IN THE NAME OF THE COMPANY:
AN ANALYSIS OF THE PROVISION AND EFFECT OF SECTION 21 OF THE COMPANIES ACT 71 OF 2008

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Abstract

A company acquires a legal personality upon incorporation and registration, before which it does not have the required capacity to enter into a valid contract. However, the promoter of a company may have to enter into an agreement on behalf of, or for the benefit of the company to be formed, either for the incorporation or for the future business of the company. Such a pre-incorporation contract often becomes a source of trouble and causes dispute over the validity or the legal consequences of the contract.

Laws in common law jurisdictions and civil law jurisdictions make various provisions for pre-incorporation contracts. Ratification by the company, once formed, of the pre-incorporation contract made by the promoter, is possible in some jurisdictions but not in the others. Third parties that enter into the pre-incorporation contract also face different scenarios in different jurisdictions.

This mini dissertation analyses the South African law that governs the pre-incorporation contracts, and compares it with the laws of a few common law and civil law jurisdictions, particularly that of China. The purpose of the study is to examine the effect and legal consequence of the pre-incorporation contract in South Africa and China, and to evaluate whether the law of South Africa provides sufficient certainty and protection to the parties involved in the pre-incorporation contract compared with that of China.

TABLE OF CONTENTS

Let every eye negotiate for itself and trust no agent. – William Shakespeare

CHAPTER 1 INTRODUCTION

1.1 Background and introduction

The company or corporation is arguably the most popular form of business in modern society. They are central to a country's economy and its prosperity for wealth creation and social renewal.[1] Some believe that the purpose of a corporation is to serve the interests of the stockholders or their members.[2] Others argue that the concept of the company as an instrument of economic capitalism has developed into one of "the enterprise" as an instrument of a new social order – one that is founded on the theory of social responsibility.[3] What seems clear is that the word "company" implies an association of a number of people for some common object or objects.[4] It is an artificial or a juristic person given a legal existence by law.[5] Such a juristic person is endowed by law with the capacity to acquire rights and incur obligations to a great extent as a natural person, but distinct from that of its members.[6] Once created, it has most of the legal rights of a real person, such as the rights to start and operate a business, to buy or sell property, to borrow money, to sue or be sued, and to enter into binding contracts.[7] It must be treated like any other independent person with rights and liabilities appropriate to itself.[8]

Incorporation of a company has some unique advantages. One such advantage is limited liability. As the rights and liabilities of a company are separate from those of its members, conducting business through a company means limited personal liability for the entrepreneurs who would like to embark on a new business venture. Debt or liability of the company remain in the company, which will not become part of the director or

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[1] The Department of Trade and Industry *South African company law for the 21st century guidelines for corporate law reform* (2004) 4.
[2] Friedman *Capitalism and freedom* (1962) 133.
[3] Schmitthoff *Commercial law in a changing economic climate* (2nd Ed) (1981) 37.
[4] Davies *Gower's principles of modern company law* (6th Ed) (1997) 3.
[5] *Salomon v Salomon and Co Ltd* [1897] AC 22 (HL)
[6] *Webb & Co Ltd v Northern Rifles* 1908 TS 462
[7] Pride et al *Business* 10th ed (2010) 116.
[8] *Salomon* case above.

shareholder's personal affairs unless it is caused by certain acts or omission of such a person.[9] Another advantage is its perpetuality as a juristic person. Unlike a natural person, a company does not have a life span until and unless it is wound up; it cannot become incapacitated owing to illness, and a change of members or shareholders does not affect the existence of the company.[10] It is therefore many entrepreneurs' choice to carry on a business venture in the form of a company. Since incorporated companies were clearly distinguished from unincorporated partnerships in the second half of the seventeenth century,[11] the company has become one of the four most important forms of enterprise in the business world.[12] Company law has also become an important subject, which serves the purpose of, inter alia, promoting economic development by encouraging entrepreneurship and enterprise efficiency, promoting innovation and investment, and reaffirming the concept of the company as a means of achieving economic and social benefits.[13]

The juristic person only comes into existence when the company is incorporated and registered in terms of the law.[14] In South African company law, registration of the incorporation is a process that may take some time.[15] In some other jurisdictions, company law imposes additional pre-conditions which must be satisfied before a company can be incorporated.[16] In a perfect world, the person or persons who would like to run a business enterprise in the form of a company should first create the legal person, i.e., incorporate and register a company. However, it is often the case that a business opportunity is identified before the company is formed. Those who would like to seize the opportunity may have to enter into a contract, envisaging running the

[9] S 77(3) of the Companies Act 71 of 2008.
[10] Davies 85.
[11] Davies 21.
[12] Cilliers et al *Cilliers and Benade Corporate Law* (3rd ed) 4.
[13] S 7 of the Act 71 of 2008.
[14] S 19(1)(a) of the Act 71 of 2008.
[15] S 13 and s 14 of the Act 71 of 2008.
[16] See, for instance, article 19 of the Company Law of the People's Republic of China provides that in order to incorporate a limited liability company, certain conditions must be satisfied, including the prescribed number of shareholders, the prescribed capital amount, an memorandum of incorporation, a company name and prescribed organization structure, and a fixed place of business and necessary means for production and operation.

business in the form of a company but before dealing with the registration formalities. In circumstances where the law requires a company to have a fixed place of business before it can be registered,[17] it is inevitable that a lease agreement or a purchase agreement of a property has to be entered into for the company not yet in existence. Such contract or agreement entered into by a person or persons who purport to act in the name of or on behalf of the company before it comes into being, with the intention that the company will be incorporated and will be bound by the agreement, is known as a pre-incorporation contract.[18]

Pre-incorporation contracts are not an infrequent source of trouble.[19] In English law, an agreement entered into by a non-existent company is null and void as between the unincorporated company and the other contracting party.[20] The position is the same in South African law.[21] Under the common law, an agreement purportedly entered into by a person in the capacity of an agent on behalf of a non-existent principal cannot be ratified by the company once formed because ratification is only possible if the relationship of principal and agent already existed at the time when the contract was entered into. As Innes CJ found in *McCullogh v Fernwood Estate Ltd.*, "the English doctrine as laid down in *Kelner v Baxter* (1866) LR 2 CP 174 … seems clear. A company cannot ratify a contract made for its benefit before it was formed; nor can it adopt such contract by resolution."[22] The non-ratification rule of the common law creates uncertainty to both the promoter of the company to be formed and the other contracting party, as the promoter may be personally bound, and the other contracting party might have intended to contract with the company once formed.

South Africa was one of the first jurisdictions to provide a "legislative solution" to "the

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[17] Article 19 of the Company Law of the People's Republic of China.
[18] See definition of "pre-incorporation contract" in s 1 of the Act 71 of 2008.
[19] Davies 141.
[20] *Newborne v Sensolid (Great Britain) Ltd* [1954] 1 QB 45 CA.
[21] *Van der Hoven v Van der Westhuizen* (48677/16) [2017] ZAGPPHC 679. In the case the court found, among other findings, that since the company was not in existence at the time the oral agreement was entered into, it was not a party to the agreement and the pre-incorporation agreement was *void ab initio*.
[22] *McCullogh v Fernwood Estate Ltd.* 1920 AD 204.

conundrum of the pre-incorporation contract".[23] The Companies Act 46 of 1926 provided for the ratification of "any contract made in writing by a person professing to act as agent or trustee for a company not yet formed, incorporated or registered" by the company after it has been duly registered.[24] In its amended form as section 35 of the Companies Act 61 of 1973, the company, once incorporated, can ratify or adopt a pre-incorporation contract if some specific requirements are complied with. Examples of these requirements are that the contract must be in writing and must be entered into by a person who professed to act as agent or trustee of the company to be formed; one of the objects of the memorandum of incorporation of the company must be ratification or adoption of the contract; two copies of the contract must be lodged with the Registrar, one of which must be certified by a notary, and the company must be entitled to commence business, et cetera.[25] Although section 35 and its predecessor were commendable legislative interventions[26] to the unsatisfactory situation under the common law, they could not provide a comprehensive solution to the problems that the promoter and the third party, i.e., the party with whom the promoter (as agent) purported to contract with on behalf of the company, were facing. The company has discretion whether or not to ratify the contract. If the company did not ratify the contract or did not come into existence, the contract simply lapsed and no one incurred any liability,[27] which would have left the third party largely unprotected. When the Companies Act 71 of 2008 came into effect, section 21 further amended its predecessor, aiming at addressing the difficulties section 35 of the 1973 Act could not resolve. Whether or not section 21 achieved its goal will be discussed in detail in this dissertation.

