

SOME LEGAL ASPECTS OF “COMPANY CONTRACTS”: REFERENCE TO COMPANIES ACT NO 07 OF 2007

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Introduction

A contract can be simply defined as a legally enforceable promise between two or more parties. Contracts play a significant role in business world, as most of the time, when it comes to companies, apart from the company employees, one company is depending on the services provided by another company.

Therefore having a valid legal contract is important not only in terms of company affairs, but also to the economy of the country. “The legal enforceability” of a contract ensure the adherence to the terms and conditions parties has agreed upon entering the contract for a considerable extent and in failure to do so will also not effect to the party who was not defaulted to the extent it would have effect if there is no legal enforceability, as most of the time remedy for the breach is compensated by the court or the terms and conditions in the contract itself.

Under the law of Contract, constituent elements of a contract can be named as; an agreement between two or more parties, the intention to create a legal relationship in compliance to the statutory formalities, the possibility of the object and capacity of the parties to enter in to a contract. Though most of these elements are applied without any difference to all contracts, without

considering whether the party is human being or a company, element of capacity is considered differently. Laws relating to companies are contained in the Companies Act No.07 of 2007 therefore this study will be carried out referring to the provisions of the Companies Act. This paper aims to discuss legal aspects of the company contracts which make the contract legally valid and enforceable under the law.

Capacity of a company to enter in to Contracts

Section 2 of the Companies Act, No.07 of 2007 talks about the legal status and capacity of a company incorporated under this Act. Section 2(2) (a) and (b) of the Act has defined capacity as follows;

“to carry on or undertake any business or activity, do any act or enter into any transaction subject to the provisions of any written law of Sri Lanka or of any other country”

Further it should be noted that this section referred to the Companies incorporated under Companies Act, which clearly suggest that this capacity can be obtain only through the incorporation of a company. Section 4 and 5 contain Companies Act, contain provisions relating to incorporation of a company and section 3 of the Act is about the different types of companies

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which can be incorporated under the Companies Act.

Once Legal personality is acquired by a Company, it separates the company from its shareholders by acting as a veil between company and the members of the company. Therefore this legal status is also called as corporate veil. Salomon v. A.Salomon & Co [1897] is the first case which has recognized the separate legal status of a company and this is a landmark case which emphasize the importance of having a separate legal personality in a company's perspective. Case facts are as follows, Mr. Saloman was a boot manufacture and he formed a company and transferred his business to the company he incorporated. Shares of the company were sold among the family members. Later, the company went bankrupt. He could settle the debentures which were bought by him, but not the unsecured debenchers. Therefore a question arose as whether Mr. Saloman was a distinct person from the company. House of Lords Held that the Company has a legal personality distinct from its members, and that the members are not bound to pay them, but the company.

This case established many principles, limited liability of its member is one principle established by this case, according to this principle members are not liable to pay the debts of the company, and also they are not liable for torts, contracts and the taxes of the company. This principle is also accepted in Sri Lanka. According to the Section 87 (1) of the Companies Act, a shareholder is not liable for an act default or an obligation of the company only due to the fact that he is a shareholder. Further in Section 87(2) it states that, liability of a shareholder is limited to any liability expressly recognized by the Article of the

company or any liability under the Act. When considering about this section it is clear that the section does not release from the liabilities, but limit it.

Nevertheless, this separate legal personality cannot be regarded as an absolute status which is acquired upon incorporation, which absolutely separate liabilities of the company from its decision makers. There are instances where court can disregard the separate existence of a company. Normally, this exemption is applied when the separate legal status is used to cover a deliberate wrong. "Agency and the alter ego doctrine" (Lifting The Corporate Veil under National Interest in Sri Lanka., 2020) which suggest that although a company is separate entity, it is possible to treat it as an agent of holding company or other controlling powers has also been applied in determine whether the corporate entity should be treated as an agent of the holding company or the ones who are controlling the company.

Further there are instances where court has disregards the legal personality of companies some examples for such situations are to prevent frauds, National security. This court interference, disregarding the legal personality is called as the lifting of the corporate veil. Grounds for the lifting of corporate veil can be common law ground and statutory grounds(Lifting The Corporate Veil under National Interest in Sri Lanka., 2020). However lifting of the corporate veil is not regularly done unless there is a very good reason (Wikramanayake, A R 2007).

