PRE-INCORPORATION CONTRACTS: A LEGAL PUZZLE IN INDIA

*Lakshmi Dwivedi & Varun Byreddy**

Abstract

This paper attempts to examine the validity of a pre-incorporation contract i.e. of a contract entered into by a company before its incorporation. The problem arises because at the time of contracting, the company is non- existent and hence the contract has been entered into with an incapable party. It is surprising that such a contemporary aspect hasn't received much scrutiny in Indian legal literature. Even though Specific Relief Act lays down the procedure for a contract to be enforceable against the company, how must a lawyer advise the promoters of the company, liability on whom can be cast by law, especially if the company refuses to accept the contract? Proper drafting of the contract can eliminate the need for law to resolve the dispute. However, due to inadequate drafting, when law does come into picture, how is to one clarify the position of all the parties to the contract. The paper begins with probing who can be considered as a promoter. By a comparative analysis, the paper tries to trace the common law and provide answers. This paper attempts to examine the law regarding the enforceability of the contract, against the company by interpreting the section of the specific relief act. On the basis of common law, it attempts the answer on the question of promoter's personal liability on a pre-

incorporation contract. It answers the question, if the promoter can recover any reincorporation expenses from the company and from the co-promoters, if any. Drawing a distinction between a pre-incorporation contract and a contract by a company defectively incorporated, it concludes with some drafting suggestions for a pre-incorporation contract.

I. INTRODUCTION

For any contract to be a valid one, it needs to be executed between two competent persons.[1] Birth of a company's competency is marked by its incorporation[2]. This gives it a separate legal existence[3] and the rights and obligations of the contract lie squarely with the company and not personally with the director or the promoter or the promoter group.[4]

Thus, as seen, there is always a group of people or persons who are working on behalf of the corporation. However, what happens when someone purports to be working on behalf of a company, which is technically not a company (due to the absence of incorporation)? Can anyone contract for a non-existent person, and in this case, an artificial person in the process of formation but which has not yet been brought

*Lakshmi Dwivedi and Varun Byreddy are fourth-year students at the NALSAR University of Law, Hyderabad. The author may be reached at lakshmidwi22@gmail.com.

[1]Indian Contract Act 1872, §10.

[2]The Companies Act 2013, §9 states that once the company is registered, the body incorporated has the "power to acquire, hold and dispose of property, both movable and immovable, tangible and intangible, to contract and to sue and be sued, by the said name."

[3]The Companies Act 2013, §21 provides that a person authorized by the Board or a key Managerial Person can enter into the contract on behalf of the company. Key Managerial person is further defined in Section 2(51) of the said act as: Chief Executive Officer or Managing Director or Manager, Company Secretary, the whole time director, Chief Financial Officer, or any such officer as may be prescribed.

[4]Solomon v. Solomon, (1896) UKHL 1.

into existence? This is precisely termed as a pre-incorporation contract i.e. a contract entered on behalf of a company prior to its incorporation.[5]

Usually, there are three stakeholders to this contract i.e. the promoter,[6] the party with which the promoter contracts with and the company (the company will be considered as a party only after the incorporation is completed) on whose behalf the promoter has entered into a contract. The legal status of this contract is extremely questionable. After all, how can anyone contract on behalf of a person who has not yet come into existence?[7] This leads us to the primary question 'What is the legal status of such a contract?

Along with the above question, another important question relating to the rights and obligations of the stakeholders can also be raised in this context. It is pertinent to mention that such a contract, especially in India stand on shaky grounds and might not enjoy 'the security of transaction".[8] Is the promoter to be held personally liable (also entitled to rights) on the contract? Will he have any defenses? When can a company be held liable and be entitled to the benefits from such a contract? Will making the company liable relieve the promoter of all liabilities (subsequently, even disentitling him from the rights under the contract)? Can the promoter recover his pre-incorporation expenses, especially

[5] M. J. Whincop, *Of Dragons and Horses: Filling Gaps in Pre-incorporation Contracts*, (1998) 12 JCL 22, 225.

[6]The Companies Act 2013, §269 has introduced the definition of the term 'Promoter' under the Indian Law for the first time. Promoter is 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. It is to be noted that this definition only refers to a promoter after the incorporation of the company. Much has to be debated about who can act as a promoter for a company before incorporation. This will be seen in the next section.

[7]STEWART KYD, TREATISE ON THE LAW OF CORPORATIONS 13 (1st ed., J. Butterworth, 1794).

[8]This term was introduced in the EEC Directive (EEC 68/151), which in a bid to secure a pre-incorporation contract, by statutory provision held the promoter personally liable for a pre-incorporation contract. This 'security' might not be available under the Indian law due to the absence of a statutory provision to the effect.

those arising under a pre-incorporation contract from other promoters or even the company after it is incorporated?

If one attempts to search answers for these questions solely within the four corners of the Indian legal framework, then they will notice that the picture regarding pre-incorporation contracts in the Indian legal framework is, to an extent, blurry.[9] There are different permutations of situations that can exist and the validity and enforcement of a pre-incorporation transaction in such different scenarios is equivocal.[10] The only guiding light is provided by the Specific Relief Act, which lays down when can companies sue and be sued for a pre-incorporation contract.[11] However, the rights and obligations of the company comprise only one aspect of the transaction. There is more to it, as we have seen. Also, the Specific Relief Act can be enforced only in certain circumstances.[12] Dearth of case laws expounding on this concept has been a major hindrance in getting answers to the numerous questions. The enforcement of contracts in India is considered to be a cumbersome process,[13] resulting in fewer case laws and limited evolution of law.[14] The paper will try to answer these questions by a critical and comparative analysis of various jurisprudences, like English Law, American Law, and South African Law.