In other jurisdictions, pre-incorporation contracts tend to be problematic. For instance,

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[23] Cassim MF "Pre-Incorporation Contracts: The Reform of Section 35 of the Companies Act" 2007 124(2) *SALJ* 365
[24] S 71 of the Companies Act 46 of 1926.
[25] S 35 read with s 172(5)(a) of the Companies Act 61 of 1973; Cilliers 58.
[26] Cilliers 57.
[27] Cilliers 60.

the non-ratification situation at common law is still unchanged in the United Kingdom.[28] The Companies Act of India does not make any statutory provision for pre-incorporation contracts,[29] but the Specific Relief Act, 1963 provides that the company, once incorporated, may sue or be sued in terms of a pre-incorporation contract entered into by the promoters for specific performance, if "such contract is warranted by the terms of the incorporation", and on the condition that "the company has accepted the contract and has communicated such acceptance to the other party to the contract".[30] It seems that the only remedy by or against the company, once incorporated, is to seek specific performance, while the company has the discretion to accept or reject the pre-incorporation contract. The People's Republic of China on the Administration of Company Registration (2014 Revision) provides that "A company formed after this Regulation comes into force shall not engage in any business activity in the name of a company if it has not been registered with the company registration authority."[31] It seems to expressly prohibit a pre-incorporation contract in the name of the company to be formed.

This dissertation intends to do a comparative study of the laws regarding pre-incorporation contracts in South Africa and in China.[32] The purpose of the study is to examine the effect and legal consequence of the pre-incorporation contract in both countries, and to evaluate whether the law of South Africa provides sufficient certainty and protection to the parties involved in the pre-incorporation contract compared with the law of China. Suggestions will be made in order to mitigate potential risk that lies

[28] S 51(1) of the Companies Act 2006 of the United Kingdom provides that "A contract that purports to be made by or on behalf of a company at a time when the company has not been formed has effect, subject to any agreement to the contrary, as one made with the person purporting to act for the company or as agent for it, and he is personally liable on the contract accordingly."
[29] The Companies Act, 2013.
[30] S 15(h) and 19(e) of the Specific Reliefs Act, 1963.
[31] Regulation of the People's Republic of China on the Administration of Company Registration (2014 Revision issued by Order No. 648 of the State Council of the People's Republic of China) trans at http://lawinfochina.com/display.aspx?id=dd9d2febfe4c959abdfb&lib=law.
[32] The writer of this dissertation is a Chinese national fluent in Chinese and a practicing attorney and sworn translator of the High Court of South Africa. Chinese legislations and literatures cited in English are either from a translated source or by self-translation. The source of translation will be noted where applicable.

with liability and ratification of the pre-incorporation contract, particularly when the parties involved are from different jurisdictions. Because harmonisation of company laws with major trading partners will be pursued as far as possible,[33] and China is a major trade partner of South Africa, the study in this dissertation should be of some practical value.

1.2 Problem statement

As pre-incorporation contracts are entered into by a person or persons as the agent of a company that does not yet exist, they involves three parties, i.e., the person who acts as the agent of the unincorporated company, the third party who entered into the contract with the agent of the unincorporated company, and the company as the principal. The legislation counteracts the situation in common law that the relationship of principal and agent cannot exist where the principal is non-existent,[34] and therefore provides more certainty to all three parties. However, some difficulties remain unresolved.

The first difficulty is the effect of pre-incorporation contracts. Section 21 leaves the discretion of whether to ratify or reject any pre-incorporation contract completely, partially or conditionally with the board of the company.[35] Because the board of the company might not consist of the incorporator or promoter who acted as the agent of the unincorporated company, this provision causes uncertainty for both the agent and the third party. It means that the pre-incorporation contract might not be binding on the company once incorporated, or only partially or conditionally binding, in which case the agent has to be liable for the liability created by the pre-incorporation contract,[36] and the third party might lose the business opportunity it intended to pursue with the

[33] See paragraph 3.5 of Chapter 3, The general principles of new company law, The Department of Trade and Industry *South African company law for the 21st century guidelines for corporate law reform* (2004) 30.
[34] Delport (ed) *Henochsberg on the Companies Act 71 of 2008* (Issue 16) 106(8).
[35] S 21(4) of Act 71 of 2008.
[36] S 21(2) of Act 71 of 2008.

company.

The second difficulty is the allocation of the rights and liabilities arising from pre-incorporation contracts. Section 21(2) provides that the person who enters into the pre-incorporation contract in the name of or on behalf of the company not yet in existence is jointly and severally liable with any other such person for liabilities created by the contract if the company is not subsequently incorporated, or, after being incorporated, rejects any part of the contract. It is not clear who is "any other such person" – whether it refers to the other co-incorporator or to the director or shareholder of the company. It is also not clear if the company rejects part of the pre-incorporation contract, on what basis the said person should be liable for the unratified part of the contract. If the person acts as an agent, such person is not liable as a party to the contract; yet this person cannot be liable on a warranty of authority because the other contracting party knew at the time of the contract that he had no authority.[37] Further, the common law option of *stipulatio alteri*, i.e., a contract for the benefit of a third party, is not excluded by section 21. It would be difficult to determine whether the person acted as an agent in terms of section 21 or as the *stipulans* in terms of *stipulatio alteri* if the wording of the contract is not clear.[38] A person acting as the *stipulans* acts as the principal, whose rights and liabilities on the contract are entirely different from those of an agent.

The third difficulty arises from ratification. Section 21 provides a timeframe within which ratification or rejection has to happen.[39] If the company fails to do so, it would be deemed to have ratified the contract.[40] No formality is prescribed by the legislation about the form of ratification. The questions one can ask include how the third party would know whether the contract has been ratified or not if the company is not obliged to notify them, and what would happen if the board of the company is not aware of the pre-incorporation contract and therefore does not have a chance to reject it.

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[37] *Peak Lode Gold Mining Co Ltd v Union Government* 1932 TPD 48
[38] Delport 106(9).
[39] S 21(4) of Act 71 of 2008.
[40] S 21(5) of Act 71 of 2008.

It is submitted that all three parties involved in pre-incorporation contracts require legal certainty. For protection from unnecessary economic stress, a balanced approach is needed. What is equally important is the balance between business efficiency and legislative control. Section 21 reformed section 35 of the Companies Act 63 of 1971 by holding the promoter personally liable if the pre-arbitration contract is not ratified by the company, thereby affording more protection to the third party,[41] but the effectiveness of the provisions and the balance of protection the provisions served must be examined.

1.3 Research questions

The questions this dissertation tries to answer are twofold:

- One, what are the effects and legal consequences of pre-incorporation contracts for the promoter, the company and the third party in terms of South African law?
- Two, does the law of South Africa provide sufficient protection to the promoter, the company and the third party in pre-incorporation contracts compared with the laws of other jurisdictions, particularly the laws of China?

By looking into these questions, an attempt will be made to identify loopholes and potential risks pertaining to the laws of South Africa and China with regard to the pre-incorporation contract.

