proposition in UK law that, where the agent is held personally liable in terms of s 36C of the Companies Act, 1985, he is also entitled to the benefits of the contract. See also s 14(2)(b) of the Canada Business Corporations Act, 1985 which provides that the promoter is 'bound by or entitled to the benefits of the contract'. Section 21(1) of the Ontario Business Corporations Act R.S.O. 1990, c. B.16 states that the promoter 'is personally bound by the contract and entitled to the benefits thereof'. Jersey and the Bahamas have similar wording in art 21(1) of the Companies Law 1991 and s 22(1) of the Bahamas Companies Act 1992, respectively. However, see *Gardner v Richardt* 1974 (3) SA 768 (C) at 770 which held in the context of the *stipulatio alteri* at common law that, if the promoter is personally liable in the event that the company does not adopt the benefit of the contract, this does not entitle the promoter to take the initiative of *enforcing* personal liability against the third party.

<sup>38</sup> Victorian Law Commission *Pre-incorporation Contracts* Report No 8 (1979) § 35, cited in J P Hambrook 'Pre-incorporation contracts and the National Companies Code: What does section 81 really mean?' (1982-3) 8 *Adelaide LR* 119 at 143.

<sup>39</sup> The promoter, in the absence of a contrary intention, has the right to hold the third party to the contract pending its adoption by the company (*Semer v Retief & Berman* 1948 (1) SA 182). Also, depending on the terms of the contract, the promoter may have the right to specific performance of an obligation intended ultimately for the company and may have a duty to perform an obligation ultimately intended to be performed by the company (*Botha v Carapax Shadeports (Pty) Ltd* 1992 (1) SA 202 (A); *Nine Hundred Umgeni Road (Pty) Ltd v Bali* 1986 (1) SA 1 (A) at 7). In the event that the company does not accept the benefit of the contract, the promoter may be bound to and be entitled by the contract in place of the company, if the contract so provides (see Philip M Meskin et al *Henochsberg on the Companies Act* (2005, loose-leaf) 63 for a concise summary of the position).

acquire the rights and obligations intended ultimately for the company, whether prior to or failing acceptance by the company,<sup>40</sup> nor does he generally become entitled to take the initiative and sue the third party for performance of the contract in his favour (unless this is provided for in the contract itself).<sup>41</sup> By contrast, the adoption of the personal liability approach in s 35 would have the anomalous result that both of these consequences would apply to the agent-promoter.

A final consideration is that, as a matter of business reality, sophisticated promoters acting as agents on behalf of a company to be formed are unlikely to be willing to undertake personal liability and would therefore ensure that they are protected by an express contractual exclusion of personal liability. This would render the legislation inefficient and ineffective. Accordingly, the statutory warranty route rather than the personal liability approach ought to be adopted in South African law.

The practical ramifications of the statutory warranty approach require close and thoughtful consideration, however, 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 would be required to whether and how the agent is to prevent the third party from unilaterally withdrawing from the arrangement pending ratification by the company (see further Part III below). By contrast, the personal liability approach provides a simple solution for the interim period, in that there is at all times an enforceable contract<sup>42</sup> to which the promoter may hold the third party pending ratification by the company.

But this is insufficient reason for preferring the personal liability approach to the implied warranty approach.<sup>43</sup> Indeed, where the pre-incorporation contract expressly excludes the personal liability of the promoter, the personal liability approach also gives rise to uncertainties about the rights of the parties during the interim period. Exactly this problem arose in *1394918 Ontario Ltd v 1310210 Ontario Inc* (discussed further in Part III below),<sup>44</sup> where the Ontario Court of Appeal had to determine the parties' rights pending ratification by the company when the third party attempted unilaterally to withdraw from (or repudiate) a pre-incorporation contract which contained an exclusion of the promoter's personal liability. The fact

<sup>40</sup> Meskin et al *ibid*.

<sup>41</sup> *Visser v Van Tonder* 1986 (2) SA 500 (T); *Gardner v Richardt* *supra* note 17 at 770.

<sup>42</sup> See e.g. *1394918 Ontario Ltd v 1310210 Ontario Inc* [2002] 154 OAC 137 (Ont CA) para 6; *Hambrook* *op cit* note 38 at 147–8.

<sup>43</sup> As contended for by *Hambrook* *op cit* note 38 at 148.

<sup>44</sup> *Supra* note 42, decided under the Ontario Business Corporations Act (*supra* note 37), which applies the personal liability approach in general, but is subject to s 21(4), which empowers the promoter and the third party to exclude the promoter's personal liability on the pre-incorporation contract pending or failing ratification by the company.

that this issue came before the court at all clearly shows that the personal liability approach is not an easy solution to the parties' rights in the interim period.

(3) *The agent's statutory warranty*

Careful consideration is required of the content of the proposed statutory warranty, the time period for its fulfilment, and the quantum of damages for breach thereof.

(a) *The content of the warranty*

The warranty clearly cannot be a warranty of the agent's authority since, as stated in *Peak Lode v Union Government*,<sup>45</sup> the agent under s 35 'professes' to act for a company not yet incorporated and therefore cannot be said impliedly to warrant that he has authority to act for the company. *Peak Lode* provides a useful alternative starting point, that of a warranty to the effect that the company will ratify the contract after its incorporation.

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,<sup>46</sup> failing *either* of which the agent will incur liability for damages. These warranties should, in terms of s 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.

Another possible warranty requiring exploration is a warranty by the agent of the future solvency of the company and its consequent ability to perform the contract. The Dutch Civil Code imposes liability on the promoter in the event of the company's insolvency in certain circumstances. Where the company is unable to honour its obligations and the promoter knows or is deemed to know of this, the Dutch Civil Code regards ratification as an act of mismanagement, which bears the consequence of personal liability for the promoter. Where the company becomes insolvent within a year of its incorporation, there is a presumption of mismanagement in terms of the Dutch Civil Code.<sup>47</sup> Supporters of an implied warranty by the agent of the company's future solvency justify it on the basis of the 'informational asymmetry' between the agent and the third party as to the affairs of the company.<sup>48</sup>

However, predictions of the company's future solvency are much more costly and uncertain than predictions of future incorporation and ratification. Sophisticated promoters would no doubt bargain out of such a warranty,

<sup>45</sup> 1932 TPD 48 at 50–1 referring to *Blower v Van Noorden* 1909 TS 890.

<sup>46</sup> Although *Peak Lode* *ibid* did not specifically mention an implied warranty that the company would be incorporated, this may well have been because the company in that case was, in fact, incorporated and the issue was therefore irrelevant to the matter before the court.

<sup>47</sup> Dutch Civil Code, section 2:203/93 in Omar *op cit* note 25 at 86.

<sup>48</sup> Whincop *op cit* note 27 at 59–84.

resulting in ineffective legislation.<sup>49</sup> Furthermore, in the light of the current business environment in South Africa and the encouragement of small businesses and entrepreneurship by relatively unsophisticated entrepreneurs, it would be an excessively heavy burden for promoters to bear; often the third party, which already has an established trade, would find the loss less devastating than a promoter who has not yet established his business.<sup>50</sup> While a warranty of the company's future solvency would effectively deter promoters from using a fly-by-night company to avoid liability, there are other ways<sup>51</sup> to guard against this abuse (see Part I(5)(b) below).

(b) *The time period for fulfilment of the warranty*

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,<sup>52</sup> the principle is that a principal must ratify acts done by an agent on its behalf within the time agreed upon by the parties<sup>53</sup> or, failing such agreement, within a reasonable time.<sup>54</sup> It would be appropriate to extend this principle to the promoter's dual warranty of incorporation and ratification by the company.

What is a reasonable time would, of course, depend on the facts and circumstances of each case, including the type of contract in question, the obligations of the parties under the contract, the nature of the goods or services involved and presumably, the backlog at the Companies Office. While the parties should, in the interests of freedom of contract as well as the Company Law Policy Paper's objectives of flexibility and facilitation,<sup>55</sup> be permitted to agree on a specific time period, the agent would have to take care to negotiate a reasonable period in which to attend to the registration of the company, lest delays at the Companies Office result in the imposition of liability on him for a breach of warranty that was out of his control.

An important further issue is whether the dual warranties of incorporation and ratification should each contain a separate time period or whether a combined time period for fulfilment of both warranties would be more effective. If separate time periods were to be prescribed for the two warranties, close attention would have to be given to the commencement of the time period for ratification, which might either be from the time of execution of the pre-incorporation contract (see s 81 of the previous Australian Companies Act, 1981) or from the time of incorporation of the

<sup>49</sup> Francis H Buckley, Mark Gillen & Robert Yalden *Corporations: Principles and Policies* 3 ed (1995) 149.

<sup>50</sup> *Ibid.*

<sup>51</sup> The directors' statement in terms of s 172(3)(a) of the Companies Act 61 of 1973 regarding the adequacy of capital is, however, unlikely to be a means for guarding against the fly-by-night company abuse, in light of its subjective wording.

<sup>52</sup> *Peak Lode* supra note 45; *Sentrale Kunsmis* supra note 16 at 398; Cilliers & Benade op cit note 11 at 60.

<sup>53</sup> A J Kerr *The Law of Agency* 3 ed (1991) 104.

<sup>54</sup> *Peak Lode* supra note 45; *Sentrale Kunsmis* supra note 16 at 398.

<sup>55</sup> *Supra* note 12 at 29–30.

company (see the New Zealand, British Columbia and Ontario provisions<sup>56</sup>).

Practice in other jurisdictions suggests that a combined time period should be prescribed. Separate time periods for incorporation and ratification could give rise to anomalies. Take the example of two identical pre-incorporation contracts stipulating incorporation of the companies within three months of their execution, and ratification within four months of incorporation. If company A is incorporated within three months and ratifies the contract within seven months of its execution, ratification will have been effected. But if the incorporation of company B takes four months and company B thereafter purports to ratify the pre-incorporation contract one month later, ratification of the contract will be ineffective, despite the fact that company B sought to ratify two months earlier than company A.<sup>57</sup>

It would therefore be preferable to have a combined warranty that the company will both be incorporated and ratify the pre-incorporation contract within the agreed time or a reasonable time after execution of the contract. This would also counter, to some extent, delays at the Companies Office in registering the company. The combined warranty is in fact the approach presently followed in Australian law.<sup>58</sup>

Finally, we must avoid imposing only *one* time period for fulfilment of *one* of the warranties, the obvious one being the ratification warranty, leaving the incorporation warranty without a time period for fulfilment. This would result in practical difficulties, by creating a loophole which would allow the agent to escape all liability for himself as well as for the company under a pre-incorporation contract that is no longer profitable, by simply neglecting to register the company.<sup>59</sup>

(c) *The statutory measure of damages for breach of the warranty*

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>60</sup> and extended to the agent acting on behalf of a non-existent principal in *Peak Lode*.<sup>61</sup> In other words, the agent does not warrant that his principal will

<sup>56</sup> Supra notes 23 and 37.

