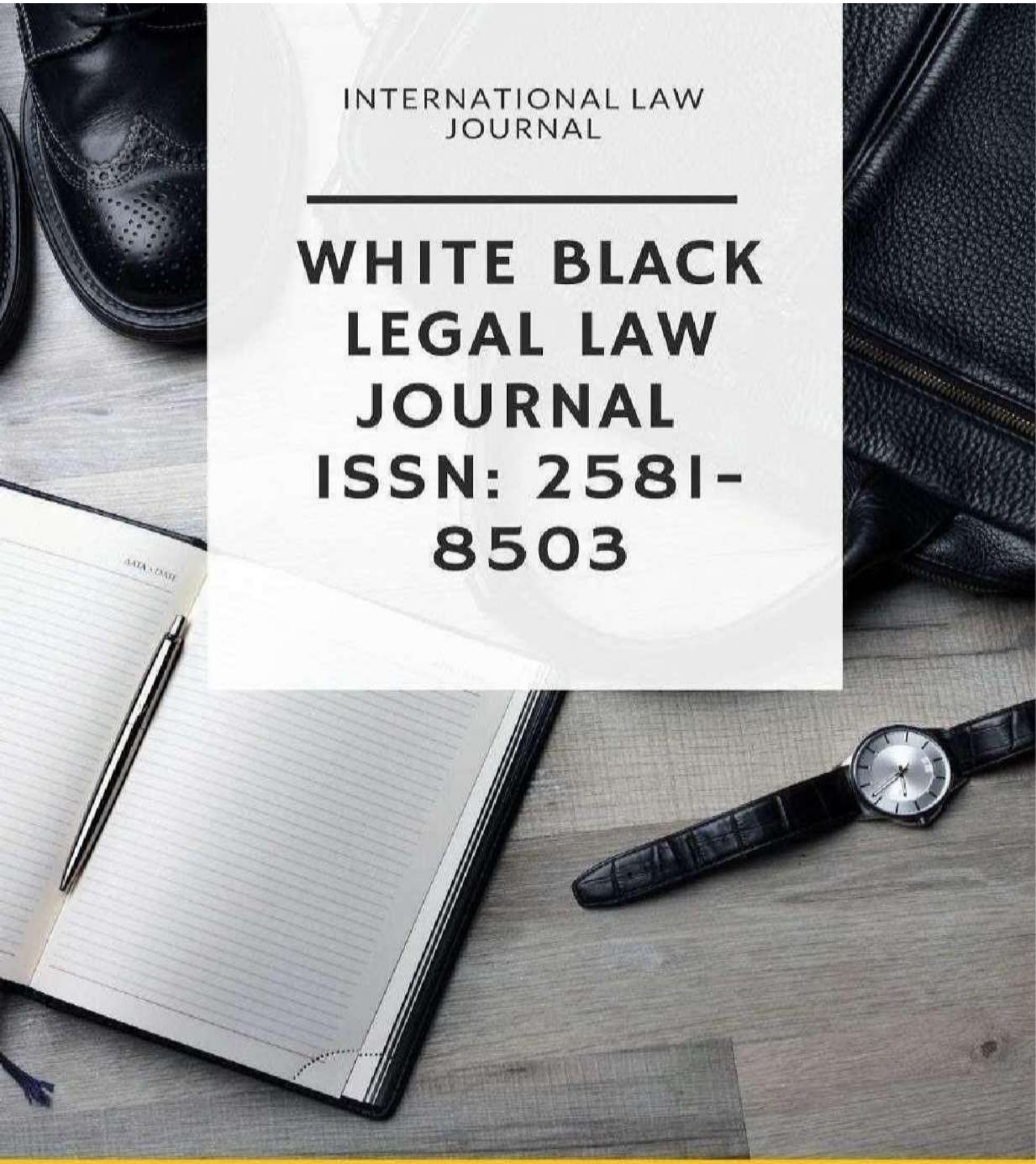

INTERNATIONAL LAW JOURNAL

WHITE BLACK LEGAL LAW JOURNAL

ISSN: 2581-8503

Peer - Reviewed & Refereed Journal

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ABOUT US

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 AND THE PROBLEM OF PROMOTER LIABILITY

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Abstract:

Before incorporation, a company has to enter a number of agreements to begin its operations. Pre-incorporation contracts are basically those contracts that a promoter enters with these parties before the incorporation of the company. These contracts are entered on behalf of promoters in their personal capacity as there is no company in existence for them to represent. This raises question of who do these agreements bind? Is it the unincorporated company or the promoter?

