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WHITE BLACK LEGAL is an open access, peer-reviewed and refereed journal providededicated to express views on topical legal issues, thereby generating a cross current of ideas on emerging matters. This platform shall also ignite the initiative and desire of young law students to contribute in the field of law. The erudite response of legal luminaries shall be solicited to enable readers to explore challenges that lie before law makers, lawyers and the society at large, in the event of the ever changing social, economic and technological scenario.

With this thought, we hereby present to you

# **PRE-INCORPORATION CONTRACTS VIS-À-VIS PUBLIC SECTOR ENTERPRISES**

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## **Introduction**

A company comes into existence when it is issued with the certificate of incorporation. As per Section 7 of the Companies Act 2013, the act provides for Incorporation of Company. In order to get it registered several documents shall be furnished before the Registrar of Companies such as Memorandum and Articles of Association duly signed by the subscribers, a declaration form by professionals who were involved in the upbringing stage of the company, declaration by the subscribers, particular details such as the name, address of the subscriber, communication address of the proposed company etc.<sup>1</sup> After the submission of such relevant documents the registrar shall register all the details, and he shall issue the certificate of incorporation and the company is now said to be incorporated.<sup>2</sup> Following this the company is also allotted with unique corporate identity number<sup>3</sup>, which will help identify the registered entity.

From the date of incorporation of such subscribers to the memorandum and all other persons, as may be, from time to time, become the members of the company, shall be a body corporate, capable of exercising all the functions of an incorporated company.<sup>4</sup>

So, the lifetime of company begins with the incorporation and it can commence its business. The body corporate will have a seal of its own and a perpetual succession. It can issue shares, generate income, acquire hold or sell tangible or intangible properties, pay taxes etc<sup>5</sup>. And also, it is free to contract with any person as, it has achieved the status of a legal person in the eyes of the law, after such registration.

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<sup>1</sup> The Companies Act, 2013, 7(1), No. 18, Acts of Parliament, 2013 (India)

<sup>2</sup> The Companies Act, 2013, 7(2), No. 18, Acts of Parliament, 2013 (India)

<sup>3</sup> The Companies Act, 2013, 7(3), No. 18, Acts of Parliament, 2013 (India)

<sup>4</sup> The Companies Act, 2013, 9, No. 18, Acts of Parliament, 2013 (India)

<sup>5</sup> *Id*



But what of the initial expenses incurred and arrangements made during the setting up of the company? How it may be managed? Is the company in a footing to contract with third person, even before its existence? This is where the concept of pre-incorporation contracts comes into picture.

### **Pre-Incorporation Contracts**

Contracts that are made on behalf of the company by the promoters before the incorporation of the company for gaining some rights and property are called pre-incorporation contracts. A corporate promoter is a firm or person who does the preliminary work related to the formation of a company, including its promotion, incorporation, and flotation, and solicits people to invest money in the company when it is being formed.

As per Section 2(69) of the Companies Act, 2013 the term 'Promoter' may be defined as the following:

- a) A person who has been named as such in a prospectus or is identified by the company in the annual return in section 92; or
- b) A person who has control over the affairs of the company, directly or indirectly whether as a shareholder, director or otherwise; or
- c) A person who is in agreement with whose advice, directions or instructions the Board of Directors of the company is accustomed to act<sup>6</sup>.

Provided that nothing in the sub-clause (c) shall be applicable to those who are advising Directors or giving advise in a professional capacity. Hence, we now have a clear picture of who can act as a promoter.

They are bound to promote their company at the operational level or make sure that their company is running successfully. For this purpose, they enter into various contracts.

Pre-incorporation contracts are those contracts that are necessary, which helps to start running a business prior to incorporation of a body corporate. When promoters get into pre-incorporation contracts, the company is not yet formulated and is just an apparent entity which means, it does not exist at that point of time.

