PROMOTERS OF A COMPANY - THE MINDS BEFORE INCORPORATION

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ABSTRACT

This Articles highlights the role of Promoters in relation to the corporate personality and their legal position before and after the incorporation of the company. It also strives to comprehend the ambiguous relationship between the company and the promoter, and also their duties and obligations, which are derived from statutory as well as judicial interpretations. Further, the article deliberates on the functions of Promoters vis-à-vis The Companies Act, 2013 and the liabilities imposed upon them, therein. Finally, the piece dwells into the validity of the contracts between the promoters and third party before the incorporation of the Company and the remedy that can be sought by the aggrieved party under the Specific Relief Act, 1963 for its performance, with special relevance to Indian jurisdiction. The article also provides some constructive suggestions apropos the position of promoters that can surely succour in promoting the dual objective of Enhancing the functioning of the Company as an institution and at the same time protecting the interests of its members.

Introduction

Every reality has a dream and behind every dream is a veiled mind. Same goes with the dream of incorporating a company and the veiled mind behind the same belongs to an individual who is termed as a Promoter in Corporate Parlance. She is the person who first visualizes Company as a Separate Legal Entity with a Perpetual Succession and Common Seal[1]. The one who prophesizes the company is known as a promoter. In real life scenario, Promoters epitomize Parents and the company their child, who strives to ensure that their child educates and remains under the supervision of, and receives the guidance of quality teachers and mentors, who are the Board of Directors (BoD) in case of Company. They formulate a detailed plan for the child to ensure his well-being and success. This role is played by the promoter apropos the Company. Thus, she is the most imperative and foundational pillar for the edifice of company, before its incorporation and most often, even after.

Most Statutes worldwide have no definite role of a promoter incorporated within the legislation. The reason is obvious for the same. As the Company emerges, the position of Promoter subsists as her idea turns into reality. Hence, the position of promoter is ad interim and not perpetual. She is a person who visualizes to provide a corporate veil to the company and herself disappears behind this veil.

Promoters: Who & Why

The legal and succinct definition of Promoter is perhaps difficult to comprehend. Thus, the judiciary has played a crucial role in loosening this state of Perplexity and has made a serious attempt to outline the existence of a promoter, when the statute is ambulatory on the subject. Joseph H. Gross, has stated that the term has never been explicitly defined either judicially or legislatively as the term 'Promoter' is not a term of Art, nor a term of Law, but of Business. Lord Bowen has stated that the term in a single word signifies a no. of business operations, familiar to the commercial world, by which a company is generally brought into existence[2]. Similarly, it has been decided that the promoter is a person who brings about the incorporation and organization of the corporation. He brings together the persons who become interested in the enterprise, aids in procuring the subscription, and sets in motion the machinery which leads to the formation itself[3]. He is the one who undertakes to form a company with reference to a

[1] . Lewis Henry Haney, Business Organization and Combination.
[2] . Whaley Bridge Calico Printing Co v. Green, (1880) LR 5 QBD 109.
[3] . Bosher v. Richmond Land Co., 89 Va 455.

given project and to set it going, and who takes the necessary steps to accomplish that purpose[4]. Thus, there is no definite meaning.

Hence, it has been construed that whether a person is a promoter or not is a question of fact and depends upon the role played by him in the promotion of the business, further stating that the functions of the promoter come to an end as soon as they hand over the company to a governing body, like the BoD[5]. However, this description is not totally valid in Indian Context as role of Promoter does not come to an end after handing over the affairs of the company to the BoD. Thus, the Promoter can be summed up as follows, 'Before a company is formed there must be some persons who have the intention to form the Company, and who takes the necessary steps to carry that intention into operation. Such persons are called Promoters[6].