<sup>57</sup> This example is taken from Hambrook op cit note 38 at 132.

<sup>58</sup> Supra note 23.

<sup>59</sup> Section 14(2) of the Canada Business Corporations Act contains a similar defect, in that a valid acceptance of a pre-incorporation contract by a company only requires an *adoption* of the contract within a reasonable time and there is no corresponding time limit for *incorporation* of the company. Its practical ramifications, however, are not the same as argued above, because the Canadian Act adopts the personal liability approach and not the implied warranty approach. See M A Maloney 'Pre-incorporation transactions: A statutory solution?' (1985) 10 *Canadian Business LJ* 409 at 415.

<sup>60</sup> Supra note 45.

<sup>61</sup> Supra note 45. See further Kerr op cit note 53 at 306 and Part V below.

carry out the contract but only that it will be bound by it.<sup>62</sup> The agent, therefore, is 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.

The essential difference between the measure of damages for breach of the contract itself, as opposed to that for breach of warranty, is that the former is the amount that the third party would have been able to recover in execution against the company had the company been incorporated and subsequently ratified the contract but failed to perform it at all; while the latter is the amount that the third party would have been awarded in a judgment against the company. The nub of this distinction between *recoverable (or execution)* damages and *awardable (or judgment)* damages is that the financial position of the principal company is central to the quantum of recoverable damages for breach of warranty — it is that portion of the damages, awardable in a judgment against the company, that would actually have been recovered from the company on execution.

There are a number of reasons for preferring the lower quantum of recoverable damages for breach by the agent of the dual warranty of incorporation and ratification. To legislate awardable damages would be tantamount to a warranty of the company's future solvency which, as discussed in Part I(2) above, would be much too harsh and unsuitable. Secondly, the agent who is held liable for awardable damages would, paradoxically, be in an even more burdensome position than the agent who is held personally liable on an unratified pre-incorporation contract. This is because, while both agents will bear the full liability of the company under the unratified pre-incorporation contract, the latter agent also gains the benefit of the company's rights under the pre-incorporation contract, while the former agent does not.

Thirdly, the awardable damages route would have bizarre consequences in practice. Where the principal company that fails to ratify the pre-incorporation contract is an insolvent company, the third party will obtain *greater* damages from the agent than he would have been able to obtain from the company itself had the company ratified and thereafter breached the pre-incorporation contract. As stated in *Blower v Van Noorden*, to hold the agent liable on the contract itself (that is, for awardable damages) would result in anomalous and inequitable results, whereby the third party would obtain as great an amount of damages from the agent who acts for an insolvent as from the agent who acts for a millionaire.<sup>63</sup>

<sup>62</sup> *In re National Coffee Palace Company* [1883] 24 Ch D 367 at 375, followed in *Blower v Van Noorden* supra note 45.

<sup>63</sup> *In re National Coffee Palace Company* supra note 62 at 375 followed in *Blower v Van Noorden* supra note 45 at 897–900 on the common law.

Significantly, both the New Zealand<sup>64</sup> and British Columbia<sup>65</sup> statutes apply the recoverable measure of damages. Similarly, Australian law has repealed the awardable measure of damages contained in its previous legislation<sup>66</sup> in favour of the recoverable measure.<sup>67</sup>

The practical drawback of choosing the recoverable measure of damages over the awardable measure is that, where the company is insolvent and fails to ratify the pre-incorporation contract, or is non-existent, the third party would be entitled only to nominal damages from the agent for breach of the agent's dual warranty.<sup>68</sup> This would open pre-incorporation contracts to abuse by unscrupulous promoters who deliberately keep the company asset-free, secure in the knowledge that their blatantly deliberate breach of warranty of ratification would entitle the third party to no more than nominal damages (in view of the company's insolvent financial position). Such a promoter could, alternatively, refrain from registering the company, in which event his deliberate breach of warranty of incorporation would also carry mere nominal damages, since it is impossible to establish what a non-existent principal would have been able to pay had it ever come into existence.<sup>69</sup> The unscrupulous promoter might take advantage of these loopholes in circumstances where he no longer wishes the company to be bound by a particular pre-incorporation contract, for example due to changes in market conditions rendering the pre-incorporation contract unprofitable or due to the subsequent availability of a more favourable transaction. It is argued in Part I(5)(c) below that the answer to this sort of abuse lies in the court's discretion to grant just and equitable relief, as this enables the court in an appropriate case to extend the promoter's primary liability for breach of warranty to cover more than what is normally recoverable.

(d) *Who is liable for the damages?*

There is often more than one promoter of a company to be formed and the question then arises who ought to be liable for breach of warranty of incorporation and/or ratification — should it be only the signatory to the pre-incorporation contract or should all the promoters be jointly and severally liable? The statutory provisions of most jurisdictions, including those of Australia and Canada, simply impose liability on the signatory to the pre-incorporation contract.

<sup>64</sup> Section 183(2) of the New Zealand Companies Act 1993.

<sup>65</sup> Section 20(2)(c) of the British Columbia Business Corporations Act; M Gillen *Notes on Business Associations University of Victoria Faculty of Law* (2002) 200 available at [www.law.uvic.ca/mgillen](http://www.law.uvic.ca/mgillen).

<sup>66</sup> Section 81(4) of the Companies Act 1981 provided for damages for breach of warranty in the amount 'which that party could have obtained [in] a *judgment* against the company' [my emphasis].

<sup>67</sup> Section 131(2) of the Corporations Act 2001 provides for damages 'that the company would be liable to *pay* to the [third] party' [my emphasis].

<sup>68</sup> See Gillen *op cit* note 65 at 192 for a similar point on s 20 of the British Columbia Business Corporations Act 2002.

<sup>69</sup> As stated in *Indrieri v Du Preez* 1989 (2) SA 721 (C) at 727 in the context of breach of warranty of authority at common law.

But this may have inequitable results, as is illustrated in *Bay v Illawarra Stationery Supplies Pty Ltd*<sup>70</sup> where the four promoters used the services of Dyke, as their agent, to assist in the establishment of the business of the as yet unformed company, including entering into a pre-incorporation contract with Illawarra. Upon breach of the statutory warranty of incorporation and ratification of the pre-incorporation contract, Illawarra claimed payment of damages. Illawarra claimed the damages from the four promoters, on the ground that since they were in fact the principals of Dyke, they were liable for the damages. The court rejected this contention and held that, since the legislation imposed liability on the person who *executes* the pre-incorporation contract, only Dyke was liable to Illawarra for breach of the statutory warranty, even if he was merely the promoters' agent, and was not himself a promoter.<sup>71</sup> This is a harsh and unfair consequence, since it results in the imposition of liability on the signatory to a pre-incorporation contract without considering whether the signatory was in fact a promoter. In many cases it is not the promoter himself who signs the pre-incorporation contract but an agent, employee, accountant or even a family member or friend.<sup>72</sup> Furthermore, it is often only one promoter out of a group of several co-promoters who signs the pre-incorporation contract and who will accordingly be held solely liable in the event that the company is not incorporated or does not ratify the pre-incorporation contract within a reasonable time.

For the sake of fairness and equity this consequence ought to be avoided in South African law. Liability ought instead to be imposed on all the promoters jointly and severally (as is done by the Dutch Civil Code<sup>73</sup>), notwithstanding the fact that only one promoter (or even none of the promoters but some other person such as an agent, accountant, employee, family member or friend) signed the pre-incorporation contract, provided that the pre-incorporation contract falls within the scope of the promotion. It is also worth considering whether a co-promoter who was not yet a promoter at the time of execution of the relevant pre-incorporation contract ought to be exempted from liability.<sup>74</sup>

#### (4) *Limitations on the agent's liability*

Superimposed on the agent's liability for breach of the dual warranty of incorporation and ratification, ought to be a number of limitations.<sup>75</sup> First, if the pre-incorporation contract is not ratified but is instead novated or

<sup>70</sup> (1986) 4 ACLC 429.

<sup>71</sup> The court also noted that, provided Dyke could prove that he had acted as the agent of the promoters in executing the pre-incorporation contract, he could subsequently (after satisfying Illawarra's claim) recover his loss from the promoters. This however fails fully to overcome the prejudice to the signatory to the pre-incorporation contract.

<sup>72</sup> Maloney *op cit* note 59 at 412n11.

<sup>73</sup> *Supra* note 47. This provides that the promoters of a company remain jointly and severally liable unless the company ratifies the agreement.

<sup>74</sup> See J H Gross 'Pre-incorporation contracts' (1971) 87 *Law Quarterly Review* 367 at 381-2 on the approach of the American courts at the time.

<sup>75</sup> These limitations are to varying extent features of the statutory provisions on pre-incorporation contracts in other jurisdictions.

substituted by a contract between the company and the third party in substantially the same terms, the agent ought to be released from liability for the company's failure to ratify the pre-incorporation contract. Secondly, it would be inequitable in certain circumstances to impose liability on the agent for failure of ratification or of incorporation within a reasonable time, for instance where a group of agents-turned-executive-directors acts contrary to their prior understanding by refusing to ratify a pre-incorporation contract signed by one of them. Consequently, the court should be granted a discretion, where it would be just and equitable to do so, to relieve the agent from his liability for breach of the dual warranty and to instead impose secondary liability on the company for the breach of warranty. This is further discussed in Part I(5)(a) below.

Express exemption from liability as agreed between the agent and the third party ought to provide a third way of limiting the agent's liability. Allowing the parties to exclude the agent's liability if they so wish is essential to the principle of freedom of contract and it would also promote the policy objective, emphasized in the Company Law Policy Paper,<sup>76</sup> of a flexible corporate law system. But third party protection must not be allowed to be circumvented. The third party may not be aware of the legal complexities and implications of a contract made on behalf of a company that is not yet in existence. Consequently, an exemption clause should be recognized in our law only if it is written and expressed in terms that are simple and basic enough for an unsophisticated third party to become aware of the specific remedy that he is waiving.<sup>77</sup> Indeed, both the Saskatchewan and the Ontario courts have ruled that an implied exemption clause is not permissible — see *Landmark Inns of Canada Ltd v Horeak*<sup>78</sup> and *Szecket v Huang*,<sup>79</sup> respectively. Academics in Australia have gone so far as to suggest that a prescribed standard exemption form should be introduced for the release of the promoter's liability.<sup>80</sup> This would certainly be a desirable protective mechanism in the present South African business environment.