1.4 Methodology

This mini dissertation conducts a comparative study of the law on pre-incorporation contracts in South Africa and China, with reference to the laws of the United Kingdom and India where necessary. By explaining the background and purpose of the study,

[41] See discussion by Cassim MF in *"*Pre-Incorporation Contracts: The Reform of Section 35 of the Companies Act*"* 2007 124(2) *SALJ* at 365.

this chapter sets a context against which each aspect of the legal effect and consequence of pre-incorporation contracts in terms of section 21 of the Companies Act 71 of 2008 of South Africa will be analysed. A similar analysis will be conducted on the Chinese law on pre-incorporation contracts. Similarities and differences in the laws of the above jurisdictions will be discussed through statutory provisions and court cases. A conclusion will be drawn at the end to show the pros and cons of the current law in South Africa in comparison with the laws in other countries and to show how it can be improved. It will also attempt to make suggestions on how to extend protection to the contracting parties in practice.

Some of the Chinese legislations referred to in this article are translated by unknown translators in China, with the English translation published via various websites. Wherever a translation on a website is used, the URL of the website is cited as the source. When the statute, regulation or journal articles are in Chinese, the reference provided in English is translated by the writer of this dissertation.

1.5 Outline of chapters

This mini dissertation contains four chapters. Chapter 1 is the introduction that draws the outline of the background of the research and lays down the problem statement and the research questions.

Chapter 2 – the effect and legal consequences of pre-incorporation contracts – will discuss the effect of pre-incorporation contracts. Common law position and statutory provisions in section 21 of the Companies Act 71 of 2008 will be analysed to show the circumstances that might render pre-incorporation contracts invalid or binding on the promoter only, and the benefit and liability attached to pre-incorporation contracts in such circumstances. Legal consequences that flow from rejection, ratification, partial or conditional ratification and deemed ratification by the company will be analysed, as well as the retrospective effect of the ratification.

In Chapter 3 – comparison with other jurisdictions – the focus will be shifted to Chinese law and practice to show how and whether pre-incorporation contracts are effective and enforceable in China. Similarity with and difference from the South African law will be pointed out to demonstrate potential risks that the South African and Chinese parties may face when entering into pre-incorporation contracts.

Chapter 4, the last chapter, draws the conclusion. It summarises the pros and cons of South African law in dealing with pre-incorporation contracts in comparison with the laws of other jurisdictions. Suggestions are made regarding how the South African statutory provisions can be improved, and what aspects should be considered in drawing up pre-incorporation contracts, especially when the parties are from different jurisdictions.

CHAPTER 2

THE EFFECT AND LEGAL CONSEQUENCES OF PRE-INCORPORATION CONTRACTS

2.1 Common law position

One of the requirements for a contract to be valid and binding is that the parties must have the necessary capacity to contract.[42] Before incorporation a company is not yet a legal person and therefore cannot be a party to a contract. In terms of South African common law, when a person professes to enter into a contract for the benefit of a company to be formed, such person could act either as the principal or the agent. In both instances the contract is valid, but the legal consequences are distinctive.[43]

Under Roman-Dutch common law, *stipulatio alteri*, a contract can be made by a person, acting as a principal (the "stipulator"), with another person (the "promisor") for the benefit of a third person. Such a third person can be a company that is not yet in existence at the date when the contract is made.[44] The company can adopt the contract once formed, but whether the company adopts the contract is a matter of fact and depends on the circumstances of each matter.[45] If and when the company duly accepts the contract, it becomes a party to the contract, the stipulator falls out of the contract, and the contract is binding on and enforceable by the company.[46] However, if the company is not incorporated or fails to adopt the contract, whether the person who entered into the contract (the "stipulator") is personally entitled to the rights of the contract depends on the terms and circumstances of the contract.[47] Whether the stipulator has the right to enforce specific performance of an obligation that will ultimately benefit the company, or the stipulator has to perform an obligation that should ultimately be performed by the company, also depends on the construction of

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42 Hutchison at el *The law of contract in South Africa* (2nd ed) 6.
43 *McCullogh v Fernwood Estate Ltd* 1920 AD 204.
44 *McCullogh* case above.
45 Delport 106 (11).
46 *McCullogh* case above.
47 Pretorius et al *Hahlo's South African company law through the cases* (6th ed) 106.

a particular contract.[48] In *Nine Hundred Umgeni Road (Pty) Ltd v Bali* 1986 (1) SA 1 (A), the respondent contracted with the appellant for a lease agreement for the benefit of a company to be formed. The appellant submitted that the respondent contracted as "principal" and is therefore personally liable for the performance of the obligations and entitled to the rights of the lessee flowing from the contract. However, the court found that the principal is not personally entitled to exact or obliged to render the performance which is stipulated for the third party unless the contract so provides. The court also found that even if the stipulator is compelled to perform certain obligations before the formation of the company, he would not personally incur any liability under the contract. If the stipulator fails to perform the obligations of the lessee, the only remedy available to the promisor, i.e., the lessor, is to cancel the contract, but the lessor will not be able to claim damages from either the stipulator or the company, unless the contract provides for personal liability of the stipulator. It is therefore submitted that under *stipulatio alteri* the rights and obligations of the stipulator do not flow as a matter of law, but are a question of construction.

On the other hand, when a person enters into a pre-incorporation contract as an agent, such person might be personally bound. The English doctrine as laid down in *Kelner v Baxter* (1866) LR 2 CP 174 – where a person professes to contract on behalf of a non-existent principal, the agent is personally liable, because the principal who had not been in existence at the time of making the contract cannot thereafter ratify or adopt the contract, and the agent is deemed to have contracted on his own behalf – was recognised by South African law.[49] However, the non-existence of the purported principal does not necessarily mean personal liability of an agent. In the case of *Newborne v Sensolid (Great Britain) Ltd* [1954] 1 QB 45; [1953] 1 All ER 708, Lord Goddard CJ found that "It seems to me a very long way from saying that every time a prospective company, not yet in existence, purports to contract everybody who signs from the company makes himself personally liable." It was concluded that the contract

[48] *Gardner v Richardt* 1974 (3) SA 768 (C)
[49] *Peak Lode Gold Mining Co Ltd v Union Government* 1932 TPD 48

made between a non-existent company, though signed by the plaintiff purporting to be its agent, and the defendant, is a nullity. The court of *Nordis Construction Co (Pty) Ltd v Theron, Burke and Isaac* 1972 (2) SA 535 (N), by citing the above case, found that personal liability of the agent has to be established on the intention of the parties, and that to hold the agent personally liable upon a contract intended to be made with the principal "would be to make a new contract for the parties which neither of them ever intended." Following the *Newborne* case, the High Court of Australia had come to the same conclusion in *Black v Smallwood* (1966) 39 Australian LJR 405.[50]

In accordance with the above, it is submitted that in terms of our common law, whether pre-incorporation contracts are bound and enforceable by the company once formed, has to be decided on the facts and circumstances of each case.

2.2 The statutory provision under section 21 of the Companies Act 71 of 2008

In terms of s 21 of the Act,[51] a person is allowed to enter into a written agreement in the name of, or purport to act in the name of, or on behalf of, a company that is contemplated to be formed but does not yet exist.[52] This provision grants the promoter of a non-existent company a statutory agency to enter into a valid agreement. To give such provision legal effect, the section goes on to provide that once the company is incorporated, it may completely, partially or conditionally ratify or reject any pre-incorporation contract or other action purported to have been made or done by the agent (the promoter or promoters of the company).[53] It further provides that if the company, within three months of incorporation, fails to either ratify or reject a pre-incorporation contract, or other action purported to have been made or done in the name of the company, or on its behalf, the company will be regarded as having ratified that agreement or action, and there is therefore a deemed ratification of the agreement

[50] Pretorius 111.
[51] Act 71 of 2008.
[52] S 21(1).
[53] S 21(4).

or action by the company.[54] The retrospective effect of the ratification and the liability of the company and the agent before and after the ratification were also provided for in the section.[55]