One can avoid this mess by simply entering into contracts after incorporation.[15] Incorporation under the Indian Law might take around

[9]Prasidh Raj Singh, *Promoter and Pre-incorporation Contract*, 6 ASIAN JOURNAL OF INTERNATIONAL LAW, 1-2 (2011), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1938065 ("**Singh**").

[10]To name a few, different situations that can arise include no ratification by the company, ignorance of the status of the company, status of the company as a third party to the contract etc. More on this will be elucidated later.

[11]Specific Relief Act 1963, §15 (h) & 19(e).

[12]Specific Relief Act 1963, §10.

[13]Somasekhar Sudareshan, *India cuts a sorry figure with Contracts*, BUSINESS STANDARD, 9th May 2011, http://www.business-standard.com/article/economy-policy/india-cuts-a-sorry-figure-with-contracts-111050900030_1.html.

[14]Ponzetto & Fernandez, *Case Law versus Statute Law: An Evolutionary Comparison*, 37 JOURNAL OF LEGAL STUDIES (2008) [hereinafter Ponzetto & Fernandez].

[15]William J. Rand, *High Pressure Sales Tactics and Dead Trees: What to do with Promoters' Pre-Incorporation Contracts*, 4 RUTGDER'S BUSINESS LAW JOURNAL 1 (2007) [hereinafter Rand].

15 days to one month[16] and for a foreign company, this might take around 1.5 months.[17] It is always advised to wait for incorporation and get the benefit of a secure transaction rather than enter into legal conundrums of a pre-incorporation contract in India. However, as noticed in England, companies hardly issue prospectus before entering into arrangements for business and property[18]and sometimes the promoters deem it necessary to enter into legally binding arrangements[19] to make sure that company reaps the benefits for which it was formed.[20] Apart from contracts for constructing the office, hiring lawyers for the company etc. (few illustrations), they might enter into contracts related to the specific business of the company to 'lock-in' the other party.[21] However, there is a possibility that technicalities might render such attempts infructuous since it is a pre-incorporation contract[22] or there might be a scenario that the promoter has to personally pay the fees of the lawyer or might have to pay the builders out of his own pockets. As noted, the answer is blurry and equivocal.[23]

This paper will first address the theoretical framework of the pre-incorporation contract, specifically the nexus between the promoter and

[16]*Time Frame for Incorporation*, AVA PROFESSIONAL CONSULTANTS, http://www.avaprofessionals.com/knowledge-center/company-registration-india/time-frame-for-incorporation/.
[17]*Incorporating a company in India*, MADAN & CO, http://madaan.com/incorporate.htm.
[18]Thomas Reith, *The Effect of Pre-incorporation Contracts in German and English Law*, 37 INTERNATIONAL AND COMPARATIVE LAW QUARTERLY 109 (1988) [hereinafter Reith].
[19]These arrangements, at least in India might not be legally binding.
[20]Maleka Femida Cassim, *Difficult Aspects of Pre -Incorporation Contracts in South African Law and Other Jurisdictions*, 13 BUS. L. INT'L (2012) [hereinafter Cassim].
[21]EDWARD FRY, A TREATISE ON THE SPECIFIC PERFORMANCE OF CONTRACTS 200 (BiblioLife, 2009) [hereinafter Fry].
[22]Dr. Joseph H. Gross, *Liability of Pre-incorporation contracts: A Comparative Review*, 18 MCGILL LAW JOURNAL (1972), http://www.lawjournal.mcgill.ca/userfiles/other/1732404-gross.pdf [hereinafter Gross]. The present state of the law is considered in most common law countries as "unsatisfactory and replete with serious difficulties for promoters, companies and the public at large" and the rules on this subject are "highly technical and inconvenient and it is clearly desirable that they should be abrogated.
[23]A. RAMAIYA, GUIDE TO COMPANIES ACT (17th ed., 2010) [Hereinafter Ramaiya].

the company. Out of such impossible theoretical framework, some answers might be sought which will also try to examine the contractual relationship between the three stakeholders, especially its enforceability and if any defenses will be available to the parties. This will also address relation between the promoter and co-promoters. Then, the paper will look into the difference in the effect between defective incorporation and pre-incorporation contracts. The paper will conclude with the examination of some legal and non-legal solutions for securing the transaction.

II. PROMOTER AND THE ROLE OF PROMOTER

Common Law propounds that *"the term promoter is a short and convenient way of designating those who set in motion the machinery by which the Act enables them to create an incorporated company"*[24] and 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*."[25]

Promoter plays a very important role in a company. Formation of a company starts with the promotion of a company. Usually the idea of the company will be of the promoters, they have the idea of the business and its feasibility. After considering many things and doing a basic research or assessment only promoters will decide to form a body to do business. The decision to create what kind of body will also be decided by the promoters i.e. whether to form a sole proprietorship or partnership or limited liability partnership or a company will be also decided by the promoter.[26] Promoters have various duties before the company is formed and they take care of incorporation and they enter into pre-incorporation contracts.

[24]Erlanger v New Sombrero Phosphate Co, (1878) 3 App Cas 1218.
[25]Twycross v. Grant, (1877) 2 CPD 469 (CA).
[26]*Role of Promoter in Company establishment*, LAW TEACHER (June 24, 2019), http://www.lawteacher.net/free-law-essays/business-law/role-of-promoters-in-company-establishment-business-law-essay.php.

To understand the liability of the promoter regarding the pre-incorporation contracts we have to understand the definition of the promoter and also have to see statutory definitions of the this word. In India the definition of the word promoter is not clearly defined. The Companies act, 1956 defined the word promoter with respect to prospectus. Section 62 of the 1956 act defines promoter as *"a promoter who was a party to the preparation of the prospectus or of the portion thereof containing the untrue statement, but does not include any person by reason of his acting in a professional capacity for persons engaged in procuring the formation of the company*". The relevance of this provision is only with respect to claims for compensation made by shareholders in case if any misstatement or misrepresentation made in the prospectus issued to raise capital. This definition is to be applied only under those circumstances where compensation is claimed by a person who has purchased shares and debentures on the faith of the content given in the prospectus. This definition expressly prohibits professionals who act for the company.

