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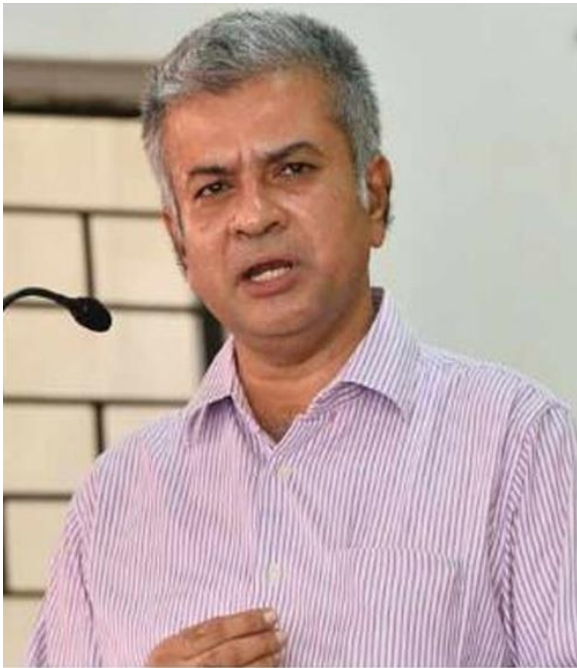
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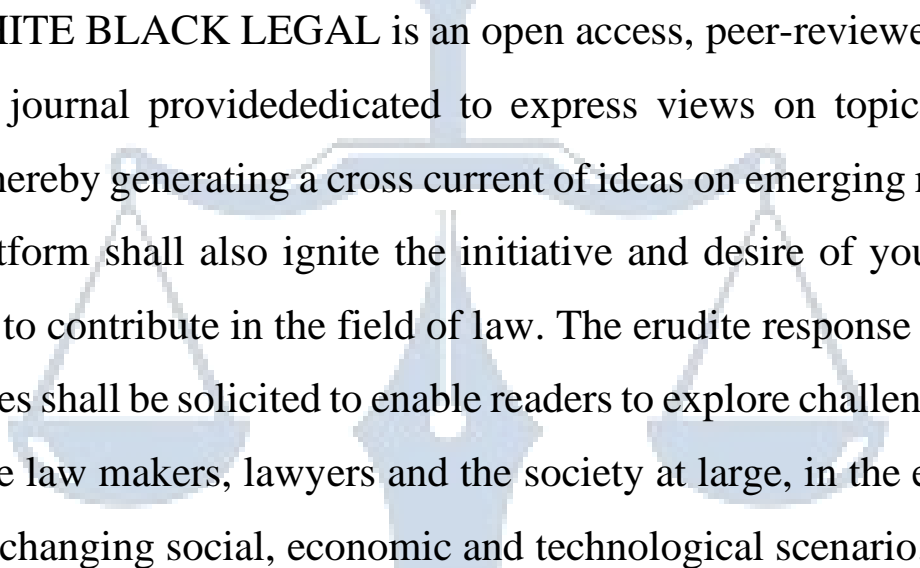


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Subhrajit did his LL.M. in Sports Law, from Nottingham Trent University of United Kingdoms, with international scholarship provided by university; he has also completed another LL.M. in Energy Law from University of Petroleum and Energy Studies, India. He did his B.B.A.LL.B. (Hons.) focussing on International Trade Law.

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With this thought, we hereby present to you

W H I T E   B L A C K  
L E G A L

# **PRE-INCORPORATION CONTRACTS:** **A CRITICAL ANALYSIS OF THE** **CONUNDRUM IN INDIA**

*Authored By- Devesh\**

Pre- Incorporation Contracts are contracts entered by the promoters for the company before its incorporation. One might ask the following questions:

- (1) What is a company?
- (2) Who are the promoters?
- (3) What does the term incorporation mean?

**Meaning of a Company**-The word ‘company’ has no strictly technical or legal meaning (*Stanley, Re* [1906] 1 Ch. 131)<sup>1</sup>. It means an association of persons for some common objectives. Those objectives can be economic (to carry business for profits or gains) or non-economic in nature. As per the Companies Act,2013<sup>2</sup>, a company is a company incorporated under this Act or under any previous company law<sup>3</sup>.

**Basic Understanding: Promotion, Incorporation, and Promoters**-Though promotion and incorporation are usually used interchangeably, these two are different concepts in the legal context. Promotion means the complete process by which a company is brought into existence i.e., the Idea’s conception to Company’s creation. The persons who are involved in this process are known as promoters<sup>4</sup>.