Several other jurisdictions (such as Australia and Canada) permit the promoter to exclude not only his primary liability (that is, his liability for breach of the dual warranty) but also his secondary liability under a court order imposing liability on the promoter for the *company's* breach of a ratified pre-incorporation contract (see Part I(5)(b) below). South African law should decline to follow this rather radical approach, and should confine exemption clauses to exclusions of the agent's primary liability. Permitting the agent to exclude his secondary liability would go too far for the relatively unsophisticated South African business environment with its marked disparities in bargaining power between contracting parties. However, in deciding

<sup>76</sup> Supra note 12 at 29.

<sup>77</sup> Maloney op cit note 59 at 428; Hambrook op cit note 38 at 146.

<sup>78</sup> (1982) 18 Sask R 30, [1982] 2 WWR 377 (QB).

<sup>79</sup> (1998) 168 DLR (4th) 402 (Ont CA).

<sup>80</sup> Leon Getz 'Pre-incorporation contracts: Some proposals' 1967 *University of British Columbia LR* 381, at 408–9 cited in Hambrook op cit note 38 at 146.

whether or not to impose secondary liability on the agent, a court could take into account the presence of an exemption clause purporting to exclude the agent's secondary liability, depending on the respective bargaining positions of the parties, the agent's control and influence over the incorporated company and any other relevant facts of the matter.<sup>81</sup>

(5) *Judicial discretion to impose secondary liability*

A statutory solution for balancing the conflicting rights of the agent and the company by simply imposing potential liability on the agent prior to ratification of a pre-incorporation contract, and imposing potential liability on the company following ratification, will not solve all the problems and the abuse of pre-incorporation contracts. Agents could attempt to evade liability by using fly-by-night companies to ratify pre-incorporation contracts, while boards of directors could attempt to avoid the company's becoming liable by wrongfully refusing to ratify pre-incorporation contracts. It would clearly be appropriate in certain circumstances for the company to be held liable on a pre-incorporation contract which it did not in fact ratify (referred to hereafter as secondary liability of the company<sup>82</sup>), while in other circumstances the agent should be held liable for the company's breach of a ratified contract (referred to hereafter as secondary liability of the agent<sup>83</sup>). The statutory provisions on pre-incorporation contracts must therefore 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 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 contract.

(a) *The secondary liability of the company*

A typical example of a situation where the company rather than the agent ought to bear the burden is where the promoters-turned-executive-directors initially have an understanding amongst themselves that the pre-incorporation contract will be ratified by the company upon its formation but subsequently in their capacity as directors without legal justification refuse to ratify it. In such circumstances it would be unfair to the particular promoter who signed the pre-incorporation contract to be held liable to pay damages to the third party for breach of the statutory warranty,<sup>84</sup> since the breach occurred through no fault of his.

The court should therefore have a discretion to adjust the equities between the company and the promoter, and to impose the signatory

<sup>81</sup> Maloney op cit note 59 at 429.

<sup>82</sup> Roman Tomasic & Stephen Bottomley *Corporations Law in Australia* (1995) 240.

<sup>83</sup> Ibid.

<sup>84</sup> This consequence would be avoided by adopting the suggestion in Part I(3)(d) above that liability ought to be imposed on all the promoters jointly and severally, as opposed to on the signatory alone.

promoter's liability on the company itself. This would bring about a fair balance of the conflicting rights and liabilities of the company and the agent while ensuring that the third party is not left without a remedy in circumstances where a court might find it inequitable to burden the agent or promoter with liability. It is a prominent feature of the company laws of many leading jurisdictions, including Australia, New Zealand and Canada, that the court is granted the power to impose secondary liability on the company.

The court's discretion to impose secondary liability on the company should not be restricted merely to all or part of the damages suffered by the third party following the breach of the statutory warranty, but should also extend to validating the pre-incorporation contract either in whole or in part.<sup>85</sup> The company may have received real or personal property under an unratified pre-incorporation contract and thus be unjustifiably enriched at the expense of the third party, and the statute should address the right of the third party to obtain restitution under these circumstances. The company might also be unjustifiably enriched at the expense of the agent, in which event the agent should also be granted the right to apply to the court for a remedy against the company.<sup>86</sup> This is particularly relevant in the interim period where, as explained in Part III below, the agent may personally perform an obligation that is due by the (as yet unformed) company under the pre-incorporation contract, in order to prevent the third party from unilaterally withdrawing or resiling from the pre-incorporation contract. In addition to the above remedies, the court should also be given a wide catch-all discretion to make any order it considers fit, or any order which is just and equitable; see, for example, the New Zealand,<sup>87</sup> Australian<sup>88</sup> and Canadian<sup>89</sup> statutory provisions.

*(b) Secondary liability of the agent — the abuse of the fly-by-night company*

The typical situation where the agent should be saddled with the company's liability is the case of the 'fly-by-night company' (also known as opportunistic adoption or sham incorporation),<sup>90</sup> where the agent, in the realization that a pre-incorporation contract is no longer beneficial, procures a shell company or an insolvent company to ratify the contract, so that the third party is left with a meaningless right of action against a company without assets, with the result that the agent effectively escapes liability for breach of the statutory warranty. The fly-by-night company enables promoters to

<sup>85</sup> As in s 184(1) of the New Zealand Companies Act 1993.

<sup>86</sup> See e.g. s 20(5) of British Columbia Business Corporations Act 2002 which clearly permits this. Section 14(2) of the Canada Business Corporations Act 1985 and s 184(1) of the New Zealand Companies Act 1993 also appear to allow scope to the promoter to approach the court for a remedy against the company for unjust enrichment.

<sup>87</sup> Section 184(1) and (2) of the New Zealand Companies Act 1993.

<sup>88</sup> Australian Corporations Act 2001 (Cth), s 131(3).

<sup>89</sup> Canada Business Corporations Act 1985, s 14(3).

<sup>90</sup> Gillen op cit note 65 at 195; Tomasic & Bottomley op cit note 82 at 241.

speculate at the expense of third parties, by having the company adopt favourable pre-incorporation contracts but to avoid liability on unfavourable ones.

Another instance where the company's liability would be more appropriately borne by the agent is demonstrated by the facts of *Landmark Inns v Horeak*,<sup>91</sup> where Horeak, in his capacity as promoter for an optical company to be formed, had signed a contract with the plaintiff to lease premises in the plaintiff's shopping centre, causing the plaintiff to renovate the premises according to the lessee's specifications. Horeak thereafter decided to lease alternative and more desirable premises. When Horeak notified the plaintiff that he had no intention of proceeding with the lease, the plaintiff claimed damages against him for the cost of renovations and several months of lost rent. In order to avoid liability under the plaintiff's claim, Horeak subsequently incorporated the company and caused it to adopt the contract of lease with the plaintiff, in order to avoid personal liability for the damages claimed by the plaintiff. The company was an empty shell with no assets. In an equitable decision, the court rejected Horeak's contention and held him to be personally liable for the damages claimed by the plaintiff.<sup>92</sup>

Like secondary liability of the company, secondary liability of the agent is a widely adopted trend seen in, inter alia, Australia, Canada and New Zealand. But, for the reasons elaborated in Part I(2) above, the discretionary secondary liability of the agent ought not to extend so far as to hold the agent primarily liable under the contract itself. The court's discretion should be confined to apportioning to the agent his fair share of the damages suffered by the third party consequent upon the company's breach of contract.<sup>93</sup> In exercising its discretion the court should take into account a number of relevant factors, such as the capitalization of the company and the control which the promoter has over the incorporated company.

Imposing secondary liability on the agent for the company's breach of contract is in effect a form of statutory piercing of the corporate veil,<sup>94</sup> where the company's separate legal personality is disregarded and liability for the company's breach is imposed on the agent. This indeed was suggested in *Botha v Van Niekerk*,<sup>95</sup> where the court considered the legal principles on lifting of the corporate veil. Parallels may be drawn between the facts of this case and the agent's secondary liability. A contract for the sale of land was concluded between the applicant and Van Niekerk 'or his nominee'. After the applicant demanded a guarantee for payment of the balance of the

<sup>91</sup> [1982] 2 WWR 377 (QB).

<sup>92</sup> However, the court did not rely on its discretion to apportion liability between the company and the promoter in terms of s 14(3) of the Canada Business Corporations Act, but instead justified its decision by stating that a company may not adopt a contract that has already been repudiated. The basis of the court's decision has been criticised by Gillen op cit note 65 at 197, who is of the view that the facts of the case clearly called for application of s 14(3).

<sup>93</sup> See e.g s 131(4) of the Australian Corporations Act 2001 (Cth); s 185 of the New Zealand Companies Act 1993.

<sup>94</sup> Tomasic & Bottomley op cit note 92 at 241.

<sup>95</sup> 1983 (3) SA 513 (W).

purchase price, Van Niekerk adopted the attitude that a nomination had taken place and that the second respondent — a company which had been incorporated after the date of the contract and had an issued share capital of only R1 — had replaced him as the purchaser. The applicant argued that the second respondent was merely Van Niekerk in another guise and that the court ought accordingly to lift the veil of incorporation and enforce the contract against Van Niekerk. The court, however, rejected the applicant's contention and reasoned that the applicant had of her own accord contracted herself into that position, that she had not stipulated that the nominee was required to have sufficient financial means and that it was still possible that the company would be able to raise sufficient funds. The court consequently found on the facts that the applicant had suffered no unconscionable injustice.

In the context of the Liability Proposal, however, the statutory piercing of the veil in order to impose secondary liability on the agent where it is just and equitable to do so would be appropriate in view of the potential for abuse of pre-incorporation contracts by agents. It would also serve to balance the conflicting rights of the agent, the company and the third party. The alternative, a third statutory warranty by the agent of the company's future solvency, would, as pointed out above, be unreasonably burdensome to the agent.

As discussed in Part I(4) above, South African law should decline to follow the radical approach of permitting the agent to exempt himself from a court order of secondary liability.