The word 'promoter' has also been defined in the SEBI (Substantial Acquisition of Shares and Takeovers) Regulations 1997[27] and also in the SEBI (Issue of Capital and Disclosure Requirements) Regulations 2011.[28] But none of these definitions help us to understand the liability of the promoters for the pre-incorporation contracts. So there was a hope that the 2013 act will define this word in a proper manner and gives clarity but it also disappointed by giving an inclusive definition[29] and not giving a descriptive definition. This definition only deals with the situations after incorporation but not pre-incorporation. So even the definition of the word promoter is not clear in India.

[27]SEBI (Substantial Acquisition of Shares and Takeovers Regulations) 1997, Regulation 3.
[28]SEBI Issue of Capital and Disclosure Regulations 2011, Regulation 2(ZA).
[29]Companies Act 2013, §2(69).

III. ENFORCEMENT OF THE CONTRACT

The peculiarity of a pre-incorporation contract revolves around the fact that a contract is entered on behalf of a non-existent company.[30] The third party has been left on shaky grounds in a number of jurisdictions with the contract being declared null and void due to lack of competent persons entering into the contract. [31] However, there are various interesting ways in which these situations were dealt under the common law where some protection to the third party was given.

The first question that needs to be dealt with is the relation between the promoter and the company, prior to its incorporation. A number of positions have been espoused in different jurisdictions to define this relation, which range from making them the agents of the company, to the trustees of the unincorporated company.[32]

The usual argument that has been made and often selectively applied is to treat the promoter as an agent of the unincorporated company.[33] However, the promoter can't bind the company as its agent since the principal is non-existent.[34] Another implication of this is manifested in the post-incorporation stage and ratification is still not permitted.[35] English Law bars ratification of a pre-incorporation contract by the company on the basis that even for ratification, the company needs to have legal capacity at the time the contract was completed, which is absent for a pre-incorporation contract.[36] The doctrine of persona ficta is so strictly followed in England that unless novation of the contract takes place to replace the company as a party to the contract, no unilateral

[30]Kelner v. Baxter, (1866) LR 2 CP 174.
[31]Gross, *supra* note 22.
[32]*Outmoded Concept Dominates Law of Promoters' Pre-Incorporation Contracts*, 2 STANFORD INTRAMURAL LAW REVIEW (1948).
[33]*Id.*
[34]*Id.*
[35]*Id.*
[36]Joseph Savirimuthu, *Pre- incorporation contracts and the problem of corporate fundamentalism: are promoters proverbially profuse?* 24 COMPANY LAWYER 196, 196-209 (2003).

ratification is permitted.[37] Any act of ratification or adoption by the company is treated to be that of an offer to third party, and not acceptance of the offer of the third party.[38] This is in spite of the recommendations of Jenkins Committee to allow for ratification for commercial expediency reasons.[39] One strand of theory suggests and which has been adopted with some flexibility in certain jurisdictions is to allow the company to ratify pre-incorporation contract.[40] Analogy is drawn to ratification of unauthorized acts of agent by the principle.[41]

South African Law confers the power on the board to ratify and in fact, has a provision for deemed ratification, i.e. if within 3 months the corporation doesn't act on the contract, it will be deemed to be ratified by the company.[42] This provision though is a step ahead of other common law jurisdictions might prove harmful for the company especially because no specific knowledge of the contract is required and the time period might be arbitrary, without giving consideration to the kind of contract. Some contracts might take longer than 3 months to be examined and be ratified.[43]

American jurisprudence tries to skirt the theoretical difficulty of ratification by introducing another concept of 'adoption' instead of ratification.[44] Though the legal effect for both of them is the same, the difference lies in being technically correct.[45] The company by adopting the benefits of the contract automatically becomes a party to the contract.[46] The liability, which is to be impinged on the company, is not justified on the basis of abstract principal-agent relationship but the power can be located within its inherent powers of forming contracts as

[37] *Id.*
[38] Reith, *supra* note 18.
[39] *Id.*
[40] *Supra* note 32.
[41] *Supra* note 32.
[42] Cassim, *supra* note 20.
[43] *Id.*
[44] Fry, *supra* note 21.
[45] Ponzetto & Fernandez, *supra* note 14.
[46] *Id.*

body corporate.[47] Thus, the company though might not be free to 'ratify' in the strictest legal sense, but is definitely free to adopt the contract with the equitable reason to protect third parties, especially if the company has taken use of the benefits of the contract.[48] But it also becomes necessary to protect the shareholders of the company from any undesired liability that the company may attract because of the promoter. Certain safeguards have been put in place to protect them which include that merely benefitting from an unsolicited act doesn't amount to acceptance and some affirmative act would be needed along with the requirement of having full knowledge of the contract, with the knowledge to the promoter not amounting as knowledge to the company.[49]

It has been noted that Indian Law along with South African law has been very liberal in this aspect and gives companies the power to 'ratify' pre-incorporation contracts entered on its behalf.[50] Under Indian Law, the same power can be located within the framework of Specific Relief Act under Section 15(h) and Section 19(e).