As per **Section 2(69)** of the **Companies Act,2013**, **promoter** means 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

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\* Devesh is an advocate at Patna High Court. The author may be reached at [deveshadvocate2020@gmail.com](mailto:deveshadvocate2020@gmail.com)

<sup>1</sup> <https://www.taxmann.com/post/blog/what-is-a-company-definition-characteristics-and-latest-case-laws/>

<sup>2</sup> § 2(20) of the Companies Act,2013

<sup>3</sup> § 2(67) of the Companies Act,2013

<sup>4</sup> As per § 2(69) of the Companies Act,2013, a person who is acting merely in a professional capacity is not a promoter. Examples- Lawyers, Chartered Accountants, etc.

instructions the Board of Directors of the company is accustomed to act.

Incorporation or Registration can be understood as a subset of “Promotion” in which legal compliances/formalities are done like Reservation of name, Filing of Documents (Articles of Association, Memorandum of Association, Declaration as to Compliance, and other documents) with the Registrar<sup>5</sup>, & the issuance of a certificate of incorporation by the Registrar on the basis of such documents and information.

Effect of registration is the creation of the body corporate by the name contained in the Memorandum of Association, capable of exercising all the functions of an incorporated company under this Act and having perpetual succession with power to acquire, hold, and dispose of property, to contract and to sue and be sued by the said name.<sup>6</sup>

So, Pre-Incorporation Contracts are nothing but contracts that are entered by the promoters with third parties, for the company (which is to be created), before its incorporation or registration as per the aforesaid Act and the relevant rules made thereunder. Many types of such contracts can be entered by the promoters for the company’s needs and purposes, such as a lease agreement, employment agreement, shareholder’s agreement, etc.

## LEGAL POSITION IN INDIA

As discussed earlier, pre-incorporation contracts are contracts that are entered by the promoters on behalf of the company, with third parties. So, the parties in such contracts are: (1) The Promoters, & (2) the Third Parties.

As the company is a non-entity before incorporation, promoters cannot be considered agents or trustees of it. The company (under-incorporation) is not a party to the contract as the company is not existing at the time of entering the contract and hence it is incompetent to contract as per provisions of the Indian Contract Act,1872<sup>7</sup>.

**(A) Liability of the company and enforceability of the pre-incorporation contracts by the company-** When a person is not in existence, then he cannot be a party to the contract, and

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<sup>5</sup> As per § 2(75) of the Companies Act,2013, Registrar means a Registrar, an Additional Registrar, a Joint Registrar, a Deputy Registrar, or an Assistant Registrar, having the duty of registering companies and discharging various functions under this Act.

<sup>6</sup> § 9 of the Companies Act,2013

<sup>7</sup> §11



therefore the company is not to incur any liability arising out of such contracts as per the doctrine of privity of contracts.<sup>8</sup> Thus so far as the company is concerned, it is neither bound nor can have the benefit of a pre-incorporation contract.

But this is subject to the provisions contained in the **Specific Relief Act,1963**.<sup>9</sup> As per **Section 19(e)**<sup>10</sup> of the same Act, specific performance may be **enforced against a company** where its promoters before its incorporation, entered into a contract for the purposes of the company,<sup>11</sup> and such contract is warranted by the terms of its incorporation (i.e., it falls under the scope of the company's objects as mentioned in the Memorandum of Association of the Company), provided the company(after incorporation) accepts the contract and has communicated such acceptance to the other party to the contract.

Similarly, As per **Section 15(h) of the Specific Relief Act,1963**, specific performance can be **enforced by a company**, where the promoters of a company have, before its incorporation, entered into a contract for the purposes of the company, and such contract is warranted by the terms of its incorporation, provided the company accepts the contract and has communicated such acceptance to the other party.

So, the liability of the company in cases of pre-incorporation contracts or the right to enforce pre-incorporation contracts of the company is conditional i.e., it fulfills the conditions provided under the Specific Relief Act,1963. No right or liability of the company arises out of such contracts unless it adopts the pre-incorporation contracts as per the aforesaid provision in Specific Relief Act,1963.

