IMPLICATIONS FOR PROMOTERS FOLLOWING THE PASSAGE OF THE SPECIFIC RELIEF ACT OF 1963

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Introduction: Promoters and their role

According to Indian laws, “company” means a company incorporated and registered in accordance with law.[1] In other words, it is only after a company has been duly “registered” that it is recognized as a company in India law. Therefore, prior to the formal incorporation of the company, the “association of persons”[2] is not considered to be a separate legal entity.

Prior to the incorporation of the company, there is a need to promote the functioning of the company. Promoters will be obligated to make adequate arrangements in order to ensure the smooth beginnings of the company. Such tasks may include: renting of office space, procuring raw materials, hiring workers, etc. Thus, agreements on behalf of a prospective company or “association of persons” (preceding the formal incorporation of the company) is known as a “pre-incorporation contract”.

This paper seeks to explore the relevance and enforceability of pre-incorporation contracts of a company under Indian law. Contractual law is governed by the Indian Contract Act, 1872 along with the Specific Relief Act, 1963. Company law is governed by the Companies Act, 2013 – which is an updated legislation based upon the Companies Act, 1956.

[1] Section 2(20) of Companies Act, 2013; and Section 3(1)(i) of the Companies Act, 1956

[2] Borrowed from the definition of a “company” as rendered by Lord Justice Lindley: “an association of many persons who contribute money or money's worth to a common stock and employed it in some trade or business and who share the profit or loss arising there from. The common stock so contributed is denoted in money and is the capital of the company. The persons who contributed it or to whom it belongs are members. The portion of capital to which each member is entitled is his share.The shares are always transferable although the right to transfer them may be restricted.”

Indian laws did not define a “promoter” until the enactment of the Companies Act, 2013. According to the new Act “promoter”[3] means a person—

(a) who has been named as such in a prospectus or is identified by thecompany in the annual return referred to in section 92; or

(b) who has control over the affairs of the company, directly or indirectlywhether as a shareholder, director or otherwise; or

(c) in accordance with whose advice, directions or instructions theBoard of Directors of the company is accustomed to act:

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

Judicial pronouncements also clarify the functional meaning of a promoter. The earliest definition of promoter is a person who as principal procures or aids in procuring the incorporation of a company.[4] Justice Cockburn said that “a promoter is one who undertakes to form a company with reference to a given project and to set it going and who takes the necessary steps to accomplish that purpose”.[5] Later, Justice Bowen held that “the term promoter is a term not of law, but of business, usefully summing up in a single word a number of business operations familiar to the commercial world by which a company is generally brought into existence.”[6]

According to the Madras High Court:

“The promoters of the Company act before the incorporation of the legal person. The promoter is a "midwife" of the business as coined by Henn and Alexander in Law of Corporations. Nevertheless, before the legal person has come into existence, it is the promoter who does the major role for the purpose of bringing the corporate person into existence like proposing the objects of the company to be incorporated, arranging finance, formation of the original scheme, making

[3] Section 2(69) of the Companies Act, 2013.
[4] Phosphate Sewage Co. v. Hartmount, (1877) 5 Ch D 394
[5] Twycross v. Grant, (1877) 2 CPD 469
[6] Whaley Bridge Calico Printing Co. v. Green, (1880) 5 QBD 109

arrangement to get the company registered, preparing prospectus, Memorandum and Articles of Association, etc., which are very crucial for the company to come into existence."[7]

The position of promoters after the enactment of Specific Relief Act, 1963

Liability in pre incorporation contracts:

It has been established in the above sections that the unincorporated company shall not be liable for any obligations arising out of a pre-incorporation contract. This view has been affirmed by the Rajasthan High Court in **Seth Sobhag Mal Lodha v. Edward Mills Co. Ltd.**[8] where the Court held that two mandatory conditions must be satisfied in order to sue for breach of contract: "(1) that the firm must be a registered firm, and (2) that the persons suing are or have been shown in the register of firms as partners of the firm. Unless these two conditions are fulfilled, there would be a fatal bar to the entire suit and it would be wholly incompetent in a court of law." The same position of law has been upheld by the Supreme Court of India in **CIT v. City Mills Distributors (P) Ltd**.[9] where it was held where the assessee company did not exist when the income concerned was earned, it is, therefore, not liable to pay tax on it.

However, this approach has been criticized[10] and even overruled by subsequent decisions. The key point of contention is the ignorance of the provisions of the Specific Relief Act, 1963[11] Thus, the promoters are entitled to preclude liability by using the provisions of the Specific Relief Act, under novation of contract and use the doctrine of equity.