It is respectfully submitted that in the case of *Seth Sobhag Mal Lodha v. Edward Mills Co. Ltd*.[51], the court erroneously denied any scope for enforcement of a pre-incorporation contract. However, it has been noted that the judgment failed to take provisions of Specific Relief Act into account for consideration of the matter.[52]

A breakdown of Section 19(e)[53] & 15(h)[54] of the Specific Relief Act points that for a pre-incorporation contract to gain validity in the eyes of the law, it must have been entered into for the purposes of the future company and must have been warranted by the terms of the incorporation. Further, the acceptance of the contract must be

[47]*Supra* note 32.
[48]Wall v. Niagara Mining & Smelting Co. of Idaho, (1899) 20 Utah 474.
[49]Gross, *supra* note 22.
[50]ANDREW GRIFFITHS, CONTRACTING WITH COMPANIES (Hart Publishing, 2005) ("**Griffiths**").
[51]Seth Sobhag Mal Lodha v. Edward Mills Co. Ltd., (1972) 42 Com Cases (Raj).
[52]Ramaiya, *supra* note 23.
[53]To be enforced by the third party.
[54]To be enforced by the company.

communicated to the third party.[55] The questions raised in this regard would involve how one is to interpret "warranted by the terms of incorporation" and how one is to interpret 'acceptance of the contract'. Does warranted by the terms necessarily imply that it must be expressly included in the articles of association or it means that such contract can be ratified as long as it is not against the objects of the company? Further can implied acceptance be considered valid i.e. by utilizing the benefits of the contracts?

Express ratification and acceptance are not the only ways to enforce a contract. If a company has accepted benefits of a pre-incorporation contract,[56] the contract won't be a complete nullity and claims can be adjudicated based on such a contract. The Apex court in India has held that the term "warranted by the terms of incorporation" must be construed to mean that it must not be ultra vires of the object of the company and dismissed the submission that an express condition needs to be articulated in the articles for the acceptance of a pre-incorporation contract.[57] Even a company's declaration of ownership to the property conveyed under the contract would suffice for the purpose of acceptance under Specific Relief Act. Thus, acceptance of benefits of the contract by the company should then essentially entail it to accept the burden of the contract too.[58]

However, a blanket rule under Specific Relief Act can't be formulated for all pre-incorporation contracts, at least in India. It must be read in conjunction with other statutes and relevant framework. Thus, in *Jai Narain Parasurampuria (Dead) and others v Pushpa Devi Saraf and others*,[59] the Supreme Court upheld the validity of the land transfer agreement, after concluding that it doesn't conflict any provision of

[55]Specific Relief Act 1963, §15 (h) and 19(e).
[56]Weaver Mills v. Balkis Ammal, (1969) AIR Mad 462; The Company took possession of the land transferred in a pre-incorporation contract with promoter acting on behalf of the company and the company improved on the land. Held, title vests in the company.
[57]Jai Narain Parasurampuria (Dead) and others v. Pushpa Devi Saraf and others, (2006) 7 SCC 756.
[58]*Id.*
[59]Griffiths, *supra* note 50.

Transfer of Property Act. However, another case held that a pre-incorporation share transfer agreement couldn't be enforced because a company not in existence can't be registered as a transferee in the register.[60] The case can also be interpreted harmoniously with Apex court ruling and with the Act by regarding that such a share transfer certificate is strictly speaking not "for the purposes of the company"[61] and hence, while interpreting the given term, care must be taken to evaluate that the contract should not only be ultra vires the objects but also must in some way contribute beneficially to the principal business for which the company is purported to be formed.[62] This makes the line very blurred and obfuscated and renders the interpretation highly subjective. Hence, it is submitted that the position formulated by the Supreme Court should be upheld, which states that as long as it is not ultra vires the objects clause of the company, it must be left to the company to ratify it.

The difference between English, Indian and American Law lies in allowing the company to have the requisite flexibility to continue with a contract that was made on its behalf before its existence. English Law, however, has been unable to grant the same power to the contracts. American law on the other hand has struck down the English Law approach in favor of the commercial benefits of the parties involved and has come up with its own techniques to enforce the contract, which is much more flexible compared to Indian law. The theories that have emerged from judicial re-thinking under American jurisprudence are ratification, adoption, acceptance of continuing offer and novation.[63] Continuing offer is synonymous to adoption wherein the pre-incorporation contract is considered to be an open-offer for[64] the corporation, which it may choose to accept by receiving or rejecting the benefits. This can be treated to be the position under Specific Relief Act, since only on the company accepting the contract, can it have some legal

[60]Inclec Investment Pvt Ltd v. Dynamatic Hydraulics Ltd, (1989) 3 Comp LJ 221, 225 (CLB).
[61]KM GHOSH AND KR CHANDRATRE, K.M. GHOSH & DR. K.R. CHANDRATRE'S COMPANY LAW: WITH SECRETARIAL PRACTICE (13th ed., Bharat Law House, 2007).
[62]*Id.*
[63]*Id.*
[64]*Id.*

effect. However, the next section will go beyond the Specific Relief and look into the common law to further examine the contract.

IV. PERSONAL LIABILITY OF THE PROMOTER

Though Specific Relief Act has spoken on conditions of enforcement between the company and the third party, there is a legal vacuum in India when it comes to the enforcement of the contract without such ratification.[65] Can the promoter be held liable personally for this contract as is followed in a number of jurisdictions e.g. UK, EU, and USA? There is another important question i.e. whether the promoter can be relieved of liability when the company ratifies the pre-incorporation contract. The judiciary in India is silent on this aspect of the law.