2.2.1 Pre-incorporation contracts in term of section 21 of the Companies Act 71 of 2008

Section 21 must be read in conjunction with section 1 of the Act, in which "pre-incorporation contract" is defined as "a written agreement entered into *before the incorporation of a company* by a person who purports to act in the name of, or on behalf of, the proposed company, with the intention or understanding that the proposed company will be incorporated, and will thereafter be bound by the agreement" (my emphasis). Therefore, for section 21 of the Act to apply, a person must "purport" to act for or on behalf of a company yet to be formed. A potential difficulty one may encounter is whether a shelf company may be acquired to ratify a pre-incorporation contract. A shelf company is a company that has fulfilled all legal requirements for registration and has been duly registered. It is an established legal entity but remains dormant in business. To use a shelf company is an easy and quick alternative for many business incorporators in South Africa. However, strictly speaking, a shelf company is already in existence, so it does not qualify as one that is yet "to be incorporated", and accordingly, section 21 cannot apply. This issue was raised by the respondent in *Venalex (Pty) Ltd v Vigraha Property CC and Others* [2015] 2 All SA 645 (KZD), in which it argued that the parties sought to conclude a pre-incorporation contract in terms of section 21 of the Companies Act, 2018, but the Applicant, a shelf company, was already incorporated at the time so it did not qualify as "a company to be formed" that was entitled to ratify the contract. The court found the three directors of the Applicant to have entered into the pre-incorporation contract in their personal capacities for the benefit of the company to be formed, and thus the common law principal of *stipulatio*

[54] S 21(5).
[55] See sections 21(2), 21(6)(a) and 21(6)(b).

alteri applied. In the circumstances, the court found "no reason why the acquisition of a shelf company could not legitimately be employed as a means to achieve the intended incorporated status of a company".

One might be able to argue that the whole purpose of section 21 is to enable a person to act as a statutory agent when the principal, the company to be formed, is not yet in existence. Similarly, if a person should act on behalf of a shelf company that exists but is not yet acquired, there is no connection between the person and the company; the relationship of principal and agent does not exist, so the same principal of section 21 should apply, otherwise the rigid interpretation might lead to "insensible or unbusinesslike results".[56] However, according to the judgment of *Cshell v Oudtshoorn Municipality* (481/2012) [2013] ZASCA 62, it is clear that when the contract expressly states that it is concluded "on behalf of a company to be formed," nomination of a company already in existence is not possible. In this case, the municipality awarded a tender to a company to be formed referred to as "Newco", but the Appellant, a company already in existence at the time the contract was concluded, sought to enforce the tender. The municipality purported to cancel the award. The court found that "CShell was accordingly in existence at the time of the submission of the tender and its award, and was never incorporated pursuant to the award of the tender, as the envisaged 'Newco'", and that "Coetzee in concluding the pre-incorporation contract quite clearly did not act as the agent for CShell, which was in existence at the time. In addition, Coetzee did not act as a principal, as he acted at all times as the agent for the company to be formed."

2.2.2 Ratification of pre-incorporation contract in terms of section 21

Section 21(4) provides that the board of the company incorporated as purported by the promoter or promoters may completely, partially or conditionally ratify or reject any pre-incorporation contract or other action purported to have been made or done in its name

[56] Delport (ed) *Henochsberg on the Companies Act 71 of 2008* (2018) Vol. 1 106(9).

or on its behalf within three months after the company is incorporated. Section 21(5) further provides that if the company fails to either ratify or reject the pre-incorporation contract or other action purported to have been made or done in its name within the three-month period, the company will be considered to have ratified that agreement or action.

Unlike its predecessor, section 35 of the 1973 Act,[57] section 21 does not prescribe any specific requirements, except that the pre-incorporation contract must be a written agreement. However, it seems the incorporator or promoter can also purport to act in the name of or on behalf of the company to be formed,[58] so the pre-incorporation contract is not limited to a written agreement. The legislation leaves the power of ratification in the hands of the directors. There is no prescribed procedure of ratification. It is submitted that this is sensible in terms of business efficiency and efficacy because the board is in charge of the daily operation of the company. However, it can also cause potential problems for the company and for the third party.

Section 21 abolished the mandatory formality of containing the ratification or adoption of pre-incorporation contracts as an object in the memorandum of association of the company on its registration, as well as the formality of lodging two copies of the pre-incorporation contract with the Registrar as prescribed in section 35 of the 1973 Act. The new Act provides an option of notification through regulation 35 of the Companies Regulations 2011.[59] In terms of the regulation, a person may give notice to a company of a pre-incorporation contract or action by filing and delivering to the company a notice in a prescribed form. Upon receiving the notice, the board of the company must file a notice of its decision whether it ratifies or rejects, completely or partially, with respect to that contract or action in the prescribed form and must deliver a copy of that notice to each person who is a party to the contract or materially affected by the action.[60] To

[57] The Companies Act 61 of 1973.
[58] S 21(1).
[59] Companies Regulations, 2011 GN9526 *GG*34239 of 26 April 2011.
[60] Regulations 35(1) and (2) and Forms CoR35.1 and CoR35.2 of the Companies Regulation, 2011.

give notice to the company is not a mandatory stipulation but a voluntary option, which means the board of the company may or may not receive a notice of a pre-incorporation contract or action. Only upon receiving the notice is the company obliged to file notice of its decision regarding the pre-incorporation contract. If it does not receive a notice, it may or may not have full knowledge of the pre-incorporation contract or any other action purportedly made or carried out in the name of the company. However, there is a mandatory provision of a three-month window period for ratification or rejection of pre-incorporation contracts or actions made or done on behalf of the company. If the board does not expressly reject the said contracts or actions, completely or in part, once the three months expire, the company is deemed to have ratified the contracts or actions.

The impact of the above provisions is two-fold. On the one hand, the board may find that it is bound by a contract or action of which it does not have full knowledge. It is often the case that the promoter who entered into a pre-incorporation contract or purported to act on behalf of a company to be incorporated does not become a director of that company when it is incorporated. This person may forget to inform the board of the said contract or action, or may orally notify the board but fail to produce a copy of the written agreement. In either case, the board may lose its chance to make an informed decision of ratifying or rejecting, or partially ratifying or rejecting the pre-incorporation contract or any other action. The phrase “to act” causes further confusion and the Act is silent on what qualifies as an action purportedly done on behalf of a company not yet incorporated. It is submitted that it is more difficult to keep track of an “action” than a written contract. Should the board have no knowledge at all, when the three-month period expires, the deemed ratification takes place, and the company is bound by the contract or action. If the board only has partial knowledge, it may overlook certain advantages or disadvantages of such a contract or action, and make a decision that is not in the best interests of the company.

On the other hand, the third party may find itself in a difficult position. Assume a

promoter concludes a pre-incorporation contract with a third party on behalf of a company to be incorporated to trade a certain commodity. The parties immediately start trading while the promoter is busy establishing a new entity. When the company is incorporated, the promoter informs the third party and the sale proceeds are paid into the company's account. However, during the first three months after incorporation and before the board of directors expressly ratifies the pre-incorporation contract, the commodity's price changes. The original terms of the pre-incorporation contract do not benefit the company anymore, but may, on the contrary, bring financial burden to the company, and the board then decides to reject the contract and does so explicitly. Does the receipt of the sale proceeds amount to implied ratification by conduct? In terms of South African common law, a valid ratification must satisfy two essential elements: (i) conduct by a corporate organ signifying a corporate intention to be bound, and (ii) full knowledge of the corporate organ of the terms of the contract.[61] In the above situation, it is difficult for the third party to prove corporate intention and full knowledge. Although section 21 (2) allows the third party to hold the promoter liable, it may not make economic sense for the third party to hold the individual liable because its real intention is to do business with the company. This type of scenario may be particularly detrimental to unsophisticated third parties.

Because Act 71 of 2008 abolished the formal requirements of lodging pre-incorporation contracts with the Registrar and it is silent on the procedure of ratification, a practical difficulty faced by the third party is to ascertain whether the company has ratified or rejected the pre-incorporation contract or any action purported. Presumably, express ratification or rejection is by resolution of the board. The board resolution may not be delivered to the third party if the third party does not request the company to do so. It is therefore possible that while the third party is relying on the deemed ratification by the company, the board had, in fact, rejected the contract (or any part of it) but did not notify the third party.

[61] MF Cassim "Some difficult aspects of pre-incorporation contracts in South Africa Law and Other Jurisdictions" (2012) 13(1) *Business Law International* 11.