The relevant provisions of the Specific Relief Act are:

15. Who may obtain specific performance .Except as otherwise provided by this Chapter, the specific performance of a contract may be obtained by -

(h) when the promoters of a company have, before its incorporation, entered into a contract for the

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[7] Probir Kumar Misra v. RamaniRamaswamy and Ors., [2010] 154 CompCas 658 (Mad)
[8] [1972] 42 CompCas 1 (Raj).
[9] (1996) 219 ITR 1 (SC).
[10] A. Ramaiya, *Guide to Company Act*, (Ed. 17th, 2010) pg. 689.
[11] Sections 15(h) and 19(e) of the Specific Relief Act, 1963.

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.

19. Relief against parties and persons claiming under them by subsequent title.—Except as otherwise provided by this Chapter, specific performance of a contract may be enforced against

(e) when the promoters of a company have, before its incorporation, entered into a contract for the purpose 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 communicated such acceptance to the other party to the contract.[12]

These provisions have been discussed and interpreted in **Vali Pattabhirama Rao v. Sri Ramanuja Ginning**[13], where the Court held that the promoter can give his right to sue to the company by incorporating the same within the articles or terms of association. Thus, if the company comes into existence by incorporation before the determined date, and applies in any form, it may even be by a letter approbating and accepting the acts of the promoter, which would make the application by the company a perfectly valid one – the same could be justified, either on the principle of adoption, or novation by a substituted application.[14]

Section 15(h) and **19(e)** of the **Specific Relief Act** provides as follows:

1. The contract should have been entered into by the promoter for the purpose of the company.

2. The terms of incorporation should warrant should warrant such contract.

3. The company should accept the contract after incorporation.

Such acceptance should be communicated to the other party to the contract[15]

[12] Sections 15(h) and 19(e) of the Specific Relief Act, 1963.
[13] (1986) 60 CompCas 568 (AP).
[14] *G.K.Palaniswami v. Sri Nandhi Transports (P) Ltd*., 1967 (3) Mad 80.
[15] K.S. Anantharaman, 'Lectures on Company Law & Competition Act (including Secretarial Practice)', Tenth ed., Nagpur, LexisNexis Butterworths Wadhwa; 2005, p.49.

So, preliminary contract enforced by the promoter at the prior to incorporation of the company will be treated as contract between two individuals who are in existence. Thus, the company do have no inherent right concerning ratification of those contract unless company acquiring the power as to the ratification by its memorandum as the subject-matter of contract is not contrary to the object of the company. Hence, the third party cannot sue the company, if any breach of contract has been taken place where such contract entered prior to the incorporation even they for the benefit of the company.

So, question is here that the position of the promoter in relation to preliminary contracts? Or in other words we can say that if the company does not execute a fresh contract incorporation and the contract is not one warranted for the purposes of incorporation of the company, what will be the legal position of the promoter who brings about such a contract?

It was observed in the case of **Phonogram Limited v. Lane**[16], that although a contract made before a company's incorporation cannot bind the company, it is not wholly devoid of legal effect, even if all the persons who negotiated the contract are attempting to incorporate a Pop group had obtained financial assistance from a recording company. He was held personally liable to refund the amount on his project failing to materialize.

So, Promoters shall be liable to pay damages for failure to perform the promises made in the name of company and this shall be so, even where the contract expressly provides that only the company's paid up capital shall be answerable for performance as it was also held in the case of **Scot. vs Lord Ebury**[17]

Under English Common Law, the ratification or adoption, after the incorporation, did not release the promoter from liability of pre-incorporation contract. Whereas in American Court recognize that if the after the incorporation company can ratify or adopt the contract, and this would bound the company and not the promoter.

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16 [1982] QB 938.
17 [1867] LR 2CP255.

Under the Indian Law the rule of **Kelner v. Baxter** is applicable but under the Specific Relief Act 1963, section 15(h) and 19(e) promoters can shift his right and responsibility to the company, if it is warranted by the terms of incorporation. The principle of novation of pre-incorporation contract is applicable in above three counties, the reason behind is that, the novation replaces the old contract with the new contract, so there is no problem of non-existence of company. Now after the Contracts (Rights of Third Parties) Act 1999, English laws may also allow company to become the part of pre-incorporation contract, when it acquires its legal existence.[18]

Jurisprudential Approach of the landmark Case

Kelner versus Baxter, (1866) LR 2 CP 174

Any contract does not bound a company that it may have entered into before the company was incorporated. This case clarified that the promoters could be held personally liable to the point where they are the ones who have entered into the contract on behalf of the company since the company could not have adopted or subsequently ratified the agreement. In itself, the document would never be binding since the company never existed in the first place.