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<sup>6</sup> The Companies Act, 2013, 2(69), No. 18, Acts of Parliament, 2013 (India)

So basically, the pre-incorporation contract cannot be executed at the time of incorporation. It can only be executed after the company is incorporated and comes into life. Therefore, promoters who are making these contracts prior to the incorporation bear the liability arising out of such contracts, until the corporate is formulated and the body ratifies the same. Since these contracts are formed before the incorporation and not after it, are henceforth termed pre-incorporation contracts.

### **Enforceability of pre-incorporation contracts**

Since these are contracts, we will have to look into the provisions of the Indian Contracts Act, 1872 for that matter, for better clarity. The very basic factor on which the contracts are formed is discussed under Section 10 of the Indian Contract Act, which discusses about the essentials of forming a valid contract. And further going deeper, we may come to discover a fact that in order to establish a valid contract, there is a minimum requirement of two parties.

So, pre-incorporation contracts when read in context with Indian Contract Act, 1872, pre-incorporation contracts are not valid for two reasons; firstly, as for the formation of any contract there should be two parties and in the current scenario, the company is not in existence at the time of agreement. Hence, there is no legal validity in the contract on whose behalf the contract is made. The second reason is that in such contracts, parties (promoters) themselves form the agreement as agents of the company but without the presence of the principal (company) itself. We know that provisions pertaining to agency does not permit such actions.

### **Consequences of Pre-incorporation Contracts**

- (i) **Company cannot be sued on pre-incorporation contract:** Sometimes contracts are made on behalf of the company even before it is duly incorporated. But no contract can bind a company even before it comes into existence. The basic principle of Contract Law, prescribes, that there shall be two parties whilst entering into a contract. *“Two consenting parties are necessary for a contract, whereas the company before incorporation, is a non-entity”*. A company has no status prior to incorporation. It has no income before incorporation, for tax purposes. Shares cannot be acquired in the name of the company, before it is incorporated. Even a transfer form can be rejected where the proposed company acts as the transferee.

In *Re English & Colonial Produce Co Ltd*<sup>7</sup>, a solicitor on the instructions of certain gentlemen (promoters), prepared necessary documents and obtained the registration of the company. He paid the registration fee and incurred incidental expenses of registration. Promoters became the directors. Unfortunately, in the meantime company fell into liquidation process. Solicitor demanded the incidental expenses borne by him. Company rejected the claim. The company was not bound to pay for those expenses and services.

- (ii) **Company cannot sue on pre-incorporation contracts:** The company is also not entitled to sue on a pre-incorporation contract. The company cannot by adoption or ratification claim benefits of a contract purporting to have been made on its behalf before the company came into existence.

*Natal Land & Colonisation Co. v. Pauline Colliery Syndicate*<sup>8</sup>, the company entered into an agreement with C, on behalf of a proposed syndicate, that the company would give the syndicate, lease on coal mining rights. The syndicate was subsequently registered and claimed lease but the company refused. An action was brought in by the syndicate but it was held that the same was not maintainable as the syndicate was not in existence when the contract was entered into.

- (iii) **Personal right and liability of the Contracting agent:** In the absence of the above two situation, question arises whether an action could be brought against the promoter who entered into the contract on behalf of the proposed company. The answer depends on the way that the contract is being constructed. If both the parties know the fact that the agent in contracting on behalf of a principal, who is non-existent entity at the time of entering into the contract, then, an action could be brought against the promoter/s, making him personally liable.

*Kelner v. Baxter*<sup>9</sup>, in this case a group of promoters for a new hotel business entered into a contract, purportedly on behalf of the company which was not yet registered, to purchase wine. Once the company was registered, it ratified the contract. However, the wine was consumed before the money was paid, and the company unfortunately went into liquidation. The promoters, as agents, were sued on the contract. They argued that liability under the contract had passed, by ratification, to the company and that they were hence not personally liable. It was held, however, that as the company did not exist at the time of the agreement it would be wholly inoperative unless it was binding on the promoters personally and a stranger cannot by

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<sup>7</sup> [1906] 2 Ch d 435 CA

<sup>8</sup> [1904] AC 120

<sup>9</sup> [1866] 15 LT 213

subsequent ratification relieve them from that responsibility

As per *Section 230 of the Indian Contract Act*<sup>10</sup>, an agent cannot personally enforce or bind the principal on their behalf, nor he is personally bound by it. Because in this case the company that is principal is not legally present as this agreement is made before incorporation of the company.