(c) *Should the court be empowered to increase the agent's primary liability?*

As discussed in Part I(3)(c), although the statutory measure of damages for the agent's breach of his dual warranty of incorporation and ratification should be the amount of damages *recoverable* from the company and not the (sometimes higher) amount of damages *awardable* against the company, a major disadvantage of the recoverable damages measure is that where the company is insolvent or never formed, the third party would be left with the valueless remedy of nominal damages against the agent. This leaves an unsatisfactory loophole in that an unscrupulous agent may audaciously breach his dual warranty, secure in the knowledge that, since he has deliberately kept the company asset-free, his soul primary liability will be for nothing worse than an award of nominal damages.

Canadian law, where the personal liability approach is followed, avoids this problem because the agent is held personally liable *on the contract itself* failing or pending incorporation and ratification. The British Columbia Act,<sup>96</sup> despite providing damages in the recoverable measure for the agent's breach of warranty, nevertheless provides scope for a remedy against an agent's audacious breach of warranty in that s 20(6) permits an application to court, *whether or not the pre-incorporation contract is adopted*, for an order 'setting

<sup>96</sup> *Supra* note 24.

the obligations of the new company and the facilitator under the pre-incorporation contract as joint or as joint and several'. Section 131 of the Australian Corporations Act, however, regrettably leaves room for just this type of abuse. Although it permits the judicial imposition of secondary liability on the agent, it adopts the damages recoverable measure for the agent's primary liability<sup>97</sup> without empowering the court to increase the agent's primary liability where appropriate.<sup>98</sup>

This very serious shortcoming in the statutory warranty approach can be avoided by extending the court's discretion so as to empower it, when just and equitable, to impose greater *primary* liability on the agent, over and above an order for damages in the recoverable measure, in the event that the company is not incorporated or fails to ratify the pre-incorporation contract. This additional liability could take the form of a higher delictual or 'awardable' measure of damages or any other appropriate order.

## II THE RATIFICATION STAGE

### (1) *A positive step of ratification or a deemed acceptance with a right of rejection?*

Section 35 of the Companies Act presently requires a company to take a positive step to bind itself to a pre-incorporation contract — the company must ratify the pre-incorporation contract. An alternative approach would be to provide that a company, upon its incorporation, automatically becomes bound by a pre-incorporation contract made on its behalf, which may or may not be coupled with a right to reject the pre-incorporation contract. Which of these mechanisms would be most suitable if the Liability Proposal is accepted requires careful consideration.

Automatic binding of the company upon its incorporation with no right of rejection must be firmly avoided in South African law. This would make unacceptable inroads into the fundamental principle of company law theory that the company has its own separate legal personality. As Gross has compellingly stated:<sup>99</sup>

'It is one thing to subject shareholders and creditors to the normal risks of the business, and quite another to increase these by saddling the corporation with burdens imposed upon it in advance by overly optimistic promoters. The management of the corporation elected by the shareholders should be free to decide for itself what obligations are to be assumed or incurred.'

Although automatic adoption by the company without a right of rejection has the advantage of protecting the reliance interest of the third party on the

<sup>97</sup> That is, damages for breach of warranty in 'the amount that the company would be liable to *pay* to the [third] party if the company had ratified the contract and then did not perform it at all' — s 131(2) of the Corporations Act 2001.

<sup>98</sup> Even if s 131(3) of the Australian Corporations Act, 2001 could be interpreted to allow a court to remedy the agent's audacious breach of warranty by empowering the court to 'do anything that it considers appropriate' where proceedings are brought to recover damages for the agent's breach of warranty, s 131(3) applies only where the where the company is *incorporated and fails to ratify* a pre-incorporation contract. It therefore still leaves room for the audacious agent to escape liability by deliberately refraining from *registering* the company.

<sup>99</sup> Gross *supra* note 84 at 368–9.

pre-incorporation contract, it goes much too far in tilting the balance of the conflicting rights of the parties in favour of the third party. The third party's interests are more appropriately protected by giving the court discretion to impose secondary liability on the company as proposed above.

Both a positive step of ratification and an automatic 'adoption' with the option of rejection respect the principle of separate corporate personality by giving the company freedom of choice in respect of the pre-incorporation contract, but the first of these pays greater heed to this principle. It is more likely that the company will be fully versed with the terms of the pre-incorporation contract and that the appropriate organ of the company will properly exercise its judgment on the contract if it has to resolve to ratify it. A deemed acceptance by the company carries the distinct risk that the corporation may omit a careful perusal or indeed any perusal of the pre-incorporation contract and yet find itself bound by it.

The current requirement in s 35 of a positive step of ratification should therefore be retained. This is particularly important if the formalities of s 35 were to be abolished as suggested in Part IV below. A side-effect of abolishing these formalities is that less attention will be drawn to pre-incorporation contracts, including the attention of the company and its corporate organs.

An interesting question arises in the area of pre-incorporation contracts for the provision of legal services to incorporate the company and the payment by agents of incorporation fees — if agents run the risk of being held liable for the fees involved in setting up a company in the event that the company once incorporated fails to ratify the relevant agreement, agents would no doubt shy away from forming companies. Ought a narrow exception to be made in these cases, in terms of which companies once incorporated become automatically bound, without the option of rejection, to pay reasonable incorporation costs?<sup>100</sup> Even in these circumstances, inroads into the principle of separate corporate personality are not justified. There are other more effective safeguards to protect the agent. First, the company's articles of association<sup>101</sup> commonly contain an article empowering the directors to reimburse the promoters for the costs of promotion and incorporation. In most cases the board of directors simply reimburses the promoters (particularly where the promoters are the majority or sole directors on the board) and no problems arise. Secondly, if the directors refuse to reimburse the promoters, the latter could, on an extension of the principle in *In Re New British Iron Company*,<sup>102</sup> arguably rely on an implied contract, based on the incorporated company's articles of association, that the

<sup>100</sup> Arthur R Pinto & Douglas M Branson *Understanding Corporate Law* (1999) 27 state that in American law (Iowa) adoption by the company is nonetheless required in these circumstances. By contrast, Maloney op cit note 59 at 420 contends that the company should be automatically and involuntarily liable for reasonable compensation provided that the services were necessary and there was an understanding that the services would be paid for by the company.

<sup>101</sup> See e.g. art 59 of Table A and art 60 of Table B in schedule 1 of the Companies Act 61 of 1973.

<sup>102</sup> [1898] 1 Ch 324, which held that a director could rely on an implied contract of employment with the company based on the company's articles of association.

company would reimburse them. Thirdly, the agent may apply to court for an order in the interests of justice and equity (as discussed in Part I(5)(a) above), which could include either an order imposing secondary liability on the company for the unratified legal services contract or alternatively, an order that the company must compensate the agent in the amount of the incorporation fees by which the company was unjustifiably enriched.

(2) *The manner of ratification*

Unlike the Close Corporations Act,<sup>103</sup> which specifies the manner in which a close corporation must ratify a pre-incorporation contract (by way of the consent in writing of all the members of the close corporation), s 35 of the Companies Act does not provide for any special ratification procedure. Similarly, s 131 of the Australian Corporations Act 2001, like its predecessor, s 81 of the Companies Act 1981, does not specify the manner of ratification. In view of the silence of the legislation on this matter, it has been suggested that Australian law generally requires a board resolution to ratify a pre-incorporation contract.<sup>104</sup> In Canadian law, it has similarly been stated that the clearest form of adoption is a formal resolution of the board of directors after incorporation,<sup>105</sup> while in New Zealand, although such a degree of formality is not required in all cases,<sup>106</sup> a board resolution is recommended and is usually obtained in practice.<sup>107</sup> On the other hand, the manner of ratification of a pre-incorporation contract in French law is not by resolution of the board of directors but rather by a resolution of the company in general meeting.<sup>108</sup>

In South African law a board resolution should generally suffice for the ratification of a pre-incorporation contract, particularly since it is the board that is responsible for the day-to-day running of the company (art 59 of Table A and art 60 of Table B in schedule 1 of the Companies Act). South African law ought not generally to require a resolution of the company in general meeting for ratifying a pre-incorporation contract, save in special circumstances where the board cannot be said to be an independent board for the purposes of ratifying the pre-incorporation contract in question. Such circumstances would exist, for example, where the majority of the board were previously promoters of the company who were involved in executing the pre-incorporation contract and who therefore have an interest in ensuring that the company ratifies the pre-incorporation contract, resulting in their consequent release from any liability for breach of the dual statutory

<sup>103</sup> Section 53 of the Close Corporations Act 69 of 1984.

<sup>104</sup> Hambrook op cit note 38 at 141 on s 81 of the Australian Companies Act 1981.

<sup>105</sup> Maloney op cit note 59 at 416.

<sup>106</sup> The New Zealand Companies Act 1993, s 184(2) states that a pre-incorporation contract may be ratified by a company in the same manner as a contract may be entered into on behalf of a company, taking into account the formalities for entering into contracts generally.

<sup>107</sup> CCH New Zealand Limited 'Ratifying a pre-incorporation contract' available at [www.ch.co.nz/co\\_law/articles/incorp.asp](http://www.ch.co.nz/co_law/articles/incorp.asp).

<sup>108</sup> This is the case where the pre-incorporation contract is not mentioned in the company's constitution and is, therefore, not deemed to be automatically adopted by the company: see Omar op cit note 25 at 86.

warranty of incorporation and ratification. Although the fiduciary duties of the promoters and the board to act in good faith and in the best interests of the company may deter any improper conduct, it would nonetheless be prudent for the board to leave the ratification of the pre-incorporation contract to the company in general meeting, in order to avoid a potential conflict of interest.<sup>109</sup>

Important issues arise on the question of implied ratification or ratification by the conduct of executive directors.

Canadian law permits adoption 'by any action or conduct signifying [the company's] intention to be bound',<sup>110</sup> while case law in Singapore<sup>111</sup> and France<sup>112</sup> is to the effect that ratification may be implied by the conduct of a corporate organ. Ratification by conduct may certainly enhance business efficiency<sup>113</sup> and business convenience, as well as serve the interests of third parties where companies inadvertently overlook the express ratification of a pre-incorporation contract. It would also bring s 35 pre-incorporation contracts into closer alignment with both pre-incorporation contracts concluded by stipulatio alteri (whereby adoption of the benefit is a question of fact dependent on the circumstances of the case and bearing no formalistic requirements)<sup>114</sup> as well as with common-law agency principles (which recognize both express and implied ratification).<sup>115</sup> Nonetheless, these considerations are outweighed by the negative consequences of ratification by conduct, and for this reason South African law ought to confine itself to recognizing only express ratification of pre-incorporation contracts.