A. Non-Ratification

An inroad to the Common Law position would be helpful in this regard. The common Law in this context gave prime importance to the intention of the parties in adjudicating the contract.[66] If the promoter purported to act for the corporation, then he was held personally liable for the contract. However, if the contract is entered in name of the proposed company and the promoter merely authenticated the signature, the promoter was absolved from all liability.[67] The justification for the same was based on the intention of the parties i.e. who they look to when contracting. The illustration for the same could be found in the two English cases, which rendered the distinction highly technical.[68] The most often cited authority for enabling enforcement against the promoter has been *Kelner v. Baxter*[69] in which, the promoter signed "on behalf of

[65]Ramaiya, *supra* note 23.
[66]Rand, *supra* note 15.
[67]ARDEN & PRENTICE ED., BUCKLEY ON COMPANIES ACT (17th ed., LexisNexis, 2009) [hereinafter Arden & Prentice].
[68]N. N. Green, *Security of transaction after Phonogram*, 47 THE MODERN LAW REVIEW 671-691 (1984).
[69]The Companies Act 2013, §2(69).

the proposed company". The company wasn't formed and the enforcement of the contract was bought before the court. Here the court held that since it was evident to both the parties that the company was 'proposed' to be formed, hence the intention of both the parties could be to hold promoter personally liable in case, the company is not formed. [70]

However, a different approach was taken in the case of *Newborne v. Sensolid.*[71] In this case, a contract was entered into at a time when the company was not properly formed. From the signature, the court concluded that since the director authenticated the signature of the company and didn't purport to sign as an agent of the company. Hence, in this case the contract was rendered void.[72]

This distinctive approach has often been criticized as too technical with intention being reduced to focus on the form of signature.[73] Lord Denning also propounded that the real intent is to be discerned by the knowledge of the parties and the contract itself rather than the technical distinctions of signature and he criticized this approach.[74] However, Newborne doesn't stand as an authority to deny enforcement of the contract vis-à-vis the promoter.[75] In this case, the parties wrongfully assumed that the company was in existence when the contract was entered into. The company pleaded its unconstitutionality to get away with the contract[76]. Thus, the principle that can be filtered from these two cases is that when both the parties were aware that company was non-existent, then the question that must be asked to determine the intention of the parties is whether promoters had wished to assume liability in case

[70]*Id.*
[71]Newborne v. Sensolid, (1953) 1 All ER 708.
[72]*Id.*
[73]Arden & Prentice, *supra* note 67.
[74]Phonogram Ltd v. Lane, (1982) QB 938.
[75]SIR FRANCIS BEAUFORT PALMER, PALMER'S COMPANY LAW (25th ed., Sweet and Maxwell, 2013).
[76]*Supra* note 32.

the contract was not novated.[77] Further, in Newborne the court failed to account the promoters for breach of warranty or authority.[78]

The common law distinction between the signatures was obliterated by Section 9(c) of the EEC directive and further Section 36 of the Companies Act which laid down that any person who purports to contract for a company, will be held liable for it personally, unless expressly agreed otherwise by the parties.[79] Thus, to prevent the contract from being declared a nullity, and leaving behind a dead tree where no one is held liable, the statutory enactment reinforced the security of transactions. In India, in the absence of such statutory enactment, the question of liability is left open.[80]

Section 36C of the Companies Act, which crystallized common law and obliterated technical inconveniences, also took within its fold cases where no formal contract was entered into but services were rendered under some arrangement.[81] In the case of *Braymist Ltd v. Wise Financial Co Ltd*.[82], it was held that not only can the agents be sued under the contract but can also sue on the contract.

A look at the American jurisprudence suggests a strict liability for the promoter in case the corporation is not formed or doesn't adopt the contract. Thus, in the case of *RKO-Stanley Warner Theatres, Inc. v. Graziano,*[83] the promoter was held personally liable in spite of explicitly denying the liability for such contract and placing it on the corporation to be formed. Even after the corporation was formed, it never adopted the contract, hence the court turned down to the plea to limit the personal liability to the pre-incorporation stage.[84]

[77]*Id.*
[78]*Id.*
[79]Arden & Prentice, *supra* note 67.
[80]Ramaiya, *supra* note 23.
[81]Hellmuth, Obata & Kassabaum Inc. v. Geoffrey King (unreported, Sept. 29 2000, QBD, Technology & Construction Court).
[82]Braymist Ltd v. Wise Financial Co Ltd., (2002) EWCA Civ 127.
[83]RKO Stanley Warner Theatres, Inc. v. Graziano, (1975) 355 A.2d 830.
[84]*Id.*

Restatement of Agency suggests three routes available in case of a pre-incorporation contract: make the corporation liable on the contract; liability of the promoter to ensure that the corporation adopts the contract or; termination of promoter's liability on the corporation adopting the contract. [85] The default rule however, is to make the promoter personally liable on all such contracts.[86] Out of these alternatives, the first one would not be allowed in India since Specific Relief Act requires acceptance by the company and such acceptance can't be pre-imposed on the company without its will. The third case in India is ambiguous.

South African Law not only makes the promoter personally liable but also holds him in breach of dual warranty of statutory authority. One is that promoter will incorporate the company within reasonable period of time and also that the company would ratify the contract. This provides the third party with much needed security of transaction but "the statutory warranty approach begets uncertainty by leaving lacunae and gaps during the interim period between the execution of the pre-incorporation contract by the agent and its ratification by the company. This gives rise to a number of practical problems and challenges, such as the issues of unilateral withdrawal of the third party and mutual cancellation of the agreement during the interim period."[87]

The question of promoter's liability on the contract is an unsettled issue in Indian law due to the absence of any statutory enactment to the effect and lack of any judicial pronouncements to define the contours of the issue.[88] Ramaiyya's commentary suggests that under Section 230 of the Indian Contract Act, a promoter can't be held liable under a pre-incorporation contract since under Section 230 of the Indian Contract Act, an agent is not personally bound by the contract entered for his principal.[89] Thus, once the company is incorporated, the promoter can't sue or can be sued in case the company refuses to ratify the contract[90]

[85]Rand, *supra* note 15.
[86]*Id.*
[87]Fry, *supra* note 20.
[88]Ramaiya, *supra* note 23.
[89]*Id.*
[90]*Id.*

except on the principle of quantum merit or breach of warranty of authority.[91] Quantum merit would imply that if the promoter has rendered services to other party and it has been accepted by the other part, then he can sue under the contract.[92] However, it is submitted that such position is incorrect because it assumes an agent principal relation. The move to make promoter personally liable would depend on the intention of the parties and no such rule to make the contract void can be deduced from even Indian jurisprudence.