These problems mainly arise due to lack of statutory clarity. Through this article, I aim to assess these legal gaps and answer questions of promoter liability through common law and ancillary provisions.

Towards the end of the article, I also include some possible suggestions to avert promoter liability.

Key words *– Pre incorporation contracts, Promoter, Company, Ratification, Incorporation*

1. What is a pre-incorporation contract?

Pre-incorporation contracts are nothing but agreements entered by the promoter on behalf of the company before the incorporation of the company.[1] A pre-incorporation contract is incomplete in the sense that it will have no effect in the event the company does not actually incorporate. Even if the company has been lawfully incorporated, it is up to the company to ratify the contract. As a result, it is important for law to offer rules to fill these gaps.

[1] Singh, Prasidh Raj, *Promoter and Pre-Incorporation Contract*, SSRN (January 31, 2011) https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1938065.

The promoters while contracting act as agents of the company. The agent owes certain fiduciary duties to the company and thus, all benefits arising out of the said agreement would pass to the company even in the absence of express agreement over the same.[2] However, if the company not yet incorporated is not yet in existence, then how can it appoint an agent? This question challenges the validity of 'pre-incorporation contracts' in India. This article highlights the gaps in law and tries to address the problem of promoter liability in the event of enforceability/unenforceability of these contracts.

2. Fiduciary relationship between promoter and company:

It is a well-established legal principle that a promoter is not the agent of the company he is promoting because the company does not exist in the eyes of the law prior to incorporation.[3] A non-existent principle cannot be represented by an agent.

In the case of Kelner v Baxter (1866), The court of Common Pleas clearly stated that a promoter is not a trustee of the firm he is attempting to incorporate. The promoter has fiduciary duties and obligations, and he can be made liable legally accountable for breach of these duties.[4]

The case of Erlanger v New Sombrero Phosphate Co. (1878) affirmed the holding in Kelner v. Baxter. Promoters have a fiduciary duty towards the company.[5] They have the power to create and develop the company. They also have the authority to determine how, when, and in what form the company will be incorporated and begin operating as a commercial entity.[6]

Thus, even though the promoter cannot be said to act as an agent while entering pre-incorporation contracts, he still owes fiduciary duties towards the company.

3. Liability on Ratification and Novation:

To assess the enforceability of pre-incorporation contracts, we refer to s. 19(e) and s.15(h) of the Specific Relief Act, 1963.[7]

As per s.19(e) the third party can only enforce specific performance against the company if the

[2] *Kelner v. Baxter*, (1866) LR 2 CP 174.
[3] *Edinburgh Northern Tramways Co v Mann* (1896) SLR 33_752.
[4] (n 2).
[5] *Erlanger v. New Sombrero Phosphate Co.,* (1878) 3 App Cas 1218.
[6] *Ibid.*
[7] Specific Relief Act , 1963, § 19(e) & § 15(h).

company has ratified the contract and communicated such acceptance to the third party and such a contract is 'warranted by the terms of incorporation' of the company by inclusion in the article of association.[8] However, it is important .[9] However, it is necessary that the company in such a case must have accepted the contract after its incorporation and conveyed such acceptance to the third party of the contract.

S. 15 (h) is similar to s. 19(e), where s. 19(e) states who and when can the contract be enforced against.[10] S. 15 (h) states 'who may obtain specific performance' and states that a company can do so provided that such a contract is 'warranted by the terms of incorporation' of the company by inclusion in the article of association.[11] However, it is important that the company must have rattified the contract after its incorporation and conveyed .[12] However, it is necessary that the company in such a case must have accepted the contract after its incorporation and communicated such acceptance to the other party to the contract.

The use of words 'warranted by the term of incorporation' could mean acceptance by inclusion of the said contract in the articles of association. However, due to lack of clarity in the said act and dearth of case law on the same it still remains a question; how to interpret 'warranted by the terms of incorporation' & 'acceptance of the contract?' Does is imply that acceptance only has to be made expressly or a pre-incorporation contracts can be ratified as long as it's not contrary to the objects of the company? Implied acceptance (enjoying benefits arising out of the contract) would constitute as 'acceptance' within the meaning of this act?