First, permitting implied ratification by conduct would result in uncertainty as to when and whether pre-incorporation contracts have in fact been ratified.<sup>116</sup> Difficult distinctions would have to be drawn between the types of conduct by corporate organs that would amount to implied ratification, taking account of the differing facts and circumstances of each case, and this

<sup>109</sup> For further discussion of these issues, see Maloney op cit note 59 at 422 on Canadian law.

<sup>110</sup> Section 14(3) of the Canada Business Corporations Act 1985.

<sup>111</sup> *Cosmic Insurance Corporation Limited v Khoo Chiang Poh* [1981] 1 MLJ 61 cited in Omar op cit note 25 at 87n64.

<sup>112</sup> See Omar op cit note 25 at 86.

<sup>113</sup> *Sherwood Design Services* supra note 1 para 22. But see further below.

<sup>114</sup> Meskin et al op cit note 39 at 63.

<sup>115</sup> Kerr op cit note 53 at 101.

<sup>116</sup> However, if ratification by conduct is to be permitted in South African law, whether or not an implied ratification has occurred may well depend on all the circumstances of the case, with the essential elements of a valid ratification being (i) conduct by a corporate organ signifying a corporate *intention* to be bound and (ii) full *knowledge* by the corporate organ of the terms of the contract, as is the general principle relating to common law ratification (*Mort v Henry Shields-Chiat* 2000 (1) SA 464 (C) at 472I; B P Wanda (original text by J C de Wet) 'Agency and Representation' para 200 in W A Joubert (ed) *Law of South Africa* 2 ed vol 1). A similar principle is applied in the USA in the context of pre-incorporation contracts. Maloney advocates similar principles in Canadian law (op cit note 59 at 416–26).

Typical forms of ratification by conduct are acceptance by the company of benefits under the pre-incorporation contract or the performance by the company of the pre-incorporation contract, together with the essential prerequisite of knowledge by the company of the pre-incorporation contract — according to American law, and cited with approval in the Canadian context (Maloney op cit note 69 at 418; Pinto & Branson op cit note 100 at 27 on American law).

If the formalities in s 35 are abolished as proposed in Part IV below, this will have a significant negative effect on proof of the essential element of knowledge by the company of the pre-incorporation contract.

would inevitably result in disputes and wasted costs and resources. Whether or not the company's silence or inactivity<sup>117</sup> may amount to ratification would cause further complexities. The decision of the Ontario Court of Appeal in *Sherwood Design Services Inc v 872935 Ontario Ltd*<sup>118</sup> is a good illustration of how a court may go too far in implying ratification by conduct. In this case, the purchaser's lawyers had a practice of incorporating a number of shelf companies, for ready availability for use by their clients at short notice. The sole director of each of these shelf companies was R J Fuller, one of the partners in the law firm. The purchaser's lawyers in this case wrote a letter to the vendor's lawyers merely informing them that such a company had in fact been incorporated to complete the asset purchase. At that stage none of the necessary administrative company documents had even been completed and the purchasers were not yet installed as the directors and shareholders of the shelf company; instead, R J Fuller was still reflected as the shelf company's sole director. The court nevertheless held that the letter amounted to a sign of the company's intention to adopt the contract.

Secondly, ratification by conduct, which is justified on the grounds of business efficiency and convenience, would arguably fail to achieve these objectives to any significant degree. Since a promoter is potentially liable for damages on an unratified pre-incorporation contract (as discussed under the Liability Proposal above), the promoter has an interest in the contract; consequently, the promoter-turned-executive-director would be under a fiduciary duty to disclose his interest in the pre-incorporation contract to the board, before engaging in any conduct which signifies ratification. Since the disclosure of a promoter or director's interest in a contract has certain formalities of its own (see ss 234–40 of the Companies Act, 1973), ratification by conduct would be no less formalistic than express ratification by board resolution.

Finally, where the promoter becomes the sole or majority director and shareholder of the company, it would be difficult to prove whether the company has knowledge of the pre-incorporation contract. Because the knowledge of all the organs of the company in such a case (that is, the board of directors and the shareholders in general meeting) will be constituted by the knowledge of the promoter<sup>119</sup> — it would be practically impossible to determine when the knowledge of the promoter may be imputed to the company.<sup>120</sup> Hence implied ratification would cause more problems than it would solve and ought to be avoided.

### (3) *The retrospective effect of ratification*

Whether or not ratification of a pre-incorporation contract under s 35 in its present form has retrospective effect is uncertain and has been the subject of

<sup>117</sup> American law recognizes ratification of pre-incorporation contracts by silence or inactivity (Pinto & Branson op cit note 100 at 26), as does South African common law (Kerr op cit note 53 at 102–3).

<sup>118</sup> Supra note 1.

<sup>119</sup> This is simply the organic theory for which see *Bolton (Engineering) Co Ltd v Graham & Sons* [1957] 1 QB 159 (CA) and *Lenard's Carrying Co v Asiatic Petroleum* [1915] AC 705.

<sup>120</sup> Maloney op cit note 59 at 422.

considerable academic debate. This is an important practical issue, as it determines the point at which the company obtains rights and incurs obligations under the contract, for example, when the profits of a business which is the subject of a pre-incorporation contract accrue to the company.<sup>121</sup>

The reform of the Companies Act must put it beyond doubt that a pre-incorporation contract does have retrospective effect, and furthermore, that the retrospectivity extends to the date that the contract was made by the agent and the third party and not merely to the date that the company was incorporated. Attributing retrospectivity to s 35 would not only be in line with the concept of ratification at common law, but would also contribute to settling the juridical nature of the pre-incorporation contract and the nature of the rights and obligations of the parties in the interim period prior to ratification. Clearly, however, the contract may expressly suspend the rights and obligations of the company and the third party until after ratification.

Without a clear legislative indication, ratification may not have any retrospective effect.<sup>122</sup> Great care must therefore be taken in drafting appropriate wording. There is an international trend of adopting wording to the effect that when a company ratifies a pre-incorporation contract it is bound as if the company had been formed before the contract was entered into and had been a party to the contract. This wording is followed in the statutory provisions of Ontario,<sup>123</sup> Canada,<sup>124</sup> New Zealand,<sup>125</sup> Ireland,<sup>126</sup> Ghana<sup>127</sup> and Malaysia,<sup>128</sup> as well as in previous Australian provisions.<sup>129</sup> The correct interpretation of this popular wording has been subjected to controversial academic debate. It does not go far enough to show a clear and unambiguous legislative intention of the retrospectivity of pre-incorporation contracts. Ford's interpretation<sup>130</sup> of this popular wording is that in the absence of a legislative intention that the contract should have retrospective effect, the contract can be deemed to have been made no earlier than the time of *incorporation* of the company. The opposing view is that ratification in

<sup>121</sup> *Peak Lode* supra note 45. Richard Jooste 'When do pre-incorporation contracts have retrospective effect?' (1998) 115 *SALJ* 507 at 507.

<sup>122</sup> H A J Ford, R P Austin & I M Ramsay *Ford's Principles of Corporations Law* 9 ed (1999) para 15.290 commenting on s 131(1) of the Australian Corporations Act 2001, which merely states that 'the company becomes bound by the contract and entitled to its benefit if the company, or a company that is reasonable identifiable with it, is registered and ratifies the contract'.

<sup>123</sup> Section 21(2) of the Ontario Business Corporations Act supra note 37 states that the corporation is bound 'as if the corporation had been in existence at the date of the contract and had been a party thereto'.

<sup>124</sup> Section 14(2) of the Canada Business Corporations Act 1985 contains identical wording to the Ontario provision.

<sup>125</sup> Section 182(3) of the New Zealand Companies Act 1993 states that '[a] contract that is ratified is as valid and enforceable as if the company had been a party to the contract when it was made'.

<sup>126</sup> Section 37(1) of the Companies Act 33 of 1963. It has been contended that the wording of the Irish Companies Act, although not clear, means that the liability of a company on a pre-incorporation contract is backdated (Omar op cit note 25 at 85).

<sup>127</sup> Omar op cit note 25 at 86.

<sup>128</sup> Section 35(1) of the Companies Act 125 of 1965.

<sup>129</sup> Section 81(3) of the Corporations Act 1981 and s 183(3) of the Australian Corporations Law enacted as part of the Corporations Act 1989 (Cth) (as amended by the Corporations Legislation Amendment Act 1990).

<sup>130</sup> In the context of s 183(3) of the Australian Corporations Law (Ford op cit note 36 para 555).

such terms gives the contract legal effect from the time it was *entered into* by the agent and the third party and not only from the time of incorporation of the company.<sup>131</sup> Similarly, the Ontario statutory provision has been judicially interpreted by the Ontario Court of Appeal<sup>132</sup> to mean that adoption is retroactive to the date the agreement was signed. It is conceivable that the Canadian statute would be interpreted in the same vein, in view of its identical (retrospectivity) wording to the Ontario Act. In respect of the Irish Companies Act, it has been contended that the wording, although not clear, means that the liability of the company is backdated.<sup>133</sup>

The popular wording may be compared to the current wording of s 35, that a pre-incorporation contract 'shall be capable of being ratified . . . as if it [the company] had been duly incorporated at the time when the contract was made and such contract had been made without its authority'. On a literal reading this seems to suggest that ratification under s 35 has retrospective effect, but it is arguably even less clear than the popular wording.<sup>134</sup> In redrafting s 35 so as to evince a clear and unambiguous legislative intention that the company is bound retrospectively from the date the pre-incorporation contract was *entered into* by the agent and the third party South African law would do well to learn from the experience of other jurisdictions and to go beyond the popular wording.

### III THE INTERIM PERIOD — PRIOR TO RATIFICATION

Debate has raged amongst academic writers concerning the rights of the parties in the period between the execution of the pre-incorporation contract by the agent and the third party, and the company's ratification of the pre-incorporation contract. Section 35 neglects to provide a solution.<sup>135</sup> Indeed, even the common-law agency principles (in relation to existent principals) are unsettled on these points. In the interests of certainty and efficiency, and to provide a comprehensive statutory solution to the conundrum of pre-incorporation contracts, the amendments to s 35 ought to clarify the legal position during the interim period. Of particular practical significance is the issue whether the third party may unilaterally withdraw from a pre-incorporation contract prior to its ratification, and if not, how

<sup>131</sup> Under s 81(3) of the Corporations Act 1981, which contains substantially the same wording as s 183(3) of the Australian Corporations Law *supra* note 129 (C Gerrard 'Stamp duty implications of pre-incorporation Contracts' (1984) 12 *Australian Business Law Review* 266).

