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Pre-incorporation Contracts: Relevance and Enforceability in Jurisprudential Framework of Company Law

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Abstract

India has seen strong economic development in recent decades, with the GDP rising 7.6 percent in recent fiscal years. While economic activity is robust, the country is still a long way from becoming a leader in providing efficient Corporate-Litigation mechanisms. The administration must seize the economic momentum prevailing now and use it to advance its reform programmes; one of them being reformation of laws governing Pre-incorporation Contracts. This requires reforms at three levels. First, from the viewpoint of Protection of parties, by outlining the "Promoter's Liability regarding Pre-incorporation contracts"; through application of precedents under "Kelner v Baxter 1866" and "Newborne v Sensolid (Great Britain) Ltd 1953". Second, obtaining a comparative analysis of Enforcement of Pre-incorporation Contracts, around the world and implementing the necessary amendments; based on these observations. Third, accepting the advancement of Ratification of Pre-incorporation Contracts in Common law countries and outlining the need for an analogous legislation in Indian Law. If the government can assist in overcoming technical, institutional, and regulatory impediments, the Pre-incorporation Contracts doctrine, when combined with a rigorous titling legislation, may prove to be the most secure, transparent end means, to establish a robust Pre-incorporation Litigation system in India.

Keywords: Promoter's liability, enforcement, ratification, prospective, Pre-incorporation contracts

INTRODUCTION TO PRE-INCORPORATION CONTRACTS IN INDIA

Contracts entered into before incorporation are often believed to have no legal standing or worth. Historically, there have been significant flaws and drafting issues in the law of pre-incorporation contracts, due to a lack of a proper statement of law, in subsequent company acts of India. This created uncertainty for the judiciary in determination of liability, between a Promoter and the Company. As we know, several amendments to the company act have been enacted to address the issue regarding pre-incorporation contracts, in order to streamline the incorporation process for corporate entities. There are certain issues with ratifying the contracts entered into at the time of formation, in order to shield a firm and its members from liability. We would explore in this paper, a promoters' liability under pre-incorporation contracts and the subsequent issues that develop, as a result of entering into pre-incorporation contracts.

Pre-incorporation contracts are all those agreed upon in favour of an unformed business, or one

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that has no legal existence, according to the Companies Act of 1956 [1]. Before the Incorporation procedure. This takes place due to the fact that such contracts are quite often necessary for new businesses. Before the company may be considered to be incorporated and gain its legal features, the incorporation process must be completed; otherwise, the independent legal entity would not exist.

A Promoter's Accountability under Pre-incorporation Contracts

The promoter of a company undertakes the responsibility to establish a for-profit corporation. The path towards achieving this central objective involves entering into multiple contracts with varied business entities in the marketplace. Pre-incorporation contracts are to some extent, of a different nature, compared to a typical contract. It has a tri-party contractual function. The promoter drafts the contract with the interested party, on behalf of the firm and the confirmation deed between them becomes a bilateral contract.

Liability of Promoter under Pre-incorporation Contracts

Prior to the passage of the "Specific Relief Act 1963 by Government of India", the country's stance on pre-incorporation contracts was similar to that of the English Law. It is important to note that it was the landmark ruling in "*Kelner v Baxter"* [2], which explained that, as a company has no legal existence prior to incorporation, a promoter enters into a contract with a third party on behalf of the unformed company and the promoter becomes '*solely*' liable for the pre-incorporation contract, as the proposed company has no legal existence. Under Indian Law, if a business fails to enforce or accept a pre-incorporation contract, the firm would then be subject to the Specific Relief Act, which was passed on 13 December 1963 in the Upper House of the Indian Parliament, in order to address issues of pre-incorporation contracts, in the time to come.

In Kelner v Baxter, the promoter agreed to a proposal to trade wine with Mr. Kelner, in favour of the un-incorporated business. When Mr. Kelner was not paid, he sued the promoter, who had signed into the contract with the company. According to *Chief Justice Erle*, in a pre-incorporation contract, the principal-agent contract cannot exist, i.e., before the company is incorporated and constituted.

Consequently, he came to the conclusion that the promoter had unlimited liability, as they were the one's who were responsible for the tasks of the un-incorporated company, as the contract's signatory party. In the "*Newborne v Sensolid (Great Britain) Ltd"* [3] case, the factual circumstances of Kelner v Baxter were explained differently, and the principle was expanded further on. It was observed that if a corporation was engaged in a deal before formation, the other contracting party may refuse to fulfil their contractual commitments. *Lord Goddard* remarked that "a business does not exist antecedent to its incorporation, and if it ceases to exist, the contract executed by the un-incorporated company would also be unenforceable". Thus, neither the company nor the promoter can bring about a lawsuit for violation of a pre-incorporation contract.