Fiduciary Agent of the Company

The promoter stands in a fiduciary relationship vis-à-vis the Company[7]. She is regarded as a Trustee of the Company and her dealings must be fair and open. Thus, if the company is incorporated for the purpose of buying her own personal property, she must faithfully disclose all the facts relating to the Property. This even includes the disclosure of any profit made by her in the transaction and also any bonus or commission received from the person who sells the property to the company. Thus, as a Fiduciary agent, the Promoter is under an obligation to disclose to the Company his position, interest and also profit in the property which is subject to the sale. The company has the right to set aside any transaction and also recover compensation for its loss if any fact is concealed. Also, the Promoter can be held liable for Breach of Trust.

The important question is to whom the disclosure is to be made? Initially the courts held that the disclosure must be made to an Independent and Competent BoD[8]. However, subsequent experiences have proved that it is not always feasible to have an Independent BoD, For eg. In the case of Salomon & Co., the BoD consisted only of Family members and thus cannot be considered as purely Independent. Thus, it was held that in such situation the promoter must disclose the interests to the shareholders too. Finally, it was decided that the Disclosure must be made to the whole body of persons who are invited to become shareholders. The disclosure must be made in the prospectus, or otherwise, so that those who are or become members, as a

[4] . Twycross v. Grant, (1877) 46 LJ QB 636.
[5] . Ibid.
[6] . Charlesworth & Morse, Company Law.
[7] . Erlanger v. New Sombrero Phosphate Co. (1878) LR 3 AC 1218.
[8] . Ibid.

result of the transaction in which the promoter was acting as such, have full information regarding it[9]. However, after making a full and fair disclosure it is not unlawful for the director to sell his property to the company for a profit[10].

Hence as a Fiduciary agent, the Promoter must adhere to the two-fold restrictions imposed upon him. Firstly, the Duty to Disclose any interest and Secondly, Duty not to make any secret profit. But what if the Promoter acquires any property for Company after its incorporation? The law is perhaps silent on the subject. Thus, we can suggest that in such cases, the Registered Valuer must be empowered to reckon the market value of the property and based on this report, a resolution must be passed in the Annual General Meeting to accept or reject the property on behalf of the company. Also, the property must be further classified as Movable as well as immovable, so that if the promoter holds a share in the share capital of any company, the same can be transferred to the company, as shares being movable, by virtue of S.44 of Companies Act, 2014.

Promoters in the Companies Act, 2013

The Companies Act of 1956 did not define the term promoter, although the term was used in some of its section. The 2013 Act, on the other hand, very clearly defines the term 'Promoter'. Acc. to Sec. 2(69), the Promoter means a person (*a*) who has been named as such in a prospectus or is identified by the company in the annual return referred to in section 92; or (*b*) who has control over the affairs of the company, directly or indirectly whether as a shareholder, director or otherwise; or (*c*) in accordance with whose advice, directions or instructions the Board of Directors of the company is accustomed to act:

Provided *that nothing in sub-clause (*c*) shall apply to a person who is acting merely in a professional capacity.*

Thus, a person acting in professional capacity is outside the scope of the Definition. So, a solicitor or a Chartered Accountant cannot be considered as Promoters for the services rendered by them. Similarly, a person does not become a promoter on the ground that he has signed the Memorandum of Association of the Company for one or more shares[11]. However, if the person leaves the task of promotion to others and sits behind to share their profits, he is likely to be regarded as a promoter. Also, if the person helps in getting a purchaser for the company's patent

[9] . Gluckstein v. Barnes, 1900 AC 240.
[10] . Omnium Electric Palaces Ltd. v. Baines, 1914 1 Ch 332.
[11]. Official Liquidator v. Velu Mudaliar, (1938) 8 Co. Cases 7.

or shares, or in getting personnel for the company, he can be considered as a promoter.