Therefore, enforcement of pre-incorporation contracts in India comes from the Specific Relief Act, 1963. *Section 15(h) of the Specific Relief Act, 1963*<sup>11</sup> says that when promoters of any company form a contract for the purpose of the company before its incorporation, it is said that the company has accepted the agreement and warranted it, and also communicated this to other party. This section means that if promoters of the company on behalf of it, enters into a contract with the third party, then it is said that the company has accepted the agreement and will incur all the liabilities of the contract and it was also assumed that promoters have communicated the same to other parties. Hence, this section basically gives validation to the concept of a pre-incorporation contract.

*Section 19(e) of the Specific Relief Act, 1963*<sup>12</sup> when the promoters of the company who entered into a contract before its incorporation which is warranted by the term of incorporation, provided that the company has accepted the contract and also communicated it to the other party. This section gives relief to the promoters of the company who have entered into a pre-incorporation contract.

### **Public and Private Companies**

A private company is a company held in private hands. This means that, in most cases, a company is owned by its founders, management, and/or a group of private investors. The public isn't privy to its business.

A public company is a company that has sold a portion of itself to the public via an initial public offering (IPO), meaning shareholders have a claim to part of the company's assets and profits. Public disclosure of business and financial activities and performance is required of public companies. Also, a public company is usually a very large business entity and is normally listed and traded on a stock exchange.

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<sup>10</sup> The Indian Contract Act, 1872, 230, No. 9 Acts of British Parliament, 1872 (British India)

<sup>11</sup> The Specific Relief Act, 1963, 15(h), No. 47 Acts of Parliament, 1963 (India)

<sup>12</sup> The Specific Relief Act, 1963, 19(e), No. 47 Acts of Parliament, 1963 (India)



## **Ownership**

Private companies are owned by those who establish them and those invited to invest in them. The public-at-large cannot buy shares or otherwise invest in private companies at their own discretion.

Once a public company's stock shares trade on public stock markets, they can be bought and sold by people outside of the company. So, the company is owned by those within the organization who possess shares of company stock and by members of the general public. As a consequence, members of the public who own shares have a stake in the company and company management can be influenced by their opinions related to the company's business.

## **Public Sector Enterprises**

Public Sector Enterprises are a significant part of the Indian economy which comprises the public services and enterprises. An organisation owned by the government is called a public sector enterprise. This organisation can be a corporation, statutory corporation or a nationalised bank. The people that work in these organisations are government employees.

The organisations owned and managed by the government are known as Public Sector Enterprises or Public Sector Undertakings. It can be held either by the Central Government or a state government.

In India, as of August 2024, there are 389 Central Public Sector Enterprises (CPSEs) and subsidiaries of CPSEs, of which 70 are listed. Some of these PSUs come under the control of some of the ministers of the Parliament, like the Railways.

## **Public Enterprises Meaning**

Public Sector Enterprises are an essential part of the Indian economy. These consist of public services and enterprises that benefit people of India. The public sector enterprises are businesses owned and controlled by the government.

The government either wholly or partially owns the enterprises. These enterprises help the government participate in the economic activities of the country. The Central or the state governments can manage Public Sector Undertakings (PSUs). When managed by the Central

Government, it is known as the Central Public Sector undertaking. However, when owned and operated by a state, it is known as the state-level public sector undertakings.

### **Classification Of Public Sector Enterprises**

In the PSU's there are three main sectors, which are:

- (i) **Departmental Undertakings**: These are organised, financed and controlled by the government. The department is under the control of a minister from the Parliament. Some examples of departmental undertaking are the Indian Railways and Indian Post.
- (ii) **Non-Departmental Undertakings**: These are government companies and subsidiaries of the government. Additionally, these refer to statutory companies set up under special enactments of the Parliament and State Legislature. A few examples of non-departmental undertakings are Oil and Natural Gas Corporation, Road Transport Corporations, Hindustan Aeronautics Limited, Bharat Electronics Limited etc.
- (iii) **Financial Institutions**: These are enterprises like commercial banks, investment banks and brokerage firms. Examples of financial institutions are the State Bank of India and Unit Trust of India.