Pre-incorporation or Defective Corporation? Limitations of Extant Legislation

The *Newborne* and *Kelner* cases, which both remarked on how the promoter was held accountable, were founded on a technical difference, in the manner in which the contract was executed. It should be emphasized, however, that the *Newborne* case included a contract with a faulty organization. To address this issue of pre-incorporation contracts, it has been recommended that the doctrines of "*Corporation through Estoppel*" and "*De-facto Corporation"* be explored [4]. These theories shield promoters and directors from personal liability for transactions entered into with a corporation, that both parties perceived was incorporated but in actuality were not.

Pre-incorporation Contracts: Limitations in Enforcement

The enforcement of a pre-incorporation contract is limited by the fact that it is entered into on behalf of an illusory entity, that lacks legal personality. In a number of countries, the third party has been placed on an unequal footing [with the contract deemed void and invalid], owing to the absence of a competent party, entering into the contract. The *'first issue'* to address is the connection between the promoter and the firm. The often advanced and faulty implemented argument is the promoter's status, as an un-incorporated company's *'agent'*. However, company law contrarily states that, if principle does not exist at the moment of signing of a pre-incorporation contract, the promoter cannot be bound as the company's agent.

Another aspect is that enforcement is still not allowed at the post-incorporation stage. It is permitted under Indian law to address the issue of liabilities, but English law prohibits the company from enforcing pre-incorporation contracts, on the grounds that Pre-incorporation contracts does necessitates the firm to have a *'defined legal capacity'*, when a deal is executed. The doctrine of "*Persona Ficta"*, which translates as 'A fictitious person created under law' is so rigidly applied, that unless any action for implementation or adoption by the business is deemed [as a proposal to the third party], unilateral enforcement is not authorized, until novation of the agreement takes place to remove the company from the contract's list of parties. This is in accordance with the '*Jenkins Committee's suggestion*' [5] to expedite the enforcement process for business purposes. Allowing the business to approve pre-incorporation contracts is one notion that has been implemented with considerable latitude.

American law attempts to circumvent the theoretical issues associated with enforcement, by creating a notion of '*adoption*' in place of '*enforcement*'. Both have the same legal impact; the only difference is in being technically right. Adoption enhances the contract, since it instantly makes the corporation a signatory to the contract [6]. Although the relationship between a principal-agent do not warrant imposition of responsibility on the corporation, the authority might be identified within the firm's inherent capabilities of contract formation i.e., as a body corporate. Thus, although the firm is not allowed to '*enforce*' the contract legally, it has the liberty to accept it for reasonable purpose of protecting other signatories; granted that company successfully obtains the benefits of the agreement.

The Indian and South African laws are considered quite flexible in this regard, allowing businesses to '*enforce*' pre-incorporation contracts, executed on their behalf. This is described in the certain sections of the Specific Relief Act 1963, where authority exists within the scope of the act, under Sections 15(h) and 19(e). In the case of "*Seth Sobhag Mal Lodha et al. v. Edward Mills Co. Ltd."* [7], the court rejected any possibility of enforcing a pre-incorporation contract. The court here neglected to examine the requirements of the "Specific Relief Act 1963". In view of the law at the time, a categorization of the requirements of the act [Sections 15(h) and 19(e)] were permitted, in context of the legality of a pre-incorporation contract.

Ratification of Pre-incorporation Contracts

The Common-Law viewpoint on Ratification of Pre-incorporation Contracts might just provide the basis for development of a probable legislation in India. In this circumstance, common law has placed a premium on the parties' purpose, while adjudicating a contract. If a promoter acts on behalf of a company, they are independently accountable, under the agreement. If, on the other hand, the contract was signed under the ownership of a prospective company, with promoter acting in good faith [just as an agent to validate the signature], the promoter is absolved from any liability. The principle that we can deduct from the above precedents is that in order to determine whether the promoter intended to take obligation [under a novated contract], where both parties knew the status of the un-incorporated company at the time of enforcement; the issue that must be posed is whether or not the promoter sought to bear such liability, after the proposed incorporation of the company.