The promoter's personal liability can be avoided by construing a pre-incorporation agreement as a revocable offer or "gentle-man's agreement" under which, if the offer is not revoked, the corporation can on adoption accept the contract.[93] The advantage for the promoter under this interpretation of the contract is that he has no rights or liabilities regarding the contract provided there was no fraudulent intent or breach of warranty of authority.[94] A look at the Specific Relief Act also suggests that one can interpret the Company's ratification as acceptance of an offer by the third party. The promoter merely locks in the third party for the company.[95]However, this doctrine is not very popular with American Courts since it can be nugatory defeating the very intention of the parties to give some legal effect to the contract.[96]

An issue however arises because of the note put in the Name Approval Certificate. The Certificate, issued by the Registrar under its statutory power clearly says that no contract can be entered on behalf of the proposed company till it is registered i.e. it is incorporated.[97] It is not clear if it is a condition subsequent to issuance of certificate and to

[91]Royal Bank of Canada v. Starr, (1985) 31 BLR 124 (Canada).
[92]Cotronic (UK) Ltd v. Dezonie, (1991) BCLC 721 (CA).
[93]HARRY G. HENN & JOHN R. ALEXANDER, LAW OF CORPORATIONS (3rd ed., West Publishing Co. 2007).
[94]*Id*; RAC Realty v. WOUF Atlanta Realty Corp, (1949) 205 Ga. 154, 52 SE 2d 617; Strause v. Richmond Woodworking Co., (1909) 109 Va. 724, 65 SE 659.
[95]Cotronic (UK) Ltd v. Dezonie, (1991) BCLC 721 (CA).
[96]*Id.*
[97]Sample available at: http://coconutboard.in/kadathanad/pdfs/Certificate%20of%20Approval%20of%20Name.pdf.

harmoniously construct this note with the Specific Relief Act, one might come to conclusion that until and unless the Company ratifies the contract, any such contract can never bind the company. Thus, one strand of interpretation suggests that the contract can't be enforceable and hence would be void. Other strand would still hold the promoter liable personally and would only bar burdening the company with any such contract.

B. On Ratification by Company

Another problem with ratification/adoption is the uncertainty that underlies the continuance of the promoter's liability after the corporation ratifies or adopts the contract.

As mentioned before, the English Law denies ratification of a pre-incorporation contract. Under the English Law, novation is permitted which requires the corporation to take promoter's place. Such substitution of parties is termed novation.[98] This theory of novation has been propounded by Williston[99] and has been accepted by the courts too.[100] Novation undoubtedly releases promoter from all liability under the contract.[101]

With Specific Relief Act in place and unilateral ratification being permitted, the position resembles the American position more. The Specific Relief Act only requires the company to convey the acceptance to the other party and doesn't necessitate express assent by the third party. Thus, the position resembles American position in that respect. For this precise reason, American jurisprudence will be looked into to ascertain the position and Goodman v. Darden[102] clarified that merely because the corporation adopted the contract, doesn't dissolve the promoter of his personal liability. In this case, both the parties were aware that corporation is non-existent at the time of making of contract and further

[98]Arden & Prentice, *supra* note 67.
[99]Gross, *supra* note 22.
[100]*Id.*
[101]Rand, *supra* note 15.
[102]Goodman v. Darden, (1983) 670 P.2d 648.

that, the corporation did accept the contract and the promoter directed all the payments received under the contract to the company. Still, the court went ahead to hold that the intention of the third party was never to release the promoter from the liability. The very knowledge of it being a pre-incorporation contract would indicate that to reduce the uncertainty, the third party would have intended to make the promoter liable too which didn't end on corporation adopting the contract.[103] This might be to ask for warranty that the corporation would perform its obligations, which is analogous to the South African statutory law.[104] Thus, what the court examines is the third parties' intention as to whether the third party intended to limit the liability of the promoter on the corporation adopting the contract.[105]

In the Indian context what might be suggested is either to amend the provision for ratification or ask for novation, otherwise mere adoption by corporation won't be a guarantee for the promoter to be relieved of all its liabilities.[106] However, a case for abolishing promoter liability once the company adopts the contract can also be rooted on the principles of fairness and equity.[107] This would reduce the burden on one party and would even distribute the benefits and liabilities between the parties. Further, it would fetter the third party's choice of holding anyone of his choice liable under the contract. [108] It is also submitted that the case of Goodman has been fallaciously interpreted the intent of the parties since it failed to give due acknowledgment to the intent of the promoter, who on adoption by the company would naturally not intend to be bound personally since incorporation's primary feature is that it ensures limited liability. [109]Another argument in support of abolishing personal liability of promoter would be by the principle of contractual mutuality. On incorporation, the promoter has no personal interest in the contract and it

[103]*Id.*
[104]Cotronic (UK) Ltd v. Dezonie, (1991) BCLC 721 (CA).
[105]Wolfe v. Warfield, (1972) 296 A.2d 158.
[106]Gross, *supra* note 22.
[107]Eddie R. Flores, *The Case For Eliminating Promoter Liability On Pre-incorporation Agreements*, 32 ARIZ. L. REV. 405 (1990).
[108]*Id.*
[109]*Id.*

is solely by the virtue of the company. Hence, it is unfair to make the promoter liable. An interesting case would arise when it involves a One Person Company. Thus, the following test has been suggested:

First, has the promoter entered into a contract on behalf of a non-existent corporation? Second, has the corporation adopted or ratified the contract? Third, have the corporation and the third party contractor entered into a novation to release the promoter from liability, or, has the third party agreed to look solely to the corporation for liability? Finally, is the corporation genuine or has it been established to defeat promoter liability in connection with a fraudulent scheme?[110]

