Short Notes on:

PRE-INCORPORATION CONTRACTS EXPLAINED

Introduction

Many have found themselves unemployed as a result of the spread and effects of the COVID-19 virus. While some have chosen to search for alternate employment, others have chosen to see their circumstances as an opportune time to take the leap of starting their own business. As we see an increase in self-employment ventures in various forms, it might be that entrepreneurs find themselves needing to contract with third parties on behalf of their soon to be registered business. In these instances, it would be essential for one to educated on the use of pre-incorporation contracts (hereinafter referred to as "PIC").

Forms of PICs

There currently exists two forms of the PIC. One would be in terms of legislation, namely Section 21 of the Companies Act 71 of 2008 (hereinafter referred to as "the Act") and the other in terms of the common law *stipulatio alteri* principle. Although similar as they both refer to contracts entered into on behalf of a company yet to be incorporated, there exists a few crucial differences that would be important to note, which we shall further explore below.

Section 21 PICs Explained

Section 1 of the Act defines a PIC 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"*. It further gives authority to the entering of a PIC under Section 21. Once incorporated, the company will then have to ratify the contract for the terms to become enforceable against it. In electing to ratify the PIC, the agent who initially entered into the contract for the benefit of the company will be discharged of all liability.

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An essential aspect of PICs under the Act would be that the contract would need to be ratified within three months after incorporation.[1] Ratification simply means that the company elects to approve the terms and obligations of the agreement formally. This can either be fully, partially or conditionally. The effect would be that the terms and obligations of the agreement would apply retrospectively (as if the contract was entered into by the company from the date it was signed). If no formal ratification or rejection takes place within the three-month period, the PIC would be regarded as ratified.

Suppose the company elects not to ratify the PIC. In that case, the third party may then hold the agent who entered the agreement liable for any damages it has incurred as a result of the company choosing not to ratify. This liability would be shared jointly and severally between all the agents if there was more than one who concluded the contract initially. This liability will additionally apply if the company is not subsequently incorporated or if the company rejects any part of the contract.[2]

In the circumstance where the company subsequently chooses not to ratify the PIC fully, the agent would have the right to claim for any damages they incur on behalf of the company for any benefit the company obtains at the agent's expense.[3] It would follow that if the company chooses not to ratify the contract but enters a contract in its name under the same terms or to substitute the initial contract, the liability of the agent is then discharged.[4]

Stipulatio Alteri

The common law principle exists as an alternative which has, at the time of writing this article, not been invalidated by any legislation. Under the principle, the party entering into the agreement on behalf of the company yet to be incorporated does so, not as an agent (as with the PIC under Section 21) but rather as a principle and in their own name. The benefit of the contract would still be to serve the company to be incorporated.

Fundamental differences exist between a PIC under the common law as opposed to the Act. One such difference is the ratification period. Ratification by the company under the standard law contract need only be within a reasonable period from incorporation, depending on the facts of the matter.[5]

[1] S21(4) of the Companies Act 71 of 2008.
[2] S21(2) of the Act.
[3] S21(7) of the Act.
[4] S21(3) of the Act.
[5] *Bagradi v Cavendish Transport Co (Pty) Ltd* 1957 (1) SA 663 (D) 668.

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This would mainly depend on whether there was a time period included in the initial contract concluded.

If ratified, the agreement would not be retrospective from the date of conclusion of the contract but only from the date that the company was incorporated.

In addition to the above, the common law version of the PIC would not carry personal liability for the principle contracting for the benefit of the company, as the agent would be under the Act. Therefore, if the company is not eventually incorporated, the contract simply carries no obligations for any party thereto unless such liability is included explicitly as a term of the contract.

Conclusion

Depending on whether you find yourself involved with PICs as a third party, agent or principal, the above considerations would be necessary for ensuring peace of mind. Dependent on your role in the relationship, you would seek to carry as much authority with as little liability as possible as pre-caution against things go side-ways. For this reason, it is always recommended that you consult with an experienced professional before entering into any form of PIC.

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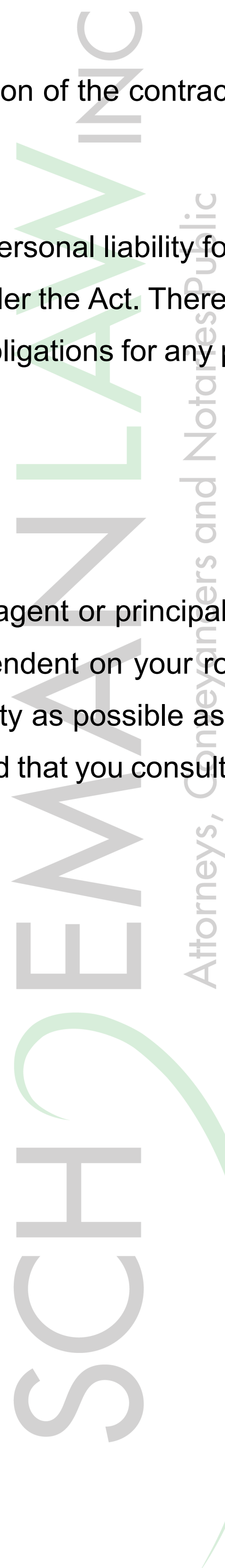

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