A different scenario with similar effect is the so-called “fly-by-night” company. In this scenario, if the promoter, after entering into the pre-incorporation contract, no longer wants to be bound by it but does not want to be held personally liable, he may register a company without any asset, or with very few assets, and then ratify the contract or wait for the three months to pass. Once the ratification takes place, the liability shifts to the company and the third party is left with a meaningless right of action against a company without any assets.[62]

The mandatory stipulation of a three-month period for ratification or rejection may also cause a potential problem. It is unclear why the legislature chose three months as the prescribed period. In view of the fact that companies’ and businesses’ transactions vary, three months might be too long for some but too short for others, especially considering the ambiguity in terms of the rights and liabilities during this period. Take the above commodity transaction as an example: the commodity price may change drastically over the three months, and the company can use this period to make a decision that is beneficial to the company but might be detrimental to the third party. In other circumstances, a company may need more time for the board to be well informed of the pre-incorporation contract and to convene a board meeting. During the three-month period or before the company ratifies the contract, the contract is only binding between the promoter who signed it and the third party. Should the parties perform under the contract, once the company ratifies or rejects the entire contract or any part of it, the promoter, the third party and the company may all have to review the rights and liabilities asserted by each other. For instance, if a deposit is paid to a promoter, is the company entitled to the interest accrued if the company ratifies the contract? Alternatively, if a deposit is paid by a promoter on behalf of the company for services to be rendered by a third party, but the third party fails to render the service, and the company elects to reject the pre-incorporation contract, does the promoter have a

[62] FHI Cassim, MF Cassim and Others *Contemporary company law* (2nd Ed) 157.

recourse of asserting a claim against the company in terms of section 21(7)? This section provides that if the company rejects a pre-incorporation agreement or action, a person, i.e. the promoter, may claim against the company any benefit the company has received or is entitled to receive in terms of the agreement or action. It is not clear what qualifies as a "benefit the company is entitled to receive". If, in the above scenario, owing to the non-performance of the third party, the agreement is cancelled, can the promoter claim against the company what was paid on behalf of the company? If the third party performs and the agreement is not cancelled, the promoter is liable for further obligations. However, because the pre-incorporation contract is made by the promoter on behalf of the company to be formed, the company is meant to ultimately receive the benefit. Will the promoter be able to assert a claim against the company for the benefit the company is entitled to receive out of the entire agreement? It seems that these questions will be decided on the facts and circumstances of each case, should such questions arise.

To amplify what is discussed above, it is worth considering the case of *Van der Hoven v Van der Westhuizen* (48677/16) [2017] ZAGPPHC 679. In *casu*, the plaintiff and the defendant entered into an oral agreement, in terms of which the plaintiff was to pay an amount of R1 350 000 to the defendant to become a shareholder of a company to be registered by the defendant. The defendant was to transfer a property to the company once formed without the company having to pay any consideration, and was to also become a shareholder of the company. The R1 350 000 paid by the plaintiff would be used as start-up capital by the company to commence with a development project. The company was duly registered, though after some delay, but the defendant failed to transfer the property into the company. The plaintiff instituted an action against the defendant for restitution and claimed the R1 350 000 paid by itself. The court found that the agreement amounted to a pre-incorporation agreement; however, since Act 71 of 2008 and the old Companies Act of 1973 both require that the pre-incorporation has to be in writing, yet the particulars of claim lack the allegation that the oral agreement was reduced to writing, the pre-incorporation agreement is void *ab initio*. It is

respectfully submitted that the decision raises questions to be considered. First, the plaintiff allegedly paid the amount of at least R1 350 000.00 to or on behalf of the defendant. Did the defendant purportedly accept payment on behalf of the company? If yes, the acceptance of the payment might amount to an action in the name of or on behalf of the non-existent company, and the act itself could be ratified by the company. It is not necessary that the oral agreement between the plaintiff and the defendant be reduced to writing. Second, assuming that the company, when incorporated, neither ratified nor rejected the action purported to have been done on behalf of the company, the company would be regarded as having ratified the action and becomes a party to the agreement. It would be the company, but not the plaintiff, that had the *locus standi* to hold the defendant accountable for the amount paid by the plaintiff to the company.

2.2.3 Retrospective effect of ratification

In the common law of agency, ratification cures the agent's lack of authority with retrospective effect.[63] However, in *Peak Lode Gold Mining Co v Union Government* 1932 TPD, the court held that the wording of section 71 of the Companies Act 46 of 1926, "as if it had been duly formed, incorporated and registered at the time when the contract was made", does not mean that the ratification of the contract by the company has retrospective effect. The company is therefore only bound to the contract from the day the company ratifies it. Although that judgment was widely criticized, and section 71 of the 1926 Act was replaced by section 35 of the 1973 Act, this case has been relevant in dealing with retroactivity and the personal liability of the person acting for the company to be formed.[64]

Section 21(6)(a) of the 2008 Act provides that should the pre-incorporation contract have been ratified by the company, "the agreement is as enforceable against the company as if the company had been a party to the agreement when it was made". It

[63] Cilliers 62.
[64] Pretorius 108.

seems that the intention of the legislature is to confirm the retrospective effect upon ratification of the pre-incorporation contract or action. This provision is helpful in enforcing certain rights against the company retrospectively; however, it is submitted that it does not expressly provide that the company may also enforce its right against the third party or the promoter retrospectively. Furthermore, this provision seems to provide for the agreement only but not for the action. It is submitted that if a promoter purportedly takes action in the name of a company to be incorporated, the rule set out in the *Peak Load* case shall apply, i.e., that the company is only bound from the day it ratifies the act.

2.3 Conclusion

In the above, section 21 of the Companies Act, 2008 has, in comparison with its predecessors, made commendable improvements in simplifying the process, protecting confidential information, protecting the third party and allowing the promoter to claim benefits from the company, et cetera. However, it leaves certain ambiguities and loopholes that may cause practical problems, some of which are discussed in this chapter. In an ideal world, the contract should make it clear as to whether the promoter is entering into the contract as a principal, i.e. *stipulatio alteri* should apply, or as an agent, i.e. section 21 of the 2008 Act should apply. It might also be safer to make provision for rights and obligations before and after ratification of the pre-incorporation contract and action.

CHAPTER 3

COMPARISON WITH OTHER JURISDICTIONS

3.1 Law of pre-incorporation contract in specific other common law jurisdictions

In some other common law jurisdictions, pre-incorporation contracts cannot be ratified. As discussed above, the English common law position is that a company cannot ratify a contract made for its benefit before it was formed, but whether the promoter is personally liable depends on the intention of the parties.[65] Section 51 of the Companies Act 2006 of the United Kingdom provides that

> "A contract that purports to be made by or on behalf of a company at a time when the company has not been formed has effect, subject to any agreement to the contrary, as one made with the person purporting to act for the company or as agent for it, and he is personally liable on the contract accordingly."

So, the statute does not change the common law position of non-ratification, but affords more certainty to the third party by explicitly providing that the promoter is personally liable unless agreed otherwise.

Although the common law position is the same in Indian law, the Specific Relief Act of 1963 changed the common law position to a certain extent. It is provided in the Act that specific performance can be enforced by and against the company in terms of a pre-incorporation contract if the contract is warranted by the terms of incorporation, and the company has accepted the contract and has communicated such acceptance to the other party to the contract.[66] These provisions seem to provide for ratification of the pre-incorporation contract by the company, even though provisions are only made for specific performance. Section 196 of the Indian Contract Act of 1872 might also bear some relevance. It provides that "where acts are done by one person on behalf of another, but without his knowledge or authority, he may elect to ratify or to disown

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[65] *Kelner* case *and Newborne* case.
[66] S 15(h) and 19(e) of the Specific Relief Act, 1963.

such acts. If he ratify (*sic*) them, the same effects will follow as if they had been performed by his authority". It seems to suggest that even if the agent is acting without authority, ratification is possible. In terms of section 182 of the Indian Contract Act, 1872, an "agent" is a person employed to do any act for another, or to represent another in dealings with third persons. The person for whom such act is carried out, or who is so represented, is called the "principal". It is doubtful whether the agent–principal relationship exists in the situation of a pre-incorporation contract, because a non-existent principal cannot "employ" someone to represent it; however, when read with section 15(h) and 19(e) of the Specific Relief Act, 1963, it seems that statutory ratification is allowed. Once the company ratifies a pre-incorporation contract, the company can be bound by the contract as the principal retrospectively in terms of section 196 of the Indian Contract Act of 1872.