Pre-incorporation contracts

In the case Rover International Ltd v. Cannon film Sale Ltd 1987 1 WLR 1597 it

was held that ‘If someone does not exist it cannot contract’. In Sri Lankan context, Similar decision was delivered in the case *Attygalle and Another v. Commercial Bank of Ceylon Ltd (2002) 1 Sri L.R.* In this case it was held that before a company is incorporated and registered it has no legal existence. During the time this case was taken up in the court, there was no statutory law to govern this area. The Companies Act No 20 of 1982 was the Act in force. This Act contained no provision relating to pre incorporation Contracts. Therefore, during that time, pre incorporation contracts were governed by the Common Law. However with the introduction of the new Companies Act No. 07 of 2007, this position changed in Sri Lanka (Wikramanayake, A R 2007).

In terms of Section 2 of the Companies Act, only the companies incorporated under this Act can acquire the legal personality, in other words capacity to enter into a contract. Nevertheless there is an exemption to this requirement. Section 23 to 25 talk about pre-incorporation contracts.

Section 23 (1) defined the terms “Pre-incorporation contracts” as,

- (a) a contract purported to have been entered into by a company before its incorporation; or
- (b) a contract entered into by a person on behalf of a company before and in contemplation of its incorporation.

As there is no existing incorporated company to enter into the contract, promoters of the company can enter into contracts on behalf of the proposed company to secure funding, acquire property and other requirements as

necessary for the proposed company (Wikramanayake, A R), but before entering into the contract promoters have to secure certain rights and obligations on behalf of the company as a precondition for proceeding with incorporation (Wikramanayake, A R 2007). Companies Act has not provided a definition for the term promoter, this term was described in the case *Twycross V Grant 1877 2CDP 469 CA*, as

“the one who undertakes to form a company with reference to a given project and to set it going, and who undertakes to form a company with reference to a given project and set it going, and who takes the necessary steps to accomplish that purpose”

However, the Act has not imposed a specific time limitation to incorporate the company, but under section 23(2) it provides that the contract can be ratified within such period as mentioned in the contract or within a reasonable period after the incorporation. According to section 23(3) of the Act enforceability of a contract ratified under section 23 (2) will be considered as same as if it were entered into by a company incorporated by this Act.

In terms of section 24, unless contrary intention is presented in the contract, the person who has entered into the contract on behalf of the company gives an implied warranty to incorporate the company within the period specified in the contract or within a reasonable period and to ratify the contract within the period provided in the contract or within a reasonable period and, if the person failed to fulfill these warranties, he will be liable for a breach of implied warranty. Further, in terms of

Section 24 (2) breach of aforesaid warranty will give rise to damages and the amount of damages will be same as if it is a breach by a company for an unperformed obligation.

According to the Section 24(3) of the Act, it discharge the liabilities of the person who entered in to the contract on behalf of the company after the fulfillment of above mentioned implied warranties.

Section 25 direct company to return property acquired under the pre incorporation contracts if the company fails to ratify the contract after the incorporation.

Company Contracts

As discussed earlier once a company in incorporated Under the Companies Act, it get a distinct legal personality which makes the company eligible to enter in to contracts in its own name. Companies Act provides some formalities need to be observed before entering in to a contract. These provisions are applied disregarding whether it is entered within Sri Lanka or outside Sri Lanka. Before 2007 company seal was and mandatory element in a company contract and the ones who signed the documents were only confirming that the seal had been affixed. Companies Act 2007 removed this requirement due to its cumbersome nature in contracting reason (Wikramanayake, A R 2007). Method of contracting is provided in the Section 19 of the Act, According to this provision if law required a natural person to have a contract or other enforceable obligation in writing, signed by that person and be notarial attested same requirements have to be fulfilled by the company in entering in to same kind of a contract or other enforceable obligation. Act provides persons who are eligible to sign on behalf of the company as follows;

- (i) two directors of the company;
- (ii) if there be only one director, by that director ;
- (iii) if the articles of the company so provide, by any other person or class of persons; or
- (iv) one or more attorneys appointed by the company,

Further under Section 19 (b) it states that, if an obligation is a one which a natural person can enter in to in writing and under the person signature, company may enter in to such in writing and signed by a person authorized to do so under company's express or implied authority. According to Section 19 (c) of the Act if a natural person is not required by the law to enter in an obligation in writing, same kind of obligations may be entered into on behalf of the company in writing or orally by a person acting under the company's express or implied authority.

