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“Dharma is to protect the Needy”

Article on
Pre-incorporation contracts: Enforceability and liability

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Abstract

Pre-incorporation contracts are the contracts for the prospective corporation entered by the person purporting to act on behalf of it. There is a lot of hue and cry in the history regarding enforceability of pre incorporation contracts. As per the general principles of contract the contract is binding only on two consenting parties and no third party is held liable for the enforcement of contract. As the company comes into existence only after incorporation it cannot be held liable for the pre incorporation contracts. So, the whole liability shifts only on the promoter and this was the well settled rule in one of the famous English cases *Kelner v. Baxeter*. Adoption of specific relief act, 1963 has changed this view in the context of India. As per section 15(h) and section 19(e) of the act, all the pre incorporation contracts entered by the promoter have validity and can be enforced by or against the company provided certain preconditions are required to be satisfied. The conditions are like the contract should be entered for the purpose of the company and should be guaranteed with the terms of incorporations. Along with this company should accept the contract on its incorporation and should communicate their acceptance to the other party. some of the best example of pre incorporation contracts are purchase of land, acquisition of place of office, appointment of basic staff payment of fees to professionals for the preparation of the documentation of incorporation etc. so the difference in the application of the principles of contract to the pre incorporation contract in different country has created a doubt whether promoter is solely responsible for the fulfilment of the contract or can the company also be held liable. The recent developments in corporate laws impose equal liability on companies in matters of pre incorporation contracts. The best possible reform to overcome this problem is to incorporate a clause of compulsory adoption of pre incorporation contracts in the articles of the company. So for the present paper the aim and objectives are to study pre incorporation contract and the need behind it, to understand the applicability of general principles of contract, to study the liability of the promoter and liability of the company for it and approach of different countries on the liability of the promoter.

Key-words: contracts, promoters, enforceability, liability, reincorporation.

Introduction

Company is an artificial person which has existence in the eyes of law. It is an agreement between a group of people who have voluntarily come together to earn profit. The company though a separate legal entity is fictitious. It cannot act apart from its members. Every act of the company is carried through its agent.

The person who propounds the idea of formation of the company is often termed as the promoter. When a company comes into existence the promoter is a person who an agent on behalf of the company enters into various contracts. These are the pre incorporation contracts. Acquisition of land, securing services of managers and other experts required for incorporation of a company are some of the examples of the pre incorporation contract.

Meaning of Promoter and Nature of Pre-incorporation contract

Before going to the meaning of the Pre-incorporation contract it is necessary to understand who is promoter?

Promoter

Promoters are persons who conceive the idea of forming a company and take the necessary steps to incorporate it by registration, provide it with share and loan capital, and acquire for it business or property, which it is to manage.³ He is the person who stands in the fiduciary relationship with the company.

According to Bowen J The 'Promoter' is not the term of law but it is a term of business, which plays the main role in the setup of a company. Whereas Cockburn CJ in *Twycross v Grant* observed 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'.⁴

As per the provisions of the Companies act 2013 the promoter is the person, who has been named as such in the prospectus and annual return, or who has control over the affairs of the company, or on whose advice the board is accustomed to act.⁵

³ *Icsi module*, The institute of company secretaries India, 60 (1st Edn, 2014)

⁴ *Pre-incorporation contracts and the promoter*, Law teacher, available at <https://www.lawteacher.net/free-law-essays/contract-law/pre-incorporation-contracts-and-the-promoter.php>
last seen 17/12/2018

⁵ Section 2 (69) of companies act, 2013

Pre-incorporation contract

In Simple terms the contracts entered prior to incorporation of the company are pre-incorporation contracts. As prior to the incorporation the company is not in existence it cannot enter into contract. But there are certain contracts which are required to be entered before the company comes into existence and thus the promoters are entrusted with the responsibility to form such contracts. So now there is a question that in case of breach of contract who shall be liable?

Pre-incorporation contract and contract law

The pre-incorporation contract as being a contract has to fulfil the conditions of a valid contract. Section 10 of Indian contract provides for certain essentials which are required to be there in every agreement to become a valid contract.