3.2 Chinese law governing pre-incorporation contracts

China adopts a civil law system. As with other civil law jurisdictions, the Chinese law is codified. The statutes are the primary source of law in China, while court cases may only play a referential role when interpreting the statute. The legislature of China grants the Supreme People's Court a quasi-legislative power,[67] with which the Supreme People's Court, from time to time, publishes judicial interpretation of the legislation, which becomes a primary source of law and binds the lower courts. In addition, the State Council of China, as the national executive body, may promulgate administrative regulations based on the Constitution and the legislation, and such regulations have the same effect as the law. Provisions in relation to pre-incorporation contracts and activities can be found in the legislation, the judicial interpretation and the administrative regulations.[68]

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[67] D Qi *Judicial interpretation by the Supreme People's Court: legislation interpretation or law making?* http://www.iolaw.org.cn/showNews.aspx?id=54956

[68] See art 79 and 94 of the Company Law of the People's Republic of China 2018 Amendment; Art 1 to art 5 of The Provisions of the Supreme People's Court on Several Issues Concerning the Application of the Company Law of the People's Republic of China (III) and art 3 of the Regulation of the People's Republic of China on the Administration of Company Registration.

The Company Law of the People's Republic of China 2018 Amendment (the "Chinese Company Law" hereinunder) is the legislation regulating the establishment and activities of companies, and the term "company" means limited liability company ("LLC" hereinunder) or joint stock company ("JSC" hereinunder) incorporated in the territory of the People's Republic of China.[69] An LLC cannot have more than 50 shareholders[70] and each shareholder must undertake to make a capital investment that becomes part of the registered capital of the company.[71] The shareholders' liability to the LLC is limited to the amount of the capital investment that they undertake to make.[72] A JSC must have more than two but less than 200 promoters,[73] who must either subscribe to all the issued shares of the company as the share capital, or subscribe to part of the issued shares and raise the balance of the share capital through public offering or offering to specific targets.[74] The shareholders' liability to the JSC is limited to the numbers of shares they subscribe.[75]

Although there are no provisions about pre-incorporation contracts in the Chinese Company Law, the term "*faqiren*" (the singular and plural forms of which are the same) is used multiple times in the provisions applicable to a JSC to refer to the promoters or the incorporators of the company. Article 79 specifically provides that the "*faqiren*" of a JSC are liable for the preparatory work of the company, and that they shall enter into an agreement with each other to specify the rights and obligations of each "*faqiren*" in the process of forming the company. Article 94 further provides that if the JSC fails to be incorporated, the "*faqiren*" shall be jointly and severally liable for the debt and cost in connection with the incorporation activities.[76] The Chinese Company Law seems to make a clear distinction between the promoters in an LLC and in a JSC. When the

[69] Art 2.
[70] Art 24.
[71] Art 23(2) and 26.
[72] Art 3.
[73] Art 78.
[74] Art 77.
[75] Art 3.
[76] Art 94(1).

founders or incorporators of both types of companies are mentioned in the same article, they are referred to as "*faqiren*" (i.e., "promoter"), as in JSC, and "shareholder", as in LLC, respectively.[77] From the provisions of the Chinese Company Law, it is not clear whether the shareholder of a LLC is also personally liable for any debt of the company if the LLC fails to be incorporated. Further, it seems that as long as a person becomes a *"faqiren"* or a promoter of a JSC, if the company is not incorporated for whatever reason, the person will be jointly liable for any debt or cost incurred from incorporation activities,[78] no matter which preparatory work[79] he is involved in. From the above provisions, it is submitted that the Chinese Company Law partly regulates the liability of the promoters in pre-incorporation activities and pre-incorporation contracts; however, it is silent on whether the company, once incorporated, can ratify the pre-incorporation contract.

The Provisions of the Supreme People's Court on Several Issues Concerning the Application of the Company Law of the People's Republic of China (III) ("Judicial Interpretation III" hereinunder), being the promulgated judicial interpretation of the Chinese Company Law, provided some clarity regarding the definition of "*faqiren*" as well as the ratification of the pre-incorporation contract by the company.

Article 1 of the Judicial Interpretation III widened the definition of promoter (*faqiren*) by providing that the person who signs the Memorandum of Incorporation for the purpose of forming a company, subscribes to the investment or shares of the company, and fulfils the obligation of incorporation shall be regarded as the promoter of the company, including the shareholder of the LLC at the time of its incorporation.

Article 2 provides that if a contract is signed in the name of the promoter for the purpose of incorporation, and the other contracting party requests the promoter to be liable for

[77] Art 199 and art 200.
[78] Above n75.
[79] Art 75.

the contract, the People's Court shall support such application. However, if the company ratifies the contract upon incorporation, or enjoys the right or fulfils the obligation of the contract as a matter of fact, and the other contracting party requests the company to be bound by the contract, the People's Court shall support such application.

Article 3 further provides that upon incorporation, if the other contracting party requests the company to be liable for a pre-incorporation contract signed by the promoter in the name of the pre-incorporation company, the People's Court shall support such application. However, upon incorporation, should there be evidence that the promoter entered into the pre-incorporation contract in the name of the company but for his own benefit, and the company objects to its being bound by the contract, the People's Court shall support such application, except for the cases where the third part is bona fide.

In article 4, it is stated that in case the company fails to be incorporated, if the creditor requests all or some of the promoters to be jointly liable for the cost and liability incurred from the incorporation activities, the People's Court shall support such application. If the promoters who are held liable request the other co-promoters to share the liability, the People's Court shall find the other promoters to be liable according to the agreed percentage of liability. Should such an agreement be missing, the liability shall be proportioned according to the agreed capital investment percentage. Should such an agreement be missing, the liability shall be shared equally by all such promoters. If the failure of incorporation is owing to the fault of a certain promoter or promoters, and the other promoters request the ones with "wrongful act" to be liable for the cost and liability incurred for incorporation, the People's Court shall allocate liability based on the facts and circumstances of each case.

Article 5 provides for delict, in terms of which if a promoter causes damage to a complainant when performing his duty in incorporating a company, and the complainant requests the company, upon it incorporation, to be liable, the People's

Court shall support such application. If the company is not incorporated, and the complainant requests all promoters to be jointly liable, the People's Court shall support such application. The company or the promoters without fault can claim against the promoter who committed the delict.

From the above provisions in the Judicial Interpretation III, two points are worth further discussion. First, in terms of article 2, ratification or acceptance by the company of a contract signed by a promoter is possible. The text of this article does not refer to novation, nor does it prescribe the form of ratification. It seems that, as long as one can prove that the company is the actual beneficiary of the contract, the company will be bound by the contract. However, according to the text of this article, it seems that only the contract "for the purpose of incorporation" can be ratified. The Judicial Interpretation III does not define what kind of contracts are regarded as being for the purpose of incorporation. For instance, assume a few persons in an existing commercial contract decide to incorporate a company so that the company can continue to perform the contract. The contract remains in force during the process of incorporation, and the promoters continue to perform. Meanwhile, they have to enter into a lease agreement for the office to be used as the domicile of the company. Can both the commercial contract and the lease agreement be regarded as a contract for the purpose of incorporation and be ratified by the company, or can only the lease agreement be considered for the purpose of incorporation? Article 23 and article 76 of the Chinese Company Law provide that an LLC or a JSC can only be established if, inter alia, the company has a "domicile".[80] One may argue that having a domicile is a pre-condition of incorporation and registration, therefore a lease agreement for the premises to be used as the domicile of the company is a contract for the purpose of incorporation. On the other hand, a commercial contract for economic gain is not necessarily one for the purpose of incorporation because a company can be incorporated even if the commercial contract is not in place. It is submitted that a

[80] Art 23(5) and 76(6) of the Chinese Company Law.

contract entered into by the promoter for the purpose of incorporation has some similarity to *stipulatio alteri*. In both instances the promoter enters into the contract in his own capacity for the benefit of the company. Once the company adopts or accepts the contract, the promoter falls out of the picture, and the contract becomes binding on the company.