Introduction

This case is concerned with the enforcement of a pre-incorporation contract. The position is that a pre-incorporation agreement does not bind the company, although certain exceptions exist in this regard. However, this case reaffirmed the standing position that any contract does not bound a company that it may have entered into before the company was incorporated.

Facts

A new hotel company was going to be established by the name of "Gravesend Royal Alexandra Hotel Company." The promoters of this company entered into a contract for the purchase of wine for the hotel. Although the deal was for the purchase of wine for Gravesend after the hotel started

[18] Pre-incorporation contracts and the promoter, as quoted at: http://www.lawteacher.net/contract-law/essays/pre-incorporation-contracts-and-the-promoter.php, at 9:00AM, on 4th Nov. 2020.

functioning, the contract was signed before the registration of Gravesend Company. For this reason, the agreement was a pre-incorporation contract.

Later on, the company Gravesend was registered. By the time the company was written, the wine had been consumed, and before the payment could be realized in total, the company went into liquidation. Eventually, for the recovery of money for the wine, the company's promoters who had entered into the contract for the company were sued for acting as the agents of the company when the agreement was entered into on the part of the company.

However, the promoters contended that they were not liable for the same repayment since they stated that the contract had been ratified when the company was incorporated incomplete. This implied that the liability had indeed shifted on to the company.

Issues

Whether the agents, i.e., the company's promoters, were liable for the pre-incorporation contract when Gravesend had ratified the agreement after the incorporation?

Held

The Court held that the situation is where a promoter had entered into a contract on behalf of a party that did not exist when such an agreement was being formed. The company had failed to repay Mr. Kelner, the seller of the wine. The judges observed that the principal-agent relationship between the promoters and the company could not exist before the incorporation since the company in itself, i.e., the principal was not in existence, leading to the conclusion that the promoters could not be agents of the company in the first place. The judges also noted that the company could not take liability for the contract, which was entered into before incorporation, neither by way of adoption nor by ratification. The Court held that the promoters were personally liable for the contract so entered into since the promoters were the parties that consented to enter into the contract.

Analysis

The Court held that since the company did not exist when the contract was entered into by the promoters. The promoters could not act on behalf of someone since anyone on whose behalf the promoters could have entered the contract. The Court also reasoned that since a stranger could not ratify an agreement, nor can a stranger adopt a deal, which leaves no way the company could have adopted the contract after the promoters entered into it. There are still ways where a promoter could have avoided the personal liability or could have done the same when he/she signs the agreement to confirm the company's signature. If the promoter adopts this way, the promoter has not acted as agents for the company, which helps the agents avoid personal liability.

Conclusion

This case reaffirmed the legal position that when a company enters into a pre-incorporation contract, it is not binding on the company. However, this case clarified that the promoters could be held personally liable when they have entered into the contract on behalf of the company since the company could not have adopted or subsequently ratified the agreement. In itself, the document would never be binding since the company never existed in the first place.

Phonogram Ltd v Lane: CA 1982

A collateral contract was entered into with a company which had not then been incorporated under which an advance by Phonogram to support an intended new pop group was repayable by the company if a recording contract was not entered into within one month. The collateral contract was signed 'for and on behalf of' the company by Mr. Lane. At the time of the collateral contract, both parties knew that the company had not yet been incorporated.

Held: Lane's appeal failed. The Court expressly rejected the argument that section 9(2) should be construed solely by reference to the Directive.

Lord Denning MR said:

'Section 9(2) is following the spirit and intent of the Directive. We should go by our statute and not by the Directive.' #and 'This is the first time the section has come before us. It will have much impact on the common law. I am afraid that before 1972 the common law had adopted some fine distinctions. As I understand, Kelner v. Baxter (1866) L.R. 2 C.P. 174 and it decided that if a person contracted on behalf of a nonexistent company, he would be liable the contract. If a man signs a contract for and on behalf 'of his horses,' he is personally liable. But, since that case was decided, several distinctions have been introduced by Hollman v. Pullin (1884) Cab. and Ell. 254; Newborn v. Sensolid (Great Britain) Ltd. [1954] 1 Q.B. 45 and Black v. Smallwood (1965) 117 C.L.R. 52 in the High Court of Australia. Those three cases seem to suggest a distinction to be drawn according to how an agent signs a contract. Suppose he marks it as 'agent for 'X' company' – or 'for and on behalf of 'X' company' – and there is no such body as 'X' company, then he can be sued upon it. On the other hand, if he signs it as 'X' company per pro himself, the managing director, then the position may be different: he is not contracting personally as an agent. It is the company which is hiring.