Pre-incorporation contract and essentials of valid contract**Offer and acceptance –**

This involves two parties, one party making the offer and the other party accepting it. In case of a pre-incorporation contract, there are also two parties, the person making an offer to the company for the contract and the promoter accepting the contract on behalf of the company. The acceptance given by the promoter on behalf of the company is legally valid, the only condition required to be fulfilled is that under section 15(h) of specific performance, the company needs to accept that contract on its incorporation and such acceptance needs to be communicated to the other party.

Intention to create legal Relationship –

The parties to the contract need to have intention to create a legal relationship. Absence of such intention will lead to invalidity of the contract. In case of pre-incorporation there is clear cut intention of the parties to create legal Relation, as the promoter is entering into contract on behalf of the future legal entity.

Lawful consideration –

The agreement to be enforceable by law must be supported by consideration. In simple terms it means something in return. Consideration need not be adequate. Promoter has passed the consideration for pre-incorporation contract. The consideration given by the company which is yet to be in existence is warranting the contract with terms of incorporation.

Capacity of parties –

The contract to be enforceable at law should be entered by the person who is of sound mind, age of majority, and not disqualified by law. When it comes to the competency, the companies act has not provided any special provision hence the provision of contract law prevails and prerequisites are strictly followed.

Though companies act has not directly specified the minimum age of the promoter, but it has indirectly given the condition like they need to have DSC and DIN. In order to have DSC and DIN the person needs to be major only.

Free and genuine consent –

Every contract mandates the free consent of the parties. In case of pre-incorporation contract the prior consent is given by the promoter on behalf of the company. Section 19 (e) of the specific performance act gives power to a company to enforce the Pre-incorporation contract against the other party but for that such contract needs to be ratified by the members of the company. Ratification indirectly shows the consent of the company.

Lawful object –

The object of the agreement must be lawful in order to make it valid. Even under companies acting as per section 3 (1) (a), a public company may be formed for any lawful purpose by seven or more persons. This section also shows that the companies are incorporated for lawful purpose only and hence it can be said that the contract entered prior to incorporation of such company is also for lawful purpose.

Certainty and possibility of performance –

The contract should not be vague and indefinite. The pre-incorporation contract under companies act though uncertain prima facie as the company for which it is entered is not in existence, but still this contract has validity. As section 15 of specific performance act provides that the p[re-incorporation contract can be enforced against the company if it is guaranteed by terms of incorporation. So it can be said that a pre-incorporation contract gives certainty on incorporation of the company.

Pre-incorporation contract and Doctrine of Privity

Nature of a Pre-incorporation contract is slightly different from a normal contract. Nature of such a contract is bilateral, and it has the features of a tripartite contract. In this type of contract, the promoter furnishes the contract with the interested person; and it would be a

bilateral contract between them. But the remarkable part of this contract is that, this contract helps the perspective company, who is not a party to the contract⁶.

Doctrine of privity of contract –

The doctrine of privity of contract clearly states that a contract neither confers any right nor imposes any obligation arising under it on any person or agent except the parties to the contract. This means that only the party to the contract can enforce the contract legally and no other party shall have the right to sue and to claim damages.

Application of strict principle of privity, the company is not entitled to any right and obligation arising out of the pre-incorporation contract, as at the time of entering into contract the company was not in existence. This makes the promoter solely liable for breach of Pre-incorporation contract and exempts the company from all the liabilities. Thus, the rule of privity of contract keeps the company from pre-incorporation.

Case Law: kelner v. Baxater

This is the English case which states as below –

- a company not yet incorporated is not liable for any contract made before incorporation on its behalf, even if after incorporation it ratifies contract.
- as there was no company into existence the agreement become wholly inoperative when the company comes into existence
- the rights and obligation created by the parties to the contract cannot be transferred to the third person who was not a party at the time of entering into contract i.e. company
- the company cannot even ratify the contract as the ratification can only be by a person ascertained at the time of the act done or by a person either in existence or in contemplation.

Thus as discussed in above case, in pure common law sense, Pre-incorporation contract does not bind the company. But there are certain exceptions to this contract, and these exceptions were developed in the USA, India and later in England. And these recent developments in corporate law and contract law make the company liable for pre-incorporation contracts.