<sup>132</sup> 1394918 *Ontario Ltd v 1310210 Ontario Inc* *supra* note 42 para 6.

<sup>133</sup> Omar *op cit* note 25 at 85.

<sup>134</sup> The retrospective effect of s 35 has been extensively debated. *Peak Lode v Union Government* (*supra* note 45) held, in the context of s 71 of the Companies Act 1926 which contained similar retrospectivity wording to s 45, that a ratified pre-incorporation contract does not operate retrospectively. The decision was supported by obiter dicta in *Semer v Retief & Berman* *supra* note 39 at 192–3, *Martian Entertainment (Pty) Ltd v Berger* 1949 (4) SA 583 (E) and *Gaybelle Investments (Pty) Ltd v Hemmer* 1951 (1) SA 486, 488. However academics widely contend that the decision and the reasoning in *Peak Lode* are incorrect, and will be overruled at an appropriate opportunity.

<sup>135</sup> The Australian and New Zealand provisions likewise fail to provide for the interim period, resulting in similar debate and confusion in those jurisdictions. See Tomasic & Bottomley *op cit* note 82 at 242; Hambrook *op cit* note 38 at 133; Gerrard *op cit* note 131 at 277.

and by whom this is to be enforced. Another issue is whether the agent and the third party are able to cancel a pre-incorporation contract by agreement prior to its ratification by the company.

Opting for the personal liability approach rather than the statutory warranty approach as the mechanism for imposing liability on the agent for an unratified pre-incorporation contract would automatically take care of the interim period, because the agent, being a party to the contract, would prior to ratification be bound by its obligations and entitled to its benefits; consequently, unilateral withdrawal by the third party would be precluded while mutual cancellation by the agent and the third party would clearly be permissible. However, as explained in Section II(b) above, there are compelling reasons for rejecting the personal liability approach in favour of the statutory warranty approach. For this reason the Liability Proposal must be coupled with a statutory solution relating to the interim period.

(1) *Unilateral withdrawal*

(a) *May the third party unilaterally withdraw during the interim period?*

Whether or not the third party has the right to withdraw unilaterally from a pre-incorporation contract prior to its ratification by the company remains controversial and is guided by no decisive authority.<sup>136</sup> However, in order to enable s 35 to achieve its true purpose, which is to enable promoters to secure legal rights for unformed companies, it is imperative to preclude unilateral withdrawal. If the third party is able to withdraw at will, a s 35 pre-incorporation contract would be no more effective than a gentleman's agreement or an offer by a nuntius, and this would negate the worth of the provision.<sup>137</sup>

Furthermore, if promoters are liable to third parties in respect of unratified pre-incorporation contracts, it would be inequitable if the third parties were permitted to dishonour their own undertakings by unilateral withdrawal. Precluding unilateral withdrawal would also promote commercial certainty — often the very formation of the company depends upon the conclusion of a valid and binding pre-incorporation contract, and, in the absence of a binding pre-incorporation contract, the entire promotion may fail.<sup>138</sup>

Finally, and more critically, the *retrospective* effect of pre-incorporation contracts would be difficult to reconcile with a conceptualization of s 35 as a 'revocable' offer from the third party's perspective which he may revoke at any time before the company's acceptance or ratification.<sup>139</sup>

<sup>136</sup> *Peak Lode* supra note 45 at 53 suggests that unilateral withdrawal by the third party is not possible, by its remark that a pre-incorporation contract has the effect of granting an option to the company.

<sup>137</sup> M S Blackman, R D Jooste & G K Everington *Commentary on the Companies Act* vol I (2002, loose-leaf) 4–11.

<sup>138</sup> Victorian Law Commission op cit note 38 § 13.

<sup>139</sup> *1394918 Ontario Ltd* supra note 42 para 10 (in the context of a s 21(4) contract under the Ontario Business Corporations Act supra note 37, where the personal liability of the promoter on the pre-incorporation contract is expressly excluded); Ford, in a letter to Hambrook dated 6 April 1982, in Hambrook op cit note 38 at 141.

It would therefore be fitting, as a general principle, to preclude unilateral withdrawal by the third party prior to ratification, provided that the specified or a reasonable time for ratification has not elapsed.<sup>140</sup>

An exception to the general prohibition on unilateral withdrawal ought perhaps to be made where performance of the pre-incorporation contract by the company falls due at a time when it is still not incorporated. In this circumstance it might be unfairly prejudicial to the third party if it were precluded from resiling from the pre-incorporation contract despite non-performance by the company of a currently due obligation. The solution to this problem does not lie in breach of warranty by the agent — the fact that an obligation is due by the not-yet-existent company does not necessarily mean that a reasonable time for incorporating the company has elapsed.<sup>141</sup> The principles laid down in *Nine Hundred Umgeni Road (Pty) Ltd v Bali*<sup>142</sup> should be extended to such a case so as to give the third party a right to withdraw unilaterally in these limited instances unless the *agent* performs the company's obligation in order to stave off cancellation. The agent would, of course, assume the risk of the company failing to reimburse him for his performance; but provided that the obligation so performed by the agent is reasonable, there appears to be no reason why the agent should not be able to recover his expenses by relying on the court's discretion to impose secondary liability on the company, pursuant to the company's unjustifiable enrichment at the agent's expense (see Part I(5)(a) above).

(b) *The consequences of a wrongful unilateral withdrawal by the third party*

The enforcement of the general prohibition on unilateral withdrawal from an as yet unratified pre-incorporation contract is a complex question. Since the agent (on the Liability Proposal above) is not a party to the pre-incorporation contract pending its ratification, the agent is not in a position to interdict the unilateral withdrawal by the third party.<sup>143</sup> The company, clearly, is also not in a position to interdict the third party as it is not yet in existence.

This may be compared with a pre-incorporation contract concluded by way of a *stipulatio alteri*, where the promoter acts as a principal and not as an agent, and can therefore interdict a unilateral withdrawal from the pre-incorporation contract by the third party.<sup>144</sup> Similarly, in jurisdictions

<sup>140</sup> However at common law when an agent acts without the authority of his existent principal, although the issue of unilateral withdrawal is an open question, Kerr's view is that the third party is not bound to the agent to abide by the transaction pending ratification and may withdraw unilaterally at any time before ratification by the principal (Kerr op cit note 53 at 107). It is submitted that ratification under s 35 should differ from common law ratification in this respect.

<sup>141</sup> *Racc (Mooifontein) (Pty) (Ltd) v Devonport Investment Holding Co (Pty) Ltd* 1976 (1) SA 299 (W) at 302–3.

<sup>142</sup> Supra note 39 in the context of a pre-incorporation contract entered into by a trustee (a *stipulatio alteri*) which does not provide for the personal liability of the trustee.

<sup>143</sup> This may be contrasted with the view of Blackman et al op cit note 137 at 4–11 that an agent under s 35 may hold the third party to the pre-incorporation contract prior to the elapse of the reasonable time for ratification.

<sup>144</sup> *Semer v Retief* supra note 39; *McCulloch v Fernwood Estate* supra note 3.

where the promoter is deemed to be the principal on the contract prior to ratification (and where the promoter's personal liability is not expressly excluded in the pre-incorporation contract), the answer is clear that the promoter has full control over the agreement prior to ratification,<sup>145</sup> and is able legally to prevent a withdrawal by the third party or to accept the third party's repudiation.<sup>146</sup>

In the context of the Liability Proposal made in this article the answer must be that, when the third party purports to withdraw or repudiate before ratification, the *company*, upon its incorporation and ratification of the pre-incorporation contract, acquires all the rights in respect of the contract, including the right to sue the third party for its breach of the pre-incorporation contract.<sup>147</sup> The effect thus is that prior to ratification, no one is entitled to sue the third party for breach of the pre-incorporation contract, but upon ratification, the company obtains the benefits of the contract with *retrospective* effect, including the right to sue for repudiation, whether for damages or, depending on the circumstances, for specific performance.

A pre-incorporation contract under s 35 may therefore be viewed as an inchoate or 'nascent' or emerging contract, the enforceability of which is suspended until the company is incorporated and ratifies the contract.<sup>148</sup> The agent may be regarded as a 'functionary'<sup>149</sup> who ensures that necessary deadlines and obligations under the pre-incorporation contract are met so that the third party is not excused from its obligations under the contract (see Part III(1)(a) above). Upon ratification of the pre-incorporation contract the company gains all rights and the benefits of the contract — including the right to sue the third party for its repudiation. Significantly, the fact that the third party repudiated the pre-incorporation contract does not mean that there is nothing left for the company to ratify — a right to sue the third party remains. This approach was, in fact, applied by the Ontario Court of Appeal in *1394918 Ontario Ltd v 1310210 Ontario Inc*<sup>150</sup> in considering a contract that contained an express exclusion of the promoter's personal liability.<sup>151</sup> Such a contract under the Ontario Act gives rise to the same complexities regarding the juridical nature and enforcement in the interim period as a pre-incorporation contract subject to the statutory warranty type of liability

<sup>145</sup> Hambrook op cit note 38 at 135.

<sup>146</sup> See *Landmark Inns* supra note 78 for an application of this principle in Canadian law.

<sup>147</sup> As held by the Ontario Court of Appeal in the *1394918 Ontario Ltd* case supra note 52.

<sup>148</sup> *1394918 Ontario Ltd* supra note 52 para 9.

<sup>149</sup> *Ibid.*

<sup>150</sup> Supra note 42, decided under the Ontario Business Corporations Act (supra note 37), which applies the personal liability approach, subject to s 21(4) which empowers the promoter and the third party to exclude the promoter's personal liability on the pre-incorporation contract pending or failing ratification by the company.