Second, article 3 provides for ratification by the company of the pre-incorporation contract entered into by the promoter in the name of the "pre-incorporation company". A pre-incorporation company refers to the entity at the stage in which the memorandum of incorporation has been concluded but the company has not been duly registered.[81] It is transitional in nature and would generally go through various stages, including the conclusion of the memorandum of incorporation, conclusion of the promoters agreement, reservation and verification of the company name and initial payment of the capital contribution, et cetera.[82] The concept of a pre-incorporation company does not exist in the South African law because a company only acquires legal personability when the incorporation of the company is registered,[83] but the legal status of a pre-incorporation company is accepted in China. Wu calls the pre-incorporation company a quasi-juristic person, but he contends that the pre-incorporation process is divided into various stages; the legal personality at each stage differs from each other. It is therefore abrupt to use "pre-incorporation company" as a general term. The term should only be applied to those pre-incorporation companies at the last stage before registration, because by then the pre-incorporation company should have reserved its name, received a capital contribution from the promoters, set up the board or the management control body, and established the domicile, et cetera, and therefore be capable of being liable as a juristic person.[84] Article 54 of the Detailed Rules for the

[81] XJ Zou and X Zhang "Issues on the effect and liability of business activities conducted by the pre-incorporation company" 2014 (5) *Economy and Law* 67.
[82] Y Wu "Analysis of the civil liability allocation model in company incorporation – comments on the draft of the Provisions of the Supreme People's Court on Several Issues concerning the Application of the Company Law of the People's Republic of China' (2007) *Chinese Journal of Law* 42.
[83] S 19 of the Companies Act 71 of 2008.
[84] See n 82 at 48.

Implementation of the Regulation of the People's Republic of China on the Administration of Company Registration (2017 Revision) (“the Detailed Rules” hereinunder) confirms the legal status of the pre-incorporation company by providing that the registration authority shall issue pre-incorporation certificates to enterprises applying for registration of pre-incorporation entities. However, the Regulation of the People's Republic of China on the Administration of Company Registration (“the Regulation” hereinunder) provides that a company will only assume a legal personality when it is duly registered by the company registration authority and has been granted a Business Licence, and that before a company is duly registered by the registration authority it cannot be involved in business activities.[85] This provision seems to be expressly prohibiting pre-incorporation business activities and is in conflict with the other statutes discussed above. Notably, it only prohibits business activities but not incorporation activities. As Wu points out, in practice, it is difficult to differentiate incorporation activities from business activities, and the prohibitive provision in the Regulation is almost not applicable.[86] It is submitted that because the Detailed Rules are drafted in terms of the Regulation, it can be regarded as a further interpretation of the Regulation. The provision of article 54 of the Detailed Rules is promulgated to legalise the status of the pre-incorporation company, and thereby to enhance legal certainty. When reading the Detailed Rules with article 3 of the Judicial Interpretation III, the promoter is allowed to enter into a contract in the name of the pre-incorporation company for all kinds of pre-incorporation activities. However, whether a contract made in the name of the company is valid is uncertain. As the name of the company has to be reserved and approved before incorporation, it only makes business sense if a pre-incorporation company shares the same name as the company. Whether the contract is made in the name of the pre-incorporation company or in the name of the company has to be determined on the facts and circumstances of each case.

[85] Art 3 of the Regulation of the People's Republic of China on the Administration of Company Registration.
[86] See n81 at 48.

The Companies Act 61 of 1973 of South Africa contains similar provisions. Section 172 (1) provides that no company having a share capital shall commence business or exercise any borrowing powers unless and until the Registrar has under the provisions of this section issued a certificate entitling the company to commence business. Section 172 (5) further provides that any contract made by a company before the date on which it is entitled to commence business shall be provisional only and shall become binding on the company on that date and not earlier. Until a certificate entitling a company to commence business is issued, the directors and the subscribers of the memorandum of the company shall be jointly and severally liable for all the debts and liabilities arising from any business conducted by the company. The difference between the South African provision and the Chinese provision is the stage at which such prohibition is imposed. In terms of the South African law, a certificate to commence business is required after a company is incorporated. As the company is already incorporated, the contract made by the company is valid even if the company is not in compliance with the section 172 requirements, but the contract is not necessarily binding on the company. Although such a process might bring more certainty and protection to the third party, it negatively affects business efficiency. The 2008 Act[87] simplified the process by removing this requirement. On the other hand, in terms of the Chinese law, the possibility exists that the contract made in the name of the company in contravention of article 3 of the Regulation might be invalid. Article 52 (5) of the Contract Law of the People's Republic of China ("the Chinese Contract Law" hereinunder) provides that a contract is invalid if it is in contravention of a compulsory provision of the legislation or an administrative regulation. A contract made in the name of the company is in contravention of the provision of an administration regulation, it seems such contract should be invalid. However, the judicial interpretation of the Chinese Contract Law confines the scope of "compulsory provision" to "compulsory provisions regarding the effectiveness of the contract". [88] According to Wang,

[87] Act 71 of 2008.

[88] Art 14 of the Interpretation II of the Supreme People's Court of Several Issues concerning the Application of the Contract Law of the People's Republic of China.

compulsory provisions regarding the effectiveness of the contract are those that expressly provide that contravention of such provisions shall render the contract invalid; or they are those that, although invalidity is not expressly prescribed the contract in contravention of such provisions, shall be against public policy. The other types of compulsory provisions are of an administrative nature, contravention of which shall not affect the effectiveness of the contract.[89] The Chinese courts seem to support this view.[90] It is therefore submitted that whether a pre-incorporation contract made in the name of the company in contravention of article 3 of the Regulation is invalid is not a matter of law but a matter of fact.

3.3 Conclusion

It seems from the above discussions that promoters of a Chinese company may enter into pre-incorporation contracts either in their own name or in the name of the pre-incorporation company.[91] Pre-incorporation contracts can be ratified by the company once formed without any required formality.[92] The bona fide third party to a pre-incorporation contract, whether signed by the promoter in the promoter's name or in the name of the pre-incorporation company, is entitled to hold the company, if incorporated, or the promoter liable.[93]

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[89] Wang *Law of Contract (vol 1)* (2002 Ed) 65.
[90] See *Xi'an Commercial Bank v Capital-Bridge Securities Joint Stock Company Limited and West Credit Guaranty Company Limited* (2005) 2nd Civil Court Final Judgment No. 150 (Supreme People's Court), in which the court found that a by-law issued by the Central Bank is a compulsory administrative regulation, which cannot be used as the basis to find the contract invalid.
[91] Art 2 and Art 3 of the Supreme People's Court on Several Issues Concerning the Application of the Company Law of the People's Republic of China (III) ("the Judicial Interpretation III).
[92] Art 2 of the Judicial Interpretation III.
[93] Art 2, 3, 4 and 5 of the Judicial Interpretation III.

CHAPTER 4 CONCLUSIONS AND RECOMMENDATIONS

The law regarding pre-incorporation contracts varies in different legal systems and from jurisdiction to jurisdiction. As pre-incorporation contracts are inevitable in the business world, the law and practice of pre-incorporation contracts are affected by legal and economic considerations, and common law jurisdictions and civil law jurisdictions may have both similar and different approaches.