One major feature of Companies Act, 2013 is the imposition of liability on the Promoter in three circumstances. They are discussed as follows:

1. Misstatement in Prospectus: The Act has negated the rule of fraudulent intention[12] and has made every person mentioned in **S.35** of the Act, which includes the Promoter, liable for any misstatement in the prospectus. If a person subscribes to any security of the company on the faith of statements contained in the prospectus issued by the company, the subscriber can sue the persons mentioned in S.35 for any loss or damage sustained, by reason of any untrue or misleading statement in the prospectus.
2. Allotment of Shares: When a company issues a prospectus, all the money which is received by it from applicants for the share is to kept deposited in a Scheduled bank. If the entire amount payable on applications for share in respect of the Minimum Subscription Amount has not been received by the company within the prescribed period, all the money received by it from the applicants is to be returned to the subscribed applicants within the stipulated period. If there is any contravention of this provision, then the promoter becomes personally liable by virtue of **S.39**.
3. Winding-up Proceedings: If the tribunal passes an order for the winding up of a company, and the liquidator has made a report to the Tribunal that a fraud has been committed, *inter alia*, in the promotion of the company, then the tribunal can order that the Promoter must be examined under **S.300**

Hence, there is a three-fold liability on the promoter, which continues even after the incorporation of the Company. However, another interesting aspect of this concept is that the promoters are not a sine qua non for a continued existence/sustenance of a company. The promoters of various companies have re-classified them as public shareholders with the approval of Securities Exchange Board of India (SEBI). Also, listed companies, requires a minimum 25 per cent of public shareholding but there is no such legal requirement of minimum promoter group holding[13]. Here, it may be noted that when a promoter led company raises funds through a IPO, then it must maintain 20% minimum shareholding of the post-issue capital for a minimum period of three years therefrom. But in this case also, such requirement is only

[12] . Derry v. Peek (1889) 14 AC 337.
[13]. Rule 19(2)(b) of the Securities Contracts (Regulation) Rules, 1957 as amended by Securities Contract (Regulation) (Third Amendment) Rules, 2017.

for a short period of time for fastening a sense of responsibility upon the promoters. In cases, where there is no identifiable promoter, even this requirement does not exist

Contracts by the Promoter

The company as an entity is competent to contract. However, this competency is bestowed upon the company only when it attains the status of a Corporate Personality by virtue of its incorporation. Thus, contract with a company which is unincorporated is null and void in the eyes of law. Hence, if the promoter, before incorporation, enters into a contract with a third party, on behalf of the company, it does not bind the company. As rightly stated by Gross, it is neither desirable nor fair to saddle a company with burdens imposed upon it in advance by overly optimistic promoters.

Earlier, if the contract was entered by the promoter on behalf of the company and signed "for and behalf of ABC Ltd.", then the promoter would be personally liable[14]. Thus, when the proposed directors personally accepted the delivery as a part of the contract entered with the company, they were held personally liable to pay for the same, as they had contracted on behalf of a non-existing Principal. However, if the promoter signed the proposed name of the company, adding his own name to authenticate it (for e.g. ABC Ltd., XYZ Director) then the contract will be considered as non-existent as Director cannot be appointed before Incorporation[15]. . Also, it has been adjudicated that pre-incorporated contracts are double-edged swords and hence the party who is personally liable for the contractual obligations is also able to enforce the benefit of the contract[16]

It has been held that a company cannot sue, ratify or adopt any pre-incorporation contract, as it was not in existence, when the contract was entered into[17]. Thus, when the solicitor paid the registration fees and other incidental expenses to get the Company registered on the instructions of the promoter, the court rejected his plea for reimbursement from the company, on the ground that the company was not in existence at the time of entering into the Contract[18].

This resulted in gross and manifest injustice to the third parties, who have no notice regarding the incorporation and thus become victims of the Controversial *Doctrine of Constructive*

[14]. Kelner v. Baxter (1866) LR 2 CP 174
[15]. Newborne v. Sensolid (Great Britain) Ltd. (1954) 1 QB 45 CA
[16]. Braymist Ltd. v. The Wise Finance Co. Ltd. (2002) Ch. 273 CA.
[17]. Natal Land & Colonization Co. Ltd. v. Pauline Colliery Syndicate (1904) AC 120.
[18]. Re. English & Colonial Produce Co. Ltd. (1906) Ch. D 435.