<sup>151</sup> This may be contrasted to *Landmark Inns* supra note 78, where the promoter repudiated the contract and the third party accepted the repudiation, resulting in a judgment by the court that the contract was at an end, and that the company could not ratify it since there was nothing left to ratify. The crucial distinction between this case and *1394918 Ontario Ltd* is that in the *Landmark Inns* case the promoter was personally liable on the pre-incorporation contract under s 14 of the Canada Business Corporations Act. Therefore the promoter in *Landmark Inns* had full control over the pre-incorporation contract in the interim period and was able to bring all rights under it to an end.

contained in the Liability Proposal. Further support can be derived from the Australian common-law case of *Bolton Partners Ltd v Lambert*,<sup>152</sup> which is authority for the proposition that ratification is effective despite the purported withdrawal of the third party from the agreement prior to ratification.

## (2) *Mutual cancellation*

Cancellation of a pre-incorporation contract by mutual consent of the agent and the third party during the interim period should be prohibited by statute. Although there may occasionally be valid reasons for a mutual cancellation and the agent's fiduciary duties may be an effective deterrent against an improper cancellation, these factors are outweighed by those against the sanctioning of mutual cancellation.

Permitting consensual cancellation would give promoters unwarranted scope to act to the prejudice of the company to be formed, particularly in view of the special importance of pre-incorporation contracts to the entire promotion of the company. Prohibiting such cancellation would also be consistent with the juridical nature of a pre-incorporation contract as a 'nascent' contract. Furthermore, cancellation does not fit the role of an agent but rather that of a principal.<sup>153</sup> Where the promoter acts by way of a stipulatio alteri for the benefit of a company to be formed, the promoter has the right, as principal, to agree with the third party to cancel the as yet unratified agreement.<sup>154</sup> It seems appropriate that this principle should a fortiori not apply where the promoter functions as an agent.<sup>155</sup>

## IV ABOLISHING THE FORMALITIES IN SECTION 35

The formalities prescribed by s 35 are both formalistic and burdensome and must be abolished. Non-compliance currently results in the parties falling back on the unsatisfactory common-law position.<sup>156</sup> This operates unfairly to the prejudice of legally unsophisticated parties who may be unaware of the complexities and pitfalls of pre-incorporation contracts and who may merely have in mind a vague purpose of entering into arrangements to benefit a company when it is formed.<sup>157</sup> This is particularly compelling in the context

<sup>152</sup> (1889) LR 41 Ch D 295 cited in Hambrook op cit note 38 at 134. Although this case has been debated and distinguished by later cases, it has never been overruled and is still relevant and applicable Australian authority (see Hambrook ibid at 135).

<sup>153</sup> At common law it is unclear whether the unauthorized agent (of an existent principal) and the third party may by agreement cancel a contract prior to ratification by the company. English and American common law permit such mutual cancellation. Kerr believes that this principle ought to be adopted in South African agency law (Kerr op cit note 53 at 106–7). However, in the context of pre-incorporation contracts, special circumstances exist, including that the principal is non-existent, requiring special rules on mutual cancellation.

<sup>154</sup> *McCulloch v Fernwood Estate* supra note 3; *Bagradi v Cavendish Transport Company (Pty) Ltd* 1957 (1) SA 663 (N); *Nine Hundred Umgeni* supra note 39 at 6; *Twenty Seven Bellevue v Hillcove* 1992 (4) SA 523 (N) at 525.

<sup>155</sup> But see Hambrook's (op cit note 38 at 135) interpretation of the common-law case *Walter v James* (1871) LR 6 Ex 124 and his interpretation of the comments on it in *Bolton Partners* (supra note 152).

<sup>156</sup> See notes 5 and 16 above.

<sup>157</sup> See e.g. *Heathfield v Maqelepo* 2004 (2) SA 636 (SCA).

of the current developing business environment in South Africa, involving large numbers of unsophisticated entrepreneurs desiring to establish small businesses. Each formality under s 35 will be dealt with in turn, though not in sequence.

The fourth formality, that two copies of the pre-incorporation contract must be lodged at the Companies Office, has been the most problematic in practice, and indeed the primary reason for sophisticated parties shunning s 35 in favour of the stipulatio alteri mechanism. The basis for this requirement is investor protection, resulting from the publicity associated with lodgement at the Companies Office, giving investors prior warning and specific knowledge of the exact contents of the pre-incorporation contract.<sup>158</sup> In practice, however, making the full terms of the pre-incorporation contract open to public scrutiny is undesirable from the perspective of both the promoter and the third party, and encourages undercutting by other parties.<sup>159</sup> Both anomalously and inconsistently, copies of pre-incorporation contracts concluded by way of stipulatio alteri need not be lodged at the Companies Office. There are much less drastic means of protecting shareholders, such as, for instance, the fiduciary duties of promoters. As stated by Lindley LJ,<sup>160</sup> the duties placed on promoters in their role as creators of the company are 'imposed by the plainest dictates of common honesty as well as by well-settled principles of company law'. Accordingly, the fourth formality ought to be wholly abolished, as is done by the Close Corporations Act of 1984.

Turning to the formality that the memorandum of association of the company on its registration must contain as an object of the company the ratification of the pre-incorporation contract, it is submitted that the abolition of its status as a requirement on which the operation of s 35 is dependent would be consistent with the proposals in the Company Law Policy Document 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.<sup>161</sup> Promoters would, however, be well advised to continue to include the ratification of pre-incorporation contracts as objects of the company as it may be prudent to ensure that a certain amount of publicity and disclosure to investors is made. This would be particularly sensible if ratification by conduct is made permissible (see Part II(2) above).

However, the requirement that pre-incorporation contracts must be made in writing should be retained. Written pre-incorporation contracts provide certainty<sup>162</sup> and make it more likely that the board of directors of the

<sup>158</sup> Blackman et al op cit note 137 at 4–8.

<sup>159</sup> However, if the Liability Proposal is adopted undercutting would be deterred by the potential liability of the promoter for breach of the statutory warranty.

<sup>160</sup> in *Re Olympia Ltd* [1898] 2 Ch 153 (CA) 165 (affirm sub nom *Gluckstein v Barnes* [1900] AC 240 (HL)).

<sup>161</sup> Supra note 12 at 33.

<sup>162</sup> *Pledge Investments (Pty) Ltd v Kramer: In re Estate Selesnik* 1975 (3) SA 696 (AD) at 703.

company will receive full and proper disclosure of the terms of the pre-incorporation before ratification.<sup>163</sup> Extending s 35 to oral arrangements would result in undesirable litigation and disputes on the factual evidence and the proof of oral pre-incorporation contracts. While limiting s 35 to written pre-incorporation contracts would in certain circumstances prejudice parties where the oral terms are sufficiently certain, the parties will in many cases simply remedy this between themselves by means of a fresh agreement between the incorporated company and the third party. As far as other jurisdictions are concerned, while the New Zealand provision appears to extend to oral pre-incorporation contracts, the Canadian statute<sup>164</sup> is explicitly limited to written pre-incorporation contracts and this is the route we should follow.

The final formality is that the promoter must 'profess' to act as agent or trustee for a company not yet incorporated. The issue of the confusing wording 'agent or trustee' has been dealt with above. The term 'profess' has also been problematic,<sup>165</sup> and the use of the term 'state' or 'declare' would have been preferable. Nevertheless, in the current context of the reform of the Companies Act, the requirement that the promoter must *expressly* declare or 'profess' to act on behalf of a non-existent company ought to be replaced by a requirement that both the promoter and the third party know or ought reasonably to have known, at the time of execution of the pre-incorporation contract, that the company does not exist.<sup>166</sup> The nature and depth of such knowledge is addressed in Part V below.

A related point concerns the use of the term 'contract', which has been problematic in South Africa and elsewhere. A pre-incorporation 'contract' is strictly speaking not a contract at all until ratified by the company; until that point there is only one party to it (the third party) and it cannot, therefore, amount to a 'contract'.<sup>167</sup> It is an inchoate or a nascent contract. Nevertheless, the term 'pre-incorporation contract' is a universally used and understood term and for that reason ought to be retained.<sup>168</sup> The best way of resolving the difficulty is by the insertion of a definition of 'pre-incorporation contract' into the Companies Act, as is done in the New Zealand and British Columbia Acts.<sup>169</sup>

<sup>163</sup> See Dickerson et al op cit note 36 as cited in Maloney op cit note 59 at 413.

<sup>164</sup> Supra note 23.

<sup>165</sup> In that it was unclear whether it amounted to an incorrect declaration or simply a declaration. 'Profess' was eventually resolved by the Appellate Division in *Sentrale Kunsmsis* supra note 17 to amount to the latter, but it would no doubt have been preferable had the term 'state' or 'declare' been used in the statute instead.

<sup>166</sup> It is noteworthy that at common law, an agent who acts without the authority of his existent principal must not only intend but also profess to act on behalf of his principal.

<sup>167</sup> AJ Kerr 'Contracting for a company not yet incorporated' (1975) 92 *SALJ* 365 at 366; Maloney op cit note 59 at 413.

<sup>168</sup> See also Ziegel op cit note 36 at 345-6; Ford op cit note 122 at 667. This may be contrasted with the view of Maloney op cit note 59 at 414 that one should employ the terminology 'transaction or agreement' instead. E E Palmer & B L Welling *Canadian Company Law Cases, Notes and Materials* 3 ed (1986) 5-18 and 5-25 also criticize the term 'pre-incorporation contract'.

<sup>169</sup> Which define pre-incorporation contracts as 'purported' contracts (supra note 23).

## V THE SCOPE OF SECTION 35

Section 35 applies only where the agent ‘professes’ to act on behalf of a non-existent company, and therefore only where *both* the agent and the third party are aware of the company’s non-existence. The question therefore arises whether the scope of s 35 ought to be extended to apply where either the agent or the third party, or both, are unaware of the company’s non-existence.

In Australia, s 131 of the Corporations Act<sup>170</sup> appears to apply regardless of the parties’ awareness of the non-existence of the company,<sup>171</sup> as do the Canadian<sup>172</sup> and British Columbia<sup>173</sup> statutes. The application of the New Zealand provision, however, on a purely literal reading, seems to depend on the agent’s subjective knowledge of the company’s non-existence.<sup>174</sup>

(1) *Where the agent but not the third party is aware of the company’s non-existence*

At present, where the agent is aware but the third party is unaware of the company’s non-existence, the parties may not rely on s 35 but must instead fall back on the common-law position. In order to decide whether the scope of s 35 ought to be extended to this scenario, an analysis of the remedies available to the third party at common law is required.

