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Pre-Incorporation Contracts and Promoters: A Study of the Legal Consequences.

By- Saanvi Agarwal

Law Student, St. Xavier's University, Kolkata, West Bengal, India

ABSTRACT

Pre-incorporation contracts are agreements entered by promoters on behalf of companies before formal incorporation. These contracts create unique legal challenges as companies cannot be bound by agreements predating their existence. Under common law, promoters bear personal liability since the intended principal lacks legal capacity. The doctrine of privity excludes non-existent entities from contractual obligations. However, Indian law through the Specific Relief Act 1963 permits companies to assume liability and enforce pre-incorporation contracts when warranted by incorporation terms. Promoters can protect themselves through novation, contractual provisions transferring liability post incorporation, or statutory adoption mechanisms. This framework balances commercial necessity with fundamental contractual principles, ensuring appropriate liability distribution between promoters and incorporated companies.

KEYWORDS

Pre-incorporation Contracts, Doctrine of privity of contract, Ratification, Promoter liability, Novation

PROMOTERS, DEFINITION, ROLE AND LEGAL FRAMEWORK

Concept and Function

Company promotion involves the discovery of business opportunities and the subsequent organization of funds, property, and managerial ability into a business entity for profit generation. Gerstenberg's definition captures this entrepreneurial process where individuals identify viable business concepts and transform them into operational corporate structures.

The promotional process begins with idea conception, followed by detailed investigation to assess the proposal's strengths and weaknesses. Promoters determine capital requirements, estimate operating expenses, and project probable income streams. Once satisfied about the venture's economic viability, they initiate the formal incorporation process.

Legal Definition

Justice C. Cockburn described a promoter as "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." This judicial definition emphasizes the active role promoters play in both conceptualizing and actualizing corporate ventures.

Section **2(69) of the Companies Act, 2013**[1] provides a comprehensive statutory definition identifying a promoter as 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.

However, a person acting merely in a professional capacity shall not be treated as a promoter.

The essential test for identifying a promoter lies in determining whether an individual demonstrates genuine commitment to forming a company and actively takes concrete steps toward that goal. The activities typically associated with promoters include:

a) He undertakes to form a company and see it going.
b) He undertakes a number of operations necessary to form a company.
c) He advices, directs and instructs the Board of Directors.
d) He has a control over the affairs of the Company, directly or indirectly.

Companies may have multiple promoters working collectively toward incorporation. This functional approach to defining promoters ensures that the legal framework captures the substance of promotional activities rather than relying solely on formal titles or designations.

PRE INCORPORATION CONTRACTS: FRAMEWORK AND ENFORCEBILITY

Definition and Nature

Pre-incorporation contracts are agreements entered into by promoters on behalf of a company before its formal incorporation. These contracts serve to establish the framework for the

[1] *The Companies Act, 2013, S. 2(69)*

company's future operations and secure necessary assets, rights, or services that will be essential for the company's successful establishment and operation. The nature of these contracts presents a unique legal phenomenon. While they appear to be bilateral agreements between the promoter and a third party, they function with tripartite characteristics since they are intended to benefit the prospective company, which is not yet a legal entity. This creates an interesting legal paradox where the intended beneficiary of the contract is not a party to it and cannot be bound by its terms.

Legal Challenges Under Common Law

Traditional common law principles create significant obstacles for the enforcement of pre-incorporation contracts. The fundamental issue arises from the fact that a company lacks legal existence at the time of contract formation, making it impossible for the entity to be bound by agreements made on its behalf. The doctrine of privity of contract, which restricts contractual rights and obligations to the actual parties of an agreement, excludes the prospective company from any contractual liability or benefit.

The landmark case of Kelner v. Baxter [2] established the foundational principle that promoters bear personal liability for pre-incorporation contracts. In this case, Mr. Kelner successfully sued promoters who had contracted for wine on behalf of a company that had not yet been constituted but subsequently failed to make payment. The court reasoned that since the company did not exist, it could not serve as a principal to authorize any agency relationship, leaving the promoters as the only parties capable of being held liable.

Phonogram Limited v. Lane[3] further reinforced this principle by confirming that contracts made before incorporation cannot bind the company, regardless of whether all parties understand the company's non-existence. Lord Denning's judgment clarified that the promoter's personal liability under pre-incorporation contracts remains unchanged even when the corporate formation project fails to materialize.