### **Liability fixing in Pre-Incorporation Contracts**

With reference to the contracts that does not fall within the purview of Sections 15 and 19 of the Specific Relief Act, the doubt arose as to whether there exists a chance of contracts getting either enforced by or against the agents who acts on behalf of the corporation. In order to effectively answer this question, the courts will have to look into the construction of the contract, in order to understand the underlying purpose of it. If the contract is made on behalf of the company which is not yet there in existence, then the personal liability of the agent might arise.

On the other hand, if the parties' contract with the knowledge of the fact that the company on behalf of which the contract has been made is non-existent, then it is deemed to be enacted in the personal capacity of the agents.

Whereas when a company contracts on its own, it cannot be enforced by or against the agent

who acts as a tool to bring the contract into existence. There won't be any personal liability in that case. It is the company which entered into the contract even though the whole transaction may be authenticated by the directors.

Given all the circumstances, whenever a dispute reaches the court regarding the pre-incorporation contract, the courts generally have an outlook to safeguard the company's interest which is getting affected by the misconduct of the agents who acted even prior to the company's existence. But this also happens to be a double-edged sword. Why because, in the circumstances where the other party commits some fraud in the pre-incorporation contracts, in the event even the company will also be at a disability to initiate an action.

Even if the company's memorandum of association permits it to undertake or validate the pre-incorporation contracts, it wouldn't suffice. If the company is to acquire rights or liabilities, then it must show that there exists a contract between the company and the other party. For that purpose, the company may enter into a fresh contract with that of the third party. Or there must be some provision for the ratification. Only in such cases, the company is said to have had intention to enter into such contracts and liability is shifted to it.

### **Issues arising from Pre-Incorporation Contracts in PSEs**

1. **Authority and Government Oversight:** In PSEs, the individuals entering into pre-incorporation contracts often require sanctions from the government or ministries. Whenever such contracts are entered into without proper approval, they may not be enforceable, similar to that of a Government Contract.
2. **Ratification and Liability:** For a PSE, ratification of pre-incorporation contract involves approval from the government or the board of the enterprise after its incorporation. If the contract is not ratified, the promoters or the individuals who entered into the contract may be held personally liable.
3. **Public Accountability:** Since PSEs deal with public funds, pre-incorporation contracts may be subject to the audit and scrutiny by constitutional bodies like Comptroller and Auditor General of India. Any irregularities in these contracts can lead to questions of accountability and even legal action under anti-corruption laws.
4. **Contractual Enforceability:** Indian courts have addressed several cases involving pre-incorporation contracts. The enforceability often depends on whether the enterprise has

acted on or ratified the contract after its incorporation. When it comes to PSEs, this issue can get a bit more complicated as the government rules on procurement and public expenditure crawls in.

### **Conclusion**

Pre-incorporation contracts in Public Sector Enterprises (PSEs) in India refer to agreements made on behalf of an enterprise before it is incorporated. These contracts are often essential in facilitating initial operations such as procuring resources, hiring personnel, or securing essential infrastructure. The legal framework surrounding these contracts intersects with both corporate and public law.

The idea of intersection of pre-incorporation contracts with that of public sector enterprises, we may arrive at certain conclusions. That is to say, pre-incorporation contracts with respect to a public company may certainly vary from that of a privately owned company. This is due to the fact that essentially there is the involvement of the larger public interest in this. This is a classic case of intermixing of corporate principles with that of the public accounting. In order to maintain the transparency promoters and officials must ensure proper government approvals and ratification to avoid a personal liability and ensure that the contracts are enforceable. Additionally, the scrutiny by the public body makes the process more complex as compared to the private sector companies, wherein there is no obligation on the private companies.

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