Even after the enactment of the Specific Relief Act, 1963, there are a number of cases where these provisions have been ignored and the promoter is made liable

In Seth Sobhag Lodha v. Edward Mills Co. Ltd. , the Rajasthan High Court erroneously denied the possibility of enforcement of a pre-incorporation contract.[13] However, the decree failed to consider s.15(h) and s.19(e) of the Specific relief Act, 1963.

[8] Specific Relief Act , 1963, § 19(e).
[9] Specific Relief Act , 1963, § 19(e).
[10] Specific Relief Act , 1963, § 15(h).
[11] *Ibid.*
[12] Specific Relief Act , 1963, § 19(e).
[13] Seth Sobhagmal Lodha v. Edward Mills Ltd., 1969 SCC OnLine Raj 73.

Express ratification/acceptance isn't the only way to enforce the contract. The Supreme Court in Jai Narain v. Pushpa Saraf and others, interpreted 'warranted by the terms of contract' to mean that the contract must not be in contravention to the objectives of the company and dismissed the submission that a express condition would be necessary to enforce such a contract.[14] The court said that if the company has enjoyed the benefits arising out of the contract then the third party can enforce the same against the company. Acceptance can also be implied, for instance a company accepting title over a the property sold under the pre-incorporation contract would be sufficient. Thus, accepting benefits of the contract also means accepting liability from it.

However, the Specific Relief act cannot be applied in isolation. S. 19 (e) & s. 15 (h) have to be read with other statues depending the case as hand.

The Supreme Court in Jai Narain v Pushpa Saraf upheld the validity of the land transfer agreement, because it was not contrary to The Transfer of Property Act.[15]

However, in the case of Inclec Investment Pvt Ltd v. Dynamatic Hydraulics Ltd, the Court dismissed the submission of the validity of the share transfer referring the ancillary law which said that a unregistered company could not act as transferee.[16] This case has been decided in harmony with the principles of pre-incorporation contract decided by the Supreme Court in Jai Narain Parasurampuria v. Pushpa Devi Saraf. [17]

Instead of simply accepting the contract's conditions, 'Novation' is another option. The corporation could enter into a new agreement with the third party. The doctrine of Novation allows the corporation to substitute the promoter's liabilities with its own. In other words, after the company is incorporated, the pre-incorporation contract is reconstituted as though the party contracting was the company and not the promoter. Thus, after incorporation, the promoter's liability ends and shifts to the company.

In Vali Pattabhirama Rao v. Sri Ramanuja Ginning, the Court concluded that after incorporation, a company may accept the acts of the promoter by a letter of approval.[18] The promoter might also

[14] Jai Narain Parasrampuria v. Pushpa Saraf, (2006) 7 SCC 756.
[15] *Ibid.*
[16] *Inlec Investment (P) Ltd. v. Dynamatic Hydraulics Ltd.*, (1989) 3 Comp LJ 221, 225 (CLB)].
[17] (n 12).
[18] *Vali Pattabhirama Rao v. Ramanuja Ginning and Rice Factory (P.) Ltd*., 1983 SCC OnLine AP 207.

provide the company the right to sue by specifying it in the article or terms of association. Either by adopting the contract or Novation of contract by a substituted action.

Indian law recognizes the doctrine of Novation with respect to pre-incorporation contracts. This allows the promoter to replace his liability with that of the company's. Indian courts are widening the ambit of Novation.

Madras High Court in Weavers Mills Ltd. v. Balkies Ammal broadened the scope of the doctrine of Novation.[19] The company on incorporation didn't expressly ratify the contract but built structures on the property bought by the promoter in the pre-incorporation contract. The company is enjoying the property arising out of the contract and is made liable under the contract.

Even after so many case laws, promoter liability in pre-incorporation contracts is not a settled position. The lack of statutory enactment and contrary judicial decision have made it hard to determine promoter liability.

However, the promoter is exempted from liability in most cases of Novation and ratification/acceptance whether expressed or implied. In such a scenario, the company will be liable against the third party.