Another point of contention during determination of liability was the difference between '*Signatures of Promoters*'. However, this was resolved due to "Section 9(c) of the EEC directive" [8] in addition to "Section 36 of the Companies Act 1956" [9]. The laws explained how anybody, who purported to contract on behalf of a business shall be held personally accountable for it. The legislation bolstered transaction security, as now the agreements which were entered into were not declared void and the company was able to avoid the formation of a dormant deed. "Section 36C of the Companies Act 1956", strengthened contracts law and eliminated procedural complexities, by including circumstances in which no agreement was made but benefits were availed, according to a draft document. The court in "*Braymist Ltd. v. Wise Financial Co Ltd.*" [10] extended the doctrine of agents being sued '*under the contract'*, to them being liable also for the conditions listed '*on the contract'*.

The United States Securities Act of 1933 argued that the promoter has severe culpability if the company has not been created or does not embrace the contract. In "*RKO-Stanley Warner Theatres, Inc. v. Graziano"* [11], the assets of the promoter were categorically attached, in spite of expressly refusing obligation for the agreement and transferring liability to an un-incorporated company. In spite of the company's formation, it was never the intention to enter into a contract and the court had thus rejected that, personal culpability should be limited to the pre-incorporation period. In the case of a pre-incorporation contract, the restatement agency suggested '*three options*': '*first'*, to make the corporation liable for the contract; '*second'*, to make the promoter liable for ensuring that the corporation adopts the contract; and '*third'*, to terminate the obligation of the promoter, upon the acceptance of agreement by the company.

According to '*Ramaiya's Commentary on Company Law'* [12], "Section 230 of the Indian Contract Act 1872" explains how a promoter is absolved of any liability in furtherance of being a signatory because an agent is not individually obligated by the agreement they agree upon, on behalf of their client. Promoters, who refuse to ratify a contract may only file a lawsuit on the grounds of '*quantum of merit*', once their business has been created. Quantum merit holds that if a promoter provides services to another party and the other party accepts such services, the promoter may sue under the contract. However, it is argued that this is an inaccurate viewpoint due to the agent-principal relationship. Making the promoter personally accountable would always depend on the participants' intent, and no such rule can be derived from Indian law.

CONCLUSION

The Prospect of a 'Refined' Pre-incorporation Law Doctrine in India

In the Indian context, it may be proposed to change the provision for ratification or to seek novation; otherwise, a corporation's adoption would not be deemed a promise, that the promoter would be absolved from all of their liability. The notion of 'fairness' and 'equity' may also be used to justify the elimination of a promoter's liability if the firm implements the contract. This idea will assist in alleviating one party's load and will even share the parties' advantages and responsibilities. Furthermore, it restricts the third-party's ability to hold anybody accountable under the contract. Another argument in favour of removing promoters' personal liability is the notion of "*Contractual Mutuality"*. As soon as a company is incorporated, the promoter no longer has a vested interest, in regard to the transaction. As a consequence, holding the promoter responsible here is unreasonable.

The practices in various countries around the globe may prove beneficial in resolving limitations surrounding pre-incorporation contracts. In civil law jurisdictions such as '*Germany*', the promoter holds other promoters jointly accountable, and the pre-incorporation corporation is recognized as a partnership. Another significant component of law of Germany is the "*Identity Principle"* [13]. It explains how when a business is incorporated, it has the same rights and duties, as the business's pre-incorporation contract stage. This hypothesis is subsequently referred to as "*theory of continuity*". Since all duties and obligations are assigned to the subsequent company in the event of a succession, a company is not required to approve the contract [at the time of incorporation], in accordance with the fundamentals of this theory.

It is argued that the German idea might be regarded as the best-possible way to minimize responsibility for a promoter. As previously stated, in India, the promoters typically have the majority of control over a company; therefore, the promoters would be guarded from any external obligations and third parties will have a surety debtor, providing them increased security against payments or rendering of services, due to them. If agreements are obtained by the corporation as if they were under succession, this would prove advantageous to both parties.

This is particularly pertinent in the Indian context, since the majority of businesses are family-owned, and pre-incorporation contracts are often advantageous to the business. The legislative should explore this alternative, since pre-incorporation contracts are a unique situation, which is conclusively not as straightforward as it looks.

Conflicts of Interest

"The authors declare no conflict of interest." This is to solemnly swear that the submitted research article is the Author's i.e., *Dev Agrawal* original work and is being submitted for publication in the Journal of Corporate Governance & International Business Law exclusively.

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