The complexity of this area was highlighted in Newborne v. Sensolid (Great Britain) Ltd[4], where the Court of Appeal provided a nuanced interpretation. Lord Goddard emphasized that since a company doesn't exist until formally created, contracts signed in its name before incorporation are void, preventing both the company and promoters from enforcing such

[2] *Kelner v. Baxter (1866) LR 2 CP 174.*
[3] *Phonogram Ltd v Lane (1981) 3 All ER 182*
[4] *Newborne v. Sensolid (1953) 1 All ER 708*

agreements. This decision created some uncertainty about whether promoters could be sued for damages while simultaneously being unable to enforce their own contractual rights.

Indian Legal Framework

The Indian legal system initially followed English common law principles regarding pre-incorporation contracts. The Indian Contract Act of 1872 renders these contracts unenforceable due to the absence of necessary contracting parties and the impossibility of creating valid agency relationships without an existing principal. Section 230[5] of the Act prevents personal enforcement by agents on behalf of non-existent principals, creating additional barriers to contract enforcement.

However, the Specific Relief Act of 1963 introduced significant exceptions to these common law principles, representing a departure from traditional English approaches. Section 15(h)[6] of the Act permits companies to sue third parties under pre-incorporation contracts provided that the contract is warranted by the company's incorporation terms and the company has a legitimate interest or entitlement under the agreement. This provision directly contradicts the common law doctrine that companies cannot ratify or adopt pre-incorporation contracts.

Section 19(e)[7] creates a corresponding right for third parties to sue the company if the incorporation terms warrant and adopt the contract. This provision significantly reduces promoter liability by creating a pathway for the company to assume contractual obligations after incorporation. The case of Vali Pattabhirama Roa v Sri Ramanuja Ginning and Rice Factory Pvt. Ltd[8] confirmed the acceptance of these statutory modifications in Indian jurisprudence.

PROMOTER LIABILITY AND PROTECTION

Promoters remain personally liable for pre-incorporation contracts under established legal principles. This liability exists because the promoter is the only legally existing party capable of being bound at the time of contract formation. Since the company cannot ratify agreements made before its existence, promoters must carefully consider their exposure when entering into such arrangements.

[5] *The Indian Contract Act of 1872, S. 230*
[6] *The Specific Relief Act of 1963, S. 15(h)*
[7] *The Specific Relief Act of 1963, S. 19 (e)*
[8] *Vali Pattabhirama Roa v Sri Ramanuja Ginning and Rice Factory Pvt. Ltd (1987) 60 Comp Cas 568 AP*

Promoters can protect themselves through several mechanisms. Novation represents the most effective approach, involving the creation of new contracts between the company and third parties after incorporation, which completely replaces the original pre-incorporation agreement. The case of Howard v Patent Ivory Manufacturing[9] demonstrated the English courts' acceptance of novation as a valid mechanism for transferring contractual obligations.

Many pre-incorporation contracts include express provisions that transfer liability to the company upon adoption or specify time periods after which promoter liability ceases if the company doesn't adopt the contract. These contractual protections can provide significant relief for promoters, though their effectiveness depends on careful drafting and the specific legal jurisdiction.

ENFORCEMENT AND REMEDIES

After incorporation, companies face limitations in both enforcing and being bound by pre incorporation contracts under traditional common law. A company cannot be held liable for preliminary contracts even if it has received benefits from work performed under such agreements. Similarly, companies cannot enforce preliminary contracts made before incorporation, meaning they have no right to sue third parties for contract fulfilment based solely on pre-incorporation agreements.

The inability to ratify such contracts stems from the fundamental requirement that a principal must exist at the time of the original contract for valid ratification to occur. Since the company did not exist when the contract was formed, subsequent ratification attempts are legally ineffective. However, companies can enter into new contracts with the same parties after incorporation to achieve the same practical results as the original pre-incorporation agreement.

Under the Specific Relief Act 1963, Indian law provides important exceptions to these general principles. Companies can obtain specific performance of pre-incorporation contracts if the contracts were made for the company's purposes and are warranted by the incorporation terms. The company must accept the contract after incorporation and communicate this acceptance to the other party for the statutory protection to apply.

[9] *Howard v Patent Ivory Co (1888) 38 Ch D 156.*

CONCLUSION

Pre-incorporation contracts occupy a complex position in corporate law, balancing the practical necessities of company formation against fundamental contractual principles. While common law traditionally imposed strict personal liability on promoters and prevented companies from assuming pre-incorporation obligations, modern statutory frameworks have created more flexible approaches. The Indian Specific Relief Act exemplifies how legislation can modify common law principles to better serve commercial realities while maintaining appropriate protections for all parties involved. Promoters must carefully navigate these legal frameworks, understanding both their potential personal exposure and the mechanisms available for transferring liability to the incorporated company.