Windeyer J. disliked that distinction in Black v. Smallwood. Professor Treitel has criticized it in The Law of Contract, 5th ed. (1979), p.559. In my opinion, the distinction has been obliterated by section 9(2) of the European Communities Act 1972. We now have the exact words, 'Where a contract purports to be made by a company, or by a person as agent for a company, at a time when the company has not been formed…' That applies whatever formula is adopted. The person who purports to contract for the company is personally liable.'

Oliver LJ said:

'Any such subtle distinctions which might have been raised are rendered now irrelevant by section 9(2) of the European Communities Act 1972 in a case where a contract is either with a company or with the agent of a company. It has been suggested that an agreement to the contrary may still be inferred because the contract was signed by a person acting as an agent to exclude the section. That I am bound to say seems to me to be wholly unarguable when the section itself in terms provides 'Where a contract purports to be made … by a person as agent for a company,' and to interpret it in the way suggested would defeat the whole purpose of the section.'

Conclusion

A promoter is neither a trustee nor any agent of the Company, which he promotes because there is no trust or principal in existence at the time of his efforts. But specific fiduciary duties, like an agent, have been imposed on him under the Companies Act. He is said to be in & fiduciary position (a position full of trust and confidence) towards the Company and the original allottee of shares. Consequently, a promoter must make full disclosure of the relevant facts, including any profit made.

He must not make any secret profits out of the transactions he makes on behalf of the Company. It is to be observed that it is not the Promoter's profit, which the law forbids, but its non-disclosure. If full disclosure is made to an independent Board of Directors or the shareholders as a body (and not to a selected few), the profit is permissible. A promoter vendor cannot evade his liability of disclosing profits by disclosing to a Board of Directors who is mere nominees of his own or in his pay.

An acceptable illustration on the point is to be found in ***Gluckstein vs. Barnes***. In this case, a syndicate of persons was formed to purchase the Olympia Company and promote and register a company to which the Olympia property was resold. At that time, the Olympia Company was in bad shape. The syndicate first bought the debentures of the Olympia Companies at a discount. Then they brought the Company for £ 1,40,000. Out of this money, provided by them, the debentures were repaid in full, and a profit of £ 20,000 was made thereon. They promoted a new company and sold Olympia to it for £ 1,80,000.

The profit of 40,000 was revealed in the prospectus, but not the profit of £ 20,000. It was held that the gain of £ 20,000 was a secret profit made by the syndicate as promoters of the Company, and they were bound to pay it to the Company, which was at that time in liquidation. On behalf of the trust, it was argued that they had made a proper disclosure. Still, it was turned down on the plea that exposure made by them in the capacity of vendors to themselves in the power of directors of the purchasing Company was not sufficient. The disclosure ought to be to an independent Board or all shareholders utilizing a prospectus.

Sometimes, contracts are made on behalf of a company even before it is duly incorporated. But no warranty can bind a company even before it becomes capable of contracting by incorporations. A pre-incorporation deal is a contract entered into by a company before incorporation, which is not possible. The ratification of a pre-incorporation agreement is not possible since ratification acts retrospectively. A person cannot agree on behalf of a company before the Company incorporated or was born or came into existence. However, it may be necessary to bind an outsider with a deal before the Company is incorporated. Hence, the need for a pre-incorporation contract.

After the in-corporation of the company: After company came into existence, a company can ratify or adopt the contract, and this would bound the company and not the promoter. under the **Specific Relief Act 1963, section 15(h)** and **19(e)** promoters can shift his right and responsibility to the company, if it is warranted by the terms of incorporation. If we look on the point of remuneration for promoter concerns, then it is clear that generally the promoter is not entitled for any kind of remuneration, salary and in any manner. However, once the company is incorporated & members of the company is improved then he may be compensated in terms of lump-sum amount. Nothing is entitled to obtained as a legal right he only be compensate on the ground of equity. If the allotment of share is taken place for promoter then automatically promoter becomes a member of the company.