Position of Pre-Incorporation Contract in India

⁶ *Pre incorporation contract and the promoter*, law teacher, available at <https://www.lawteacher.net/free-law-essays/business-law/pre-incorporation-contracts-and-the-promoter-business-law-essay.php> , last seen 1/03/2019

Earlier the same was the position of pre-incorporation contract in India as it was in England i.e. as like *kelner v. Baxater*. The common law doctrine was of the opinion that companies cannot ratify or adopt the pre-incorporation contract. But the Specific Relief act changed the complete scenario in relation to India. Section 15 is about a stranger's right to sue if he is entitled to a benefit or has any interest under the contract. And section 15(h) exclusively deals with pre-incorporation contracts.

Section 15(h) of specific relief act 1963 read with its proviso gives validity to the pre-incorporation contract entered by the promoter and states that the specific performance of contract can be obtained if the following conditions are satisfied

- The contract is entered into for the purpose of the company
- Such contract is warranted by the terms of incorporation of the company
- Company has accepted the contract
- Such acceptance has been communicated to the other party to the contract.

Section 15(h) of the act is enforced by the company against third parties. Under section 19(e) under similar circumstances, specific performance may be enforced against the company by the other party to the contract. Thus the company will adopt the contract if it is genuinely made by the promoter for the sake of the company.

Position of the Promoter

Intention of the Promoter –

The promoter is the person who has firstly initiated the idea of formation of the company. He has devoted whole of his energy in shaping that idea into a form of corporation. Thus whenever there question of his intention it is but obvious that he is more interested in survival of the corporation. The very essential behind survival of the corporation is that it has to enter into the various contracts and has to ratify the previous contracts entered by the promoter though the corporation has the choice of repudiating the contract.

Legal capacity of the Promoter –

While the accurate description of the promoter may be difficult, his legal position is quite clear. As discussed in *Erlaanger v. New sombrero phosphate co*⁷, “He stands in a fiduciary relationship. He is neither an agent nor a trustee. It is his duty to provide the company with an intelligent and independent director, if he proposes to enter into a contract with the company.”

⁷ 39 LT 269

As per the *Omnium electric palaces ltd v. Baines*⁸ Whenever the promoter is purchasing any property undoubtedly he stands in a fiduciary relationship with the company but that fiduciary relationship cannot be mixed out with ordinary out and trusteeship.

As per *R. R. Sarna v. J Reubewn*⁹, “The promoters are also not partners as the law governing the relation between partners is completely different.”

Liability –

Though the specific relief act guarantees that the specific performance of the contract can be obtained by and against the company, it can be obtained only when the member of the company ratifies the contract and communicates the same to the other party.

Unless the contract is accepted by the company, the company may not receive any benefit from such contract and the promoters would be personally liable for the contracts.

In case, the said contract is not accepted by the company in its meeting, such contract is binding to the promoters and the both, promoters and other party may demand specific performance against each other.

How the promoter can shift his Liability –

However the promoter can shift his liability on company in two ways

Acceptance of contract by the members –

As the whole contract entered by the promoter is for the benefit of the company He can put the resolution for accepting such contract and his actions for incorporation of the company before members. Once ratified by the company, the specific performance can be obtained as discussed above.

Novation –

It means substituting the old contract with new between the same parties or between different parties. The requirement is only discharge of old contracts. After Novation the new contract is binding on the newly entered parties. Thus Novation also provides an opportunity to the promoter to transfer his liability with that of the company.

Conclusion

⁸ 1900 AC 240 HL

⁹ 1946 16 comp cas 64

The consideration of the above facts makes it very clear that the promoter is solely liable for pre-incorporation of the contract if the same contract is not accepted by the company. But the provisions of the specific relief act, 1963 gives sort of relief to the promoter as whatever he is doing is for the benefit of the company only. So with the help of principles of contract like specific performance of contract and novation, the promoter can shift his liability.

Thus it would be correct to say that modern law is imposing equal liability on the company in case of pre-incorporation contract.