4. Non Ratification:

However, the question now arises what if the company does not ratify the pre-incorporation contract, then in such a case would the promoter be liable? To determine this question, common law principles have been applied. In case of Kelner v. Baxter, the promoter was made liable for acting on behalf of the company that did not exist.[20] The court rendered the whole agreement inoperative and made the promoter liable for breach of contract.[21] Similarly, in the case of Newborn v. Sensolid, the promoters are made liable to the pre-incorporation agreement for acting as agents of a non-existent principle.[22]

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[19] *Weavers Mills v. Balkis Ammal*, AIR 1969 Mad 462.
[20] (n 2).
[21] Lakshmi Dwivedi & Varun Byreddy, Pre-Incorporation contracts: A legal Puzzle, NLIU Law Review, https://nliulawreview.nliu.ac.in/wp-content/uploads/2022/01/Volume-V-Issue-I-53-79.pdf.
[22] *Newborn v. Sensolid* (Great Britain) Ltd (1953) 1QB 45; (1953) 2 WLR 595.

However, these principles are derogatory to certain cases decided by Indian courts.

Another way to determine liability, would be to focus on the fact it is the Promoter who undertakes the task of incorporating the company regarding a new project and sets it going and take necessary steps to accomplish that purpose.[23] Even s. 2(69)(b) of the Companies Act, 2013 states that 'promoter means - who has control over the affairs of the company, directly or indirectly whether as a shareholder, director or otherwise.'[24]

Additionally, Promoter is the person, who in most cases is the majority shareholder of the company and controls the affairs of the company. Thus he holds the power to ratify a contract and influence other shareholders/directors to do the same. Thus, in an instance of non-ratification he should be made liable. As the power to not ratify also vests in him.

Another view on ascertaining liability, would be by referring to s. 230 of the old companies act and applying it principle.[25] The principle states that the promoter is merely acting as the agent of the company and cannot be made liable. Thus, once the company is incorporated, the promoter can't sue or can be sued in case the company refuses to ratify the contract except on the principle of quantum merit.[26]

Although the Specific relief Act has laid down conditions for ratification/acceptance of the pre-incorporation contract, it still remains silent on events non ratification and non-incorporation,

5. Non – Incorporation:

Another instance, to determine promoter liability is on the non-incorporation of the company. What is the validity of a pre-incorporation contract then? Can the promoter be made liable? Here once again common law principles of Kelner v. Baxter and Newborn v. sensolid would apply, promoter cannot act as an agent for a non – existent principle. If the company is not incorporated, no principle exists and the contract will be binding on the promoter.[27]

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[23] *Twycross v Grant (1877)* 4 C.P.D. 40.
[24] Companies Act, 2013, § 2(69)(b).
[25] Companies act, 1956, § 230.
[26] (n 19)
[27] *Kelner v. Baxter*, (1866) LR 2 CP 174 and Newborn v. Sensolid (Great Britain) Ltd (1953) 1QB 45; (1953) 2 WLR 595.

Additionally, the promoter is responsible for incorporating the company and the undertakes the task of executing projects and agreements.28 Thus, the promoter's name is included in the prospectus. Hence, he should be the one liable in an event that the company does not incorporate.

6. Conclusion:

Through this article we can see that the earlier common law position (Kelner v. Baxter) of ascertaining liability on the promoter irrespective of ratification has been changed. Owing to the Specific Relief, that shifts the liability to newly incorporated company.

Pre-incorporation contracts are essential in business, but the legislation governing these agreements has long been fraught with problems. The common law is unable to adequately regulate these interactions. It is necessary to create an appropriate legal norm that will promote pre-incorporation transactions. Pre-incorporation transactions are not adequately regulated by current law. Under the current system of company law in India, the most effective rules should be created in light of the potential for the proposed company to fulfil sthe contract. Thus, a statutory clarification on these problems of liability will prove most effective in the current scenario.

In the light of these uncertainties prevalent in our country, it is advisable to avoid such contracts till the company is incorporated. However, in the absence of such a law some precautionary steps can be taken into consideration. Personal liability of the promoter can be significantly avoided by correct drafting. An express clause for no-personal liability in an event of non-ratification/non incorporation should be negotiated by the promoter.[29] A further clause can be added, indicating the status of incorporation of the company. The promoter can also bargain the addition of the clause claiming indemnification of all pre-incorporation expenses.[30]

However, even ratification is no guarantee that his liability will exempted. The promoter should press for novation of the pre-incorporation contract.

[28] (n 21).
[29] (n 19).
[30] (n 19).