Section 20 of the Act is about the way how attorneys are appointed by the company. According to this section Attorney is appointed either generally or in relation to a specified matter, subject to the Articles of the Association and, in compliance to the section 19 of the Companies Act, and according to the Section 20(2) of the Act, any act of the attorney within power so granted will be binding on the company. According to Section 20(3) it states that, the provisions of the Power of Attorneys Ordinance is applied to the attorneys appointed by the Company, as it is applied to an attorney appointed by a natural person.

Section 21 of the Act talks about the "Authority of Directors, officers and agents", and Section 22 is about the "Constructive Notice", according to that

section no person is deemed to have notice or knowledge of content of Articles of Association irrespective of it being filled with Registrar or being freely available.

Validity of a contract after the dissolution of a Company

According to the Companies Act No 07 of 2007 a company can be dissolved in different ways, as examples, Section 394 of the Act provide an instance and the procedure followed by the registrar of the companies to strike off a company which is not functioning from the company register, amalgamation is another way which dissolve a company, this paper focus will be given to the companies wound up following the court winding up procedure. Section 267 Of the Act has provided three modes of winding up, namely winding up by court, winding up subject to supervision of court and voluntary winding up. Winding up procedure for the each type is provided in the Act.

Section 270 of the Act provides grounds for winding up by court as follows;

- (a) the company has by special resolution resolved that the company be wound up by the court;
- (b) the company does not commence its business within a year from its incorporation or suspends its business for one year;
- (c) if the number of the members falls below the minimum number required under subsection (2) of section 4 of this Act;
- (d) the company has no directors;
- (e) the company is unable to pay its debts; or

(f) the court is of opinion that it is just and equitable that the company should be wound up.

Situations provided in (e) and (f) are subjected to number of principles laid down by the court therefore application is not relatively straight forward as the rest of the situations provided in the section 270(Wikramanayake, A R 2007).

Section 271 of the Act provide definition for the “inability to pay debts” and, according to this section three instances where court considered the company is unable to pay its debts. However, these provisions are also important in terms of Company contracts these sections provide how a party of a contract who become a creditor can recover before the dissolution of the company.

In terms of Section 272 application for winding up has to be made by petition procedure of filling this petition is provided in “ The Companies Winding Up Rules 1939”. Section 272, Further provide who can apply for winding up as;

272. (1) An application to the court for the winding up of a company shall be by petition presented subject to the provisions of this section, either by the company or by any creditor or creditors (including any contingent or prospective creditor or creditors), contributory or contributories, or by all or any of those parties, jointly or separately

Creditors in this section are limited to the creditors who have been creditors before the petition is presented. Though this section has provided contingent and prospective creditors, in terms of section 272 (1)(b) they have to provide security for

costs and establish prima facie case for winding in order to make the court hear the winding up petition presented by them. In the case *Bell Group Finance (Pty) Ltd v. Bell Group UK Holding Ltd (1996) 1 BCLC 304*, it was decided that, even if the company has no assets, liquidator can investigate whether there has been any impropriety in the conduct of the company's affairs. Further, it is important to check whether there is a winding up order for a company before enter in to a contract relating to property, because in terms of the Section 275 of the Act it make any disposition of property void after the winding up order is made. However, according to the Section 286, court is empowered to appoint a provincial liquidator during the time period between the fillings of the winding up application and hearing of the petition. Liquidator's first task is to make a list of assets and liabilities of company, and set off liabilities with liquidator's fund after prioritizing them. Powers of the liquidator is provided in the Section 292(Winding up of a limited liability company in Sri Lanka | D. L. & F. De Saram, 2020). Though liquidator is considered as an independent party, in practice most of the time this process is not carried out independently.

Companies Act contains provisions relating to the Official receiver but the first appointment to this position was made very recently. Official receiver serves as liquidator of last resort and regulator of insolvency proceedings. According to the legal experts official receiver will bring transparency and accountability to the liquidation process. Provisions relating to official receiver are contained in Section 281 to 284.

Conclusion

Entering in to a contract with a company is somewhat different from entering to a contract with natural person. Main reason for this is the legal capacity company possessed after its incorporation, which separates the controlling powers of the company, form the company. Therefore, when entering into a contract there are some aspects need to be considered. If a party becomes a creditor of a company due to a contract they can recover their dues in the winding up process up to a certain extent. With the appointment of the official receiver transparency and the accountability of the winding up process has increased therefore it can be said that the risk of loss as been reduced up to a certain extent for the parties who became creditors of the company due to the contracts they had entered with the company.

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