Notice[19] and, at times also to the Company. Hence, as a panacea to this conundrum, the legislatures worldwide made necessary amendments to protect their interests. In India, the safeguard is provided by *The Specific Relief Act, 1963*. It states that the specific performance of a contract may be obtained by any party thereto or the representative in interest or the principal, of any party, when the promoters of a company have, before its incorporation, entered into a contract for the purposes of the company, and such contract is warranted by the terms of the incorporation, the company, provided that the company has accepted the contract and has communicated such acceptance to the other party to the contract[20].

Thus, two conditions must be satisfied. First, the contract must be made for the purpose of the company and second, it must be warranted by the terms of incorporation of the company. The company may, after incorporation, adopt and enforce such a contract. Similarly, even the third party can enforce such a contract if the company has adopted it. But, if the company does not adopt the pre-incorporated contract, the promoters who entered into the Contract will be personally liable. It has been held by the Supreme Court of India, the adoption of the pre-incorporated contract can also be construed and interpreted from the facts of the case, even if the same is not reflected in the Memorandum of Association or Articles of Association of the company[21].

Sec. 51 of *The European Communities Act,1972* provides that "A contract which purports to be made by or on behalf of the company at a time when 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 an agent for it, and he is personally liable on the contract accordingly. Thus, it imposes personal liability on the Promoter. Similar provisions are made in *The English Companies Act,1989.*

Conclusion

No doubt, the Directors are the agents, trustees and brain of the Company. However, one can never ignore the importance of a promoter. There can be no BOD, shareholders and also employees in a company, without the aspiration and venturesome attitude of the promoter to defy all the odds and start a company. The promoter can become a shareholder under the present statutory arrangement. Also, there have been cases where the promoters try to increase their

[19]. A person is deemed to have knowledge about the company, except internal affairs, before engaging with the Company.
[20]. Sec. 15(h).
[21]. Jai Narayan Parasrampuria v. Pushpa Dev Saraf (2006) 113 Co. Cases 794.

stake in the share capital of the company to acquire majority of the stake, enabling them to control the management and affairs of the company. We have the recent case of Zee Entertainment, where the promoters are trying to increase their stake from 4% to 26%, so as to promote their way of doing business in a company that they envisaged. Insiders claim that the promoters were quite uneasy regarding the terms and conditions set out in the Zee-Sony Merger plan, but were incompetent to oppose the deal owing to the quantum of shares held by them. The Merger has been however, rescinded as the two entertainment barons were at odds over who would lead the combined company.

However, the shareholders express their opinions and ideas majorly in the Annual General Meeting (AGM) or in the Extra-ordinary General Meeting (EGM) in times of exigency. Thus, I propose that the Board of Directors must have a nominee of the Promoter too, so that his ideas can be brought into pragmatic realities and his expertise and experience can be utilized more effectively. The Provision of Nominee Director already exists in S. 149 of the Companies Act, 2013 where institutional lenders nominate a person in the Board, to safeguard their interest by making the necessary incorporation in the Articles under S. 161. Similar arrangement can be made for the nominee of the promoter.

Another major recommendation is the presence of the Promoter at the time of Incorporation of the Company. The Companies Act provides that there must be 7 persons (in case of Private Companies) at the time of incorporation of the company, whose names shall be outlined in the Subscription Clause of the Memorandum of Association. Thus, the act can provide that the presence of the Promoter shall be mandatory among the 7 persons. By virtue of this, the promoter by default becomes a shareholder in the Company. This would serve two purposes, First, it will provide due credit to the person, whose idea is now finally turning into reality and second, by virtue of his inclusion, in case the first directors are not appointed, then the promoter can also function as the first director of the Company, until the first AGM is conducted, as provided under Sec.152. Hence, under the initial year of the company, which is no doubt, the most important and deciding for any company, it shall have the guidance and leadership of a director, who is the promoter of the company.

Finally, I conclude on an optimistic note that the Promoter and his wisdom gets truly recognized, so as to promote entrepreneurial zeal among the youngster, thus enabling them to be Job-Givers rather than Job-Seekers.