Further, the practices from other jurisdictions can be of greater help for solving the issue of the pre-incorporation contracts. In jurisdictions like Germany, Australia and South Africa, innovative solutions have been introduced by the legislature to deal with the problem of liability of Promoters for the pre-incorporation contracts. In USA the ratification of the pre-incorporation contract need not be done expressly. Ratification of this contract will happen automatically after the company is formed if that contract has been made for the benefit of the company. Germany, which is a civil law country, the promoter can make the other promoters liable along with him and the pre-incorporation association can be treated similar to that of a partnership.[111] Another important aspect of the German Law is that there is a theory called theory of Identity, which states that the company formed after the incorporation will be treated similarly as the pre-incorporation association and after the incorporation that body will get the same rights and obligations as enjoyed by the pre-incorporation association prior to the incorporation of the company.[112] This theory was later named as the theory of Continuity and under these theories the company after its formation need not adopt or ratify the contract and the obligations and rights will be accrued to the company as if under the succession.[113]

[110] *Id.*
[111] *Id.* at 11.
[112] *Id.* at 12.
[113] *Id.*

It is submitted that this theory as adopted in Germany can be considered as the best solution to avoid the liability for the promoter. In India, as stated earlier, it will be usually the promoters who will have a major control in the company so if the contracts are accrued to the company as if under succession then the promoters will be saved from liabilities and even the third parties will also have a better debtor as the company will get obligations towards them and they will have a better security against the dues that have to be paid to them or any service if any, has to be rendered to them. In the Indian context, this will be apt as the most of the companies are family based and the pre-incorporation contracts entered also will be beneficial to the company in most of the instances. Legislature should also consider this option as the issue of pre-incorporation contracts is a special case and it's not a simple one as it appears. Under the Australian laws, where Section 131 of the Australian Corporation Act, 2001 states that the Court can interfere into this matter of the pre-incorporation contract if the Companies won't ratify the contracts. Under this law the court can order for the payment of damages to the promoter if it thinks that it's appropriate to grant such an order. It is submitted that this law is a radical step as the courts can interfere to protect the promoters whose contracts haven't been ratified by the company. In the Indian context also this may hold well because there may be a promoter who also may be a minority shareholders and the majority might not ratify the contract after the incorporation of the company. This might suit for our country as even the available remedies are not targeted to protect the promoters but only for the protection of the third party and this also depends upon the discretion of the company.

V. RELATIONSHIP BETWEEN THE PROMOTER AND THE COMPANY

Though the case laws and the academic discourse on this issue has been multifaceted and inconclusive, but the Indian Supreme Court has affirmed a previous high court ruling which defined the relation between

the two as that of a fiduciary relation.[114] It rejected the position of the promoter with respect to that of the unincorporated company as that of agency or trustees.[115] In the case of *Weavers Mills v. Balkis Ammal*[116], it was held that even without express conveyance of property by the promoter to the unincorporated company, since the promoter stands in fiduciary duty to the company, all the benefits of the pre-incorporation contract would pass on to the company.

> "*While we accept the position that a promoter is neither an agent nor a trustee of the company under incorporation, we are inclined to think that in respect of transactions on behalf of it, he stands in a fiduciary position. … The legal position of a promoter in relation to his acts, particularly purchase of Immovable properties on behalf of the company under incorporation, is a peculiar one not capable of being brought into any established or recognized norms of the law as to its character as an agent or a trustee. But, at the same time, it is impossible, to our minds, to deny that he does stand in a certain fiduciary position in relation to the company under incorporation. When he does certain things for the benefit of it, as for instance, purchase of Immovable properties, he is not at liberty to deny that benefit to the company when incorporated. We are prepared to hold that in such a case the benefit of the purchase will pass on to the company when incorporated*."[117]

Being in a position of fiduciary duty, can the promoter force the company to compensate it for the pre-incorporation expenses that the promoter incurs on behalf of the company? One position can be that if the company accepts the benefits of the contract, then it must accept the burden too and hence must compensate the promoter for all his expenses under the said

[114]Gross, *supra* note 22.
[115]*Id.*
[116]Weavers Mills v. Balkis Ammal, (1969) AIR Mad 462.
[117]Gross, *supra* note 22.

contract. However, if the company doesn't ratify the contract, then the promoter can't claim for reimbursement.[118]

The reimbursement can be in the form of increased payup during the allotment of shares.[119] However, allotment of shares in lieu of pre-incorporation services is not treated as a good consideration in a number of American jurisprudences.[120] Under the Indian Contract Act however, since consideration for past services is considered to be good consideration,[121] allotment of shares in lieu of pre-incorporation services can be permissible.

A. Liability Of A Co-Promoter

Here the issue of non-existence of a principle doesn't arise. This especially becomes pertinent when the promoter acts to incorporate a subsidiary of a foreign company. One can claim that the promoter is acting as agent of an already existing holding company, and hence could ask for his remuneration and re-imbursement from this company.