In common law jurisdictions a company does not become a legal person until it is incorporated; therefore, a pre-incorporation contract made in the name of the company before it is formed is invalid *ab initio*.[94] Further, under the common law, a person purported to act as the agent of a company not yet incorporated might be held personally liable for the pre-incorporation contract this person entered into on behalf of the company, and the company, once formed, cannot ratify the contract, because one cannot act as the agent of a non-existent principal.[95] Although statutory provisions provide some help in clarifying the liability that arises from the pre-incorporation contract, the non-ratification rule still applies in jurisdictions such as the United Kingdom and India.

Under the South African common law *stipulatio alteri*, a promoter can enter into a pre-incorporation agreement as a principal for the benefit of the company to be formed. The Companies Act 71 of 2008 and its predecessors also provided a legislative solution to the non-ratification issue. The current law of South Africa regarding pre-incorporation contracts can be summarised in the following ten aspects:

- First, a promoter can act as the agent of a non-existent company to enter into a pre-incorporation contract or perform an act.[96]
- Second, the company can ratify the pre-incorporation contract or act or any part of it. There is no prescribed form of ratification except that the pre-incorporation

[94] *Venalex* case above.
[95] *Kelner* case and *McCullogh* case above.
[96] S 21(1) of Act 71 of 2008.

contract has to be in writing.[97]

- Third, a company must ratify or reject the pre-incorporation contract or act or any part of it within three months from the date on which the company is incorporated. If the company fails to do so within the three-month period, a deemed ratification takes place. Conditional ratification is also possible.[98]
- Fourth, a pre-incorporation contract or act or any part of it ratified by the company binds the company and the liability of the promoter thereof is discharged.[99]
- Fifth, the company can enter into a new contract on the same terms and conditions as the pre-incorporation contract, in which case the liability of the promoter is also discharged.[100]
- Sixth, if the company is not incorporated or if it rejects the pre-incorporation contract or any part of it upon incorporation, the promoter and the co-promoters will be held personally liable.[101]
- Seventh, the ratification is retrospective to the date on which the pre-incorporation contract is made.[102]
- Eighth, in cases where the company rejects the pre-incorporation contract or act, the promoter who is liable for it can claim against the company the benefit the company has received or is entitled to receive in terms of the agreement or action.[103]
- Ninth, common law *stipulatio alteri* still applies.[104]
- Tenth, a pre-incorporation contract cannot be ratified by a shelf company.[105]

In civil law jurisdictions such as China, the law of pre-incorporation contracts is found

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97 S 21(4) of Act 71 of 2008.
98 S 21(4) and (5) of Act 71 of 2008.
99 S 21(6)(b) of Act 71 of 2008.
100 S 21 (3) of Act 72 of 2008.
101 S 21(2) of Act 72 of 2008.
102 S 21(6)(a) of Act 72 of 2008.
103 S 21(7) of Act 72 of 2008.
104 Delport at 106(9).
105 *Venalex* case and *Cshell* case above.

in codified legislation and regulations, in terms of which adoption and ratification are permitted,[106] and the law recognises the legal personality of a pre-incorporation company.[107] A promoter can enter into a pre-incorporation contract in his or her own name, which can be adopted by the company upon incorporation, and de facto acceptance by the company is possible.[108] A promoter can also enter into a pre-incorporation contract in the name of the pre-incorporation company, which can be adopted by the company upon formation.[109] If the company is not incorporated for whatever reason, the promoters are jointly liable for the cost and liabilities of the pre-arbitration company.[110] Although the Regulation expressly prohibits pre-incorporation business activities,[111] a pre-incorporation contract made by the promoter in the name of the company is not invalid as a matter of law.

It is submitted that both South African and Chinese law seem to place more weight on the protection of bona fide third parties. Provisions in section 21 of the South African Companies Act 71 of 2008 and in the articles of the Chinese Judicial Interpretation III (2014) to the Chinese Company Law both prescribe for personal liability of the promoters in cases where the company is not incorporated.[112] Companies can elect to reject pre-incorporation contracts in terms of the South African law,[113] but do not have such a choice in terms of the Chinese law unless it can be proven that the promoter acted in his or her own interest when concluding the contract.[114] Section 21 seems to be more ambiguous and uncertain regarding the allocation of liability because references made to pre-incorporation "action", "partial or conditional ratification/rejection", and "the benefit the company is entitled to receive in terms of the agreement" are rather vague. The provisions for pre-incorporation action allow for tacit

106 N 92 above.
107 See n 81 and n 84 above.
108 Art 2 of the Judicial Interpretation III.
109 Art 3 of the Judicial Interpretation III.
110 Art 4 of the Judicial Interpretation III.
111 N 85 above.
112 N 101 and n 110 above.
113 N 98 above.
114 Art 3 of the Judicial Interpretation III.

agreement, which causes uncertainty for the promoter, the third party and the company. This is so because it is difficult to prove the existence of the agreement, and the terms and conditions thereof, especially whether that agreement was in terms of common law *stipulatio alteri* or in terms of section 21. A valid ratification is also difficult to prove.[115] It is therefore suggested that the provision for pre-incorporation ”action” be removed. The partial or conditional ratification or rejection imposes difficulty and uncertainty on the promoter and the third party. In demonstration: using the same commodity example in Chapter 2, assume the pre-incorporation contract is for more than one type of commodity, and upon incorporation but before the three-month window period for ratification or rejection expires, the price of one commodity changes. The company may then decide to reject the part of the contract in connection with that specific commodity. “Conditional” gives an even wider discretion to the company. It is submitted that the promoter and the third party would be better protected if they do not have to subject themselves to such an arbitral discretion of the company, and the company would not be prejudiced if the power of making a partial or conditional decision is taken away. It is further submitted that the provision of section 21(7) that the promoter may assert a claim against the company for the benefit the company is entitled to receive in terms of the pre-incorporation agreement or action should be defined. For instance, if the company rejects a pre-incorporation lease agreement, the promoter might have to cancel it because he cannot perform in his personal capacity, and might be facing the damage claim for the balance of the lease. What claim can the promoter assert against the company? The benefit the company is entitled to receive is the occupation of the property, but because it is cancelled, technically speaking, the company is no longer entitled to occupation.

Also, both sets of law are silent on who should benefit from the pre-incorporation contract before the company is incorporated or after it is incorporated but before it ratifies or adopts the contract. For instance, a company in South Africa cannot open a

[115] N 61 above.

bank account before it is incorporated. If the promoter receives sale proceeds in terms of the pre-incorporation contract, it is not clear whether the company is entitled to claim the proceeds against the promoter once it is incorporated and has ratified the contract. On the other hand, although a pre-incorporation company is allowed to open a bank account in China, the promoter may still receive proceeds into his or her own account during the pre-incorporation period, especially if the pre-incorporation contract is made in his or her name, but it is not clear whether the promoter is obliged to pay the proceeds to the company upon its incorporation. Another point worth noticing is that, in terms of the Chinese law, a person becomes a promoter when this person enters into the memorandum of incorporation, who will be jointly liable for the liability created by the pre-incorporation contract if the company fails to be incorporated, no matter whether such promoter is involved in concluding the contract or any other preparatory work.[116]

Considering that the laws in South Africa and in China differ in many respects, it is advisable for parties in a pre-incorporation contract to consider the law of the country to which the pre-incorporation contract is most closely related. If the pre-incorporation contract is governed by the South African law, the parties should make sure that the terms correctly reflect the acting status of the promoter, i.e., whether as a principal as in *stipulatio alteri*, or as an agent of the company to be formed. The contract should also provide how the third party must be notified of the ratification by the company, and preferably the promoter should be personally bound for the liabilities that arise from the contract even after the pre-incorporation contract is ratified by the company, so as to avoid the situation in which the company ratifies the contract but has no assets to meet the liability. If the pre-incorporation contract is governed by the Chinese law, it is advisable, from a third party's perspective, that the contract is made in the name of the promoter himself or in the name of the pre-incorporation company. It is submitted that as the Chinese Company Law requires the promoters to commit to the amount of

[116] N 76 above.

capital contribution, and each promoter is held limitedly liable for the debt of the company at the amount of his capital contribution, the third party enjoys better legal certainty in terms of the liability in connection with a contract, including a pre-incorporation contract.

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