The common-law position is that the pre-incorporation contract is a nullity, and the agent may be held personally liable on the pre-incorporation contract.<sup>175</sup> However, the agent’s personal liability appears to depend on the parties’ intention and the proper interpretation of the contract; South African common law seems to follow the ‘rule of construction’ approach as opposed to the ‘rule of law’ approach (in which the agent’s personal liability is automatic).<sup>176</sup>

The remedy afforded to the third party against the agent for breach of an implied warranty of authority may inadvertently fail to give the third party

<sup>170</sup> Supra note 24.

<sup>171</sup> Ford op cit note 122 at 15.280. This view is probably based on the following italicised wording in s 131(1): ‘[i]f a person *enters into, or purports to enter into*, a contract on behalf of, or for the benefit of, a company before it is registered’.

<sup>172</sup> Buckley op cit note 49 at 146–7 states that the Canadian provision appears to apply the rule of law approach to *Kelner v Baxter* supra note 3. This approach disregards the intention of the third party and the promoter as to whether or not the agent should be personally liable on the pre-incorporation contract; it therefore encompasses the *Black v Smallwood* (1966) 117 CLR 52 (HCA) and the *Newborne v Sensolid (Great Britain) Ltd* [1953] 1 All ER 708 type of scenario where the promoter is unaware of the company’s non-existence. The Canadian provision refers in s 14(1) to ‘a person who *enters into, or purports to enter into*’. The words ‘or purports to enter into’ were inserted into s 14(1) by a subsequent amendment, following the decision in *Westcom Radio Group Ltd v McIsaac* (1989) 45 BLR 273 (Ont Div Crt) which held that s 14 would only operate where the promoter was *intended* to be a party to the contract (Gillen op cit note 65 at 196).

<sup>173</sup> Gillen op cit note 65 at 196, 200.

<sup>174</sup> Section 182(1) of the Companies Act supra note 23 states that a pre-incorporation contract means ‘a contract made by a person on behalf of a company before and in contemplation of its incorporation’.

<sup>175</sup> *Kelner v Baxter* supra note 3.

<sup>176</sup> *Nordis Construction Co (Pty) Ltd v Theron, Burke & Isaac* 1972 (2) SA 535 (D) applied the rule of construction approach and was followed in *Terblanche v Nothnagel* 1975 (4) SA 405 (C) at 411 and *Indrieri v Du Preez* supra note 69 at 725. It has been held occasionally that the rule of law approach should be applied: e.g. *Gompels v Skodawerke of Prague* 1942 TPD 167; *Van Eeden v Sasol Pensioenfonds* 1975 (2) SA 167 (O) at 180H; *Gardner v Richardt* supra note 37 at 772.

any substantial relief. The measure of damages in South African common law for breach of warranty of authority — even where the principal is non-existent<sup>177</sup> — is contractual in nature, being the amount that will place the third party in as good a position as if the principal were bound by the contract.<sup>178</sup> The drawback of this measure of damages is that it is dependent on the financial position of the principal, and accordingly where the principal is non-existent it is impossible for the third party to prove his damages by establishing what such a ‘principal’ would have been able to pay,<sup>179</sup> thus leaving the third party without a remedy. Similarly, where the principal company is subsequently formed but is insolvent, the damages claimable by the third party against the agent for breach of implied warranty of authority are merely nominal.<sup>180</sup> There is also the real danger that even where the company is subsequently formed and is in fact solvent, the third party may be precluded from recovering more than nominal damages from the agent on the application of the principle that one’s damages must be measured at the time of the breach, that is, at the time when the representation of authority was made, at which time the company was non-existent.<sup>181</sup> Although the plaintiff in *Indrieri v Du Preez*<sup>182</sup> contended for an extended implied warranty in circumstances where the principal is non-existent to the effect that the ‘agent’ is deemed to warrant both the principal’s existence as well as its solvency, this was rejected by the court.

Turning to the availability of a delictual remedy, where the third party is able to establish an intentional or fraudulent misrepresentation on the part of the agent, the third party may claim delictual damages<sup>183</sup> in an amount that will put him in as good a position as he would have been in had the agent’s authority not been misrepresented. If, however, the third party is able only to establish negligence on the part of the agent, the availability of a delictual remedy is unclear and untested.<sup>184</sup> This is also the position in Australian law.<sup>185</sup>

In view of the prejudice that may be caused to the third party in these circumstances, the scope of s 35 should be extended to cover the situation

<sup>177</sup> See Part I(3)(c); *Peak Lode* supra note 45; *Indrieri v du Preez* supra note 69. See also *Black v Smallwood* supra note 172 where it was stated that such an action may be available, as opposed to the obiter dictum in *Newborne v Sensolid* supra note 172 that an agent could not be liable for breach of warranty of authority where the supposed principal does not exist. Ford op cit note 122 at 15.230 prefers the view in *Black v Smallwood* as does L S Sealy *Cases and Materials in Company Law* 7 ed (2001) 29.

<sup>178</sup> See further Kerr op cit note 53 at 306–8, 318.

<sup>179</sup> *Indrieri v Du Preez* supra note 79 at 727.

<sup>180</sup> For a factual illustration of this principle see e.g. *Wickberg v Shatsky* (1969) 4 DLR (3rd) 540 (BCSC), a British Columbia common law case.

<sup>181</sup> *Hambrook* op cit note 38 at 125. But see *Delta Construction Co Ltd v Lidstone* (1979) 96 DLR (3rd) 457 (Nfld TD) which suggests that if the company is subsequently formed and is solvent, the third party will be able to recover substantial damages from the promoter for breach of warranty of authority.

<sup>182</sup> *Supra* note 69.

<sup>183</sup> Kerr op cit note 53 at 317 in relation to fictitious principals; *Indrieri v Du Preez* supra note 69 at 728 in relation to a non-existent de-registered company.

<sup>184</sup> Kerr op cit note note 53 at 310 in relation to the existent principal and at 317 in relation to the fictitious principal; *Indrieri v Du Preez* supra note 69 at 728 in relation to a non-existent de-registered company.

<sup>185</sup> Ford op cit note 122 at 15.240; *Hambrook* op cit note 38 at 127.

where the agent knows or ought reasonably to have known of the company's non-existence but the third party neither knows nor ought reasonably to have known of this fact. Where the agent's misrepresentation of authority is not fraudulent but merely negligent the third party's loss should be imposed on the agent since the agent is in a better position to know the company's status. Not only should all of the Liability Proposal be extended to this scenario, but the measure of damages should be independent of the company's financial position (see Part I(5)(c) above).

(2) *Where both the agent and the third party are unaware of the company's non-existence — the accidental pre-incorporation contract*

The accidental pre-incorporation contract<sup>186</sup> similarly does not fall within the current scope of s 35, and its effect is determined by common law. At common law, the 'contract' is a nullity and, on the authority of the *Nordis* case,<sup>187</sup> the promoter is unlikely to be held personally liable on the contract — since the common intention of the parties is to contract with an existing company, holding the agent personally liable would amount to making a new contract that neither party intended. Although the common-law remedy for innocent breach of warranty of authority may, in principle, be available to the third party,<sup>188</sup> it is likely to yield only nominal damages. In the case of an accidental pre-incorporation contract the third party will not have a delictual remedy. The question must therefore arise whether s 35 ought to be extended to the accidental pre-incorporation contract.

While the agent is in a better position to know whether or not the company has been incorporated, it would nonetheless be unnecessarily burdensome to the innocent promoter if s 35 were to be extended to this scenario. Instead, the existing position should be retained and the parties should be left to fall back on the common-law position. Since in these circumstances both parties are innocent and in good faith, they may well choose to execute a fresh contract between the incorporated company and the third party upon discovery of their error.

## CONCLUSION

Resolving the conundrum of the pre-incorporation contract in a just and fair manner requires a legislative solution. South Africa's current legislation fails to afford justice to the third party under a pre-incorporation contract. The underlying policy basis of s 35 is skewed in favour of the company and the agent acting of behalf of the unformed company. Such a policy is no longer desirable and is, furthermore, out of step with modern global trends.

In order to achieve a balance between the interests of the company, the agent and the third party, s 35 ought to be amended, in accordance with the

<sup>186</sup> *Sherwood Design Services* supra note 1 para 57.

<sup>187</sup> Supra note 186 at 545.

<sup>188</sup> Kerr op cit note 63 at 307, 318.

Liability Proposal put forward in this article, to incorporate a statutory implied warranty that the agent warrants in favour of the third party that the company will be incorporated and will ratify the pre-incorporation contract within an agreed time or a reasonable time after the date on which the pre-incorporation contract was executed between the agent and the third party, failing which the third party will be entitled to claim damages from the agent on the fairly conservative 'recoverable' measure. Coupled with this ought to be a wide judicial discretion empowering the court to fine-tune the balance between the company and the agent by apportioning liability between the company and the agent where it would be just and equitable to do so. This discretion ought to extend to both ratified and unratified pre-incorporation contracts, according to the parameters discussed above. Such a discretion would enable the court to counter many of the abuses to which pre-incorporation contracts are subject.

The rights and liabilities of the company, the agent and the third party during the interim period prior to ratification are left unsettled and confused, not only in s 35 but also in the statutory provisions of most leading jurisdictions. The amendment of s 35 would do well to go beyond global precedents in this respect so as to remove this unfortunate and troublesome lacuna. Unilateral withdrawal by the third party ought to be firmly prohibited — this will achieve the correct balance between the parties' conflicting interests and save s 35 pre-incorporation contracts from being relegated to the status of mere gentlemen's agreements.

The amended s 35 also ought to diverge from global trends by avoiding the widely used but inadequate wording according to which ratification has the effect of binding the company as if it had been a party to the pre-incorporation contract. It should instead be drafted in unambiguous terms clearly stating a legislative intention that ratification operates retrospectively to the date that the pre-incorporation contract was executed.

The formalities stipulated in s 35 should be abolished, save for the requirement that a pre-incorporation contract must be made in writing. Instead of having to 'profess' to act on behalf of a company to be formed, it ought to suffice if the agent and third party both know or ought reasonably to have known, at the time of execution of the pre-incorporation contract, that the company is not yet in existence.

Finally, consideration must be given to the scope of s 35 as amended in accordance with the Liability Proposal. While it would be worthwhile considering extension of the ambit of s 35 to situations where the third party is unaware of the company's non-existence, the reach of s 35 must continue to exclude promoters who enter into contracts at common law as principals for the benefit of companies to be formed, using the valuable mechanism of the *stipulatio alteri*, which should be retained in our law.