English Law however, restricts the liability of co-promoters only to cases where an express authority to act as agent is conferred. The courts have been slow to read implied authority[122] and have explicitly rejected conferring such liability.[123] English law suggests, albeit weakly, that pre-incorporation association to be that of partnership. However, what it is pertinent to prove is that the association is with the common objective of earning profit.[124] This becomes difficult to show when the object is merely administrative in nature i.e. to get the company organized. However, when it was shown that the object was more than administrative, i.e. for acquiring a business and operating it before incorporation (pre-ordering goods for restaurant), then it can be

[118]Cotronic (UK) Ltd v. Dezonie, (1991) BCLC 721 (CA).
[119]Arden & Prentice, *supra* note 67.
[120]Cotronic (UK) Ltd v. Dezonie, (1991) BCLC 721 (CA).
[121]A R Mohammed Jalaludeen v. V. S. Dhakshinamoorthy, Second Appeal No. 980 of 2009 (Mad HC).
[122]Reith, *supra* note 18.
[123]Ramaiya, *supra* note 23.
[124]Indian Partnership Act 1932, §1(1).

considered to be a partnership and expenses were recovered from all promoters.[125] It is difficult to hold them liable as an association sui generis but if the association was a partnership that was later incorporated then one can say that the acts of the promoter can bind the partnership as a whole.[126]

In India, partnership act lays down that partnership must be the result of an agreement[127], which need not be formal or written,[128] but the requirement to carry out business is indispensable under the Indian Partnership Act.[129]

South African law has again taken a leap forward by holding all promoters jointly and severally liable for a pre-incorporation contract entered into by any of the promoter.[130] Care must be taken to not focus merely on the signatory but also on any implied authority by other promoters.[131]

VI. PRE-INCORPORATION OR DEFECTIVE CORPORATION?

Often Newborne case and Kelner case is commented upon by mentioning how the intention of holding promoter liable hinged on technical distinction of how the contract was signed. However, it must be noted that Newborne dealt with a contract with a defective corporation. The confusion is not new and people often tend to put both of them under the same umbrella. [132] It has been suggested that the doctrines of corporation

[125]Keith Spicer Ltd v. Mansell, (1970) 1 WLR 333.
[126]Reith, *supra* note 18.
[127]Indian Partnership Act, 1932, §4.
[128]Abdul v. Century Wood Industries, (1954) AIR Mys 33.
[129]The Indian Partnership Act 1932, §4; AVATAR SINGH, INTRODUCTION TO LAW OF PARTNERSHIP (10th ed., Eastern Book Company, 2010).
[130]*Supra* note 20.
[131]In the case of Bay v. Illawarra Stationery Supplies Pty Ltd *(*1986) 4 ACLC 429*;* even when four promoters were acting together, only one of the signatory promoter was held liable.
[132]Norwood P. Beveridge, *Corporate Puzzles: Being a True and Complete Explanation De Facto Corporations and Corporations by Estoppel, Their Historical Development,*

by estoppel and de facto corporation can be used to deal with the problem of pre-incorporation contracts.[133] These doctrines protect the promoters or directors from being personally liable on contracts that were entered into with a company, that both parties, in good faith, believed to have been incorporated, when it was not.[134]

What most commentators can miss is that the distinction lies in the knowledge of the parties. In a pre-incorporation, no effort is undertaken to incorporate. Merely having good faith intent to incorporate is not a sufficient requirement for the doctrine of corporation by estoppel to operate. Some attempt must be undertaken to bring it into operation. Further, another difference that lies is in the knowledge of the parties. Whereas in pre-incorporation contract, both parties know that the company is yet to be incorporated, in a defective incorporation both have a bona fide but fallacious belief in the existence of the company. If the promoter lies about the same to the other party, then he can clearly be held liable for fraud or breach of warranty of authority.[135]

In the Indian scenario, on account of the name approval certificate, it is quite clear that the doctrine of corporation by estoppel or de facto corporation would come into play only when attempts are made to file certificate of registration.

VII. CONCLUSION

This paper would conclude with some drafting suggestions for a pre-incorporation contract and might look at some favorable alternatives that can be made a part of the law itself. Half of the problems of pre-

Attempted Abolition, and Eventual Rehabilitation, 22 OKLA. CITY U. L. REV. 935, 938 (1997).
[133]Singh, *supra* note 9.
[134]Rand, *supra* note 15.
[135]*Id.*

incorporation contract can be resolved by apt drafting which clearly sets out the intention of the parties.[136]

Regarding the drafting suggestion, the promoter must limit his risk by explicitly bargaining for no personal liability in case of failure of non-ratification and that in case of ratification, his liability would end. A further rider must be put indicating the status of the corporation and the promoter can also disown liability for making the corporation compulsorily ratify the contract. This is because the contract per se can't include a clause for compulsorily burdening the company with any liability it didn't consent too and the shareholders can't be forced with such contract.[137] It is further consistent with principle of preserving the share capital of the company.[138] Though sometimes the promoter, who might become the majority share- holder can enforce the ratification as an incident of his power but legally such enforcement is not voluntary.[139] Rights and obligation of the promoter, of the contemplated corporation along with consequences (which follows if the contemplated corporation repudiates the agreement or does nothing regarding the agreement, with or without accepting the benefits) with respect to ratification/non-ratification must be followed. [140] The promoter can also put in a clause of indemnification of all pre-incorporation expenses.[141]

Under the Indian law, one can conclude that the corporation can adopt the contract. However such adoption/ratification is no guarantee that the contract will release the promoter from the liability and hence the promoter must undertake appropriate safeguards to protect himself and press for novation of the contract. In case of non-ratification by the promoter, it is quite possible that Indian courts might take the common law road to make the promoter personally liable on the contract. However, interpretation to deny this personal liability also exists especially if one construes the pre-incorporation contract to be that of a

[136]Cotronic (UK) Ltd v. Dezonie, (1991) BCLC 721 (CA).
[137]Reith, *Supra* note 18.
[138]*Id.*
[139]Arden & Prentice, *supra* note 67.
[140]Cotronic (UK) Ltd v. Dezonie, (1991) BCLC 721 (CA).
[141]*Id.*

continuing offer for the corporation. Though South African law might hold other co-promoters jointly or severally liable, Indian Courts might take the English path and would be slow to read in liability for all co-promoters. A strong case can be made by the promoter to be indemnified for all the pre-incorporation contracts especially if the Corporation adopts the same and reimbursement for services can commonly be sought by increased allotment of shares. Finally, care must be taken to not club all pre-incorporation contracts as one that being made by defective corporations.