**(B) Liability and rights of the promoters-** Now, one might ask a pertaining question here i.e. Who can be held liable or accountable for the pre-incorporation contract, if the company (after incorporation) does not adopt the contract? The answer is the "Promoters". The position of liability of promoters can be understood better by the following case laws:

(1) ***Kelner v. Baxter***<sup>12</sup>- In this case, the proposed directors(promoters) of the company (under incorporation) entered into a contract with the plaintiff for the purchase of wine. The promoters took the delivery of the wine and then due to some reasons, the company went into liquidation. When the plaintiff sued the promoters for the non-payment, the court held that the company is not bound

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<sup>8</sup> <https://www.lawteacher.net/free-law-essays/contract-law/pre-incorporation-contracts-and-the-promoter.php>

<sup>9</sup> § 15(h) & §19(e)

<sup>10</sup> Specific Relief Act,1963

<sup>11</sup> The phrase "for the purposes of the company" means contracts that are essential for the incorporation and working of the company. For instance, a contract for the supply of plant and machinery for the working of the company, or a lease agreement for the company.

<sup>12</sup> [(1866) LR 2 CP 174]

by the contract but the promoters were held personally liable on the ground that they had contracted on behalf of a principal which was non-existent.

This principle of personal liability of promoters is also followed in India.

(2) In the case of *Seth Sobhag Mal Lodha v. Edward Mill Co. Ltd*<sup>13</sup>, it was held that the promoters of the company are personally liable for the non-performance of the obligations decided in the pre-incorporation contract<sup>14</sup>.

So, if the company does not adopt the pre-incorporation contract after its incorporation, promoters are the ones who are responsible or liable for the non-performance of the obligations of such contracts.

So far as the rights are concerned, promoters have not been given rights to bind the company with the terms of the pre-incorporation contracts.

**(C) Liability and rights of the third/other party-** Unless a company after its incorporation adopts the pre-incorporation contracts as per the provisions of the **Specific Relief Act, 1963**, the company cannot sue the third parties because the company is not considered as the party to the contract. But third parties have options:

- (1) They can sue the promoters for non-performance of the obligations if the company does not adopt the pre-incorporation contracts.
- (2) They can sue the company if the company after its incorporation adopts the contract.

## **CONUNDRUM & THE CRITICAL ANALYSIS**

Though a company is a creation of law, it is the promoters who fulfill the pre-requisites of the law for its creation. The present scenario for the promoters of companies pertaining to pre-incorporation seems to be quite disparaging. A company has two choices after being incorporated i.e. **(1)** it can opt for the adoption of pre-incorporation contracts and can take the benefit of such contract, in accordance with the provisions of Specific Relief Act, 1963, Indian Contract Act, 1872, & the Companies Act, 2013 & **(2)** it can opt to not adopt the same. No right or liability of the company arises out of pre-incorporation contracts unless it adopts the pre-incorporation contracts.

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<sup>13</sup> <https://indiankanoon.org/doc/1716446/>

<sup>14</sup> [https://blog.ipleaders.in/important-clauses-of-pre-incorporation-contracts/#Enforceability\\_of\\_pre-incorporation\\_contracts](https://blog.ipleaders.in/important-clauses-of-pre-incorporation-contracts/#Enforceability_of_pre-incorporation_contracts)

According to **Salmond**, no right can exist without a corresponding duty and vice versa<sup>15</sup>, but as per the present scenario, a company is getting an option & the right to adopt or to not adopt the contract without **any duty** i.e., it cannot be held liable for non-performance of the contract if it does not adopt the same after its incorporation.

The liability of the company in cases of pre-incorporation contracts or the right to enforce pre-incorporation contracts of the company is conditional and that condition itself is dependent upon the choice of the company i.e., to adopt or to not adopt the contract.

Similarly, the third parties have options: (a) to initiate action against the promoters for non-performance of the obligations if the company does not adopt the pre-incorporation contracts or (b) to initiate action against the company if the company after its incorporation adopts the contract.

But the promoters have not been given the right to bind the company with the terms of the pre-incorporation contracts despite the promoters being a party to the pre-incorporation contract. The disparaging affairs for the promoters are: they are held personally liable for non-performance of the obligations mentioned in the pre-incorporation contract, but their interests have not been protected in the same manner as that of a company or the third party.

Promoters incur personal liability on the ground that such contracts are considered as a contract made on behalf of the principal known to both parties (the promoter & the third party) to be non-existent and hence such contracts are deemed to have been entered into personally by the actual maker<sup>16</sup>.

The conundrum lies in the fact that, if they are to be held liable, they should be the ones who must get rights in return but the law protects the interests of companies and third parties i.e., the Specific Relief Act, 1963 recognizes the rights of companies and third parties.

## CONCLUSION

Though a company is a creation of law, it is the promoters who fulfill the pre-requisites of the law for its creation and hence play an indispensable role in the company's formation. But their interests are not protected in the same manner, as that of the company or the third party. Provisions of law

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<sup>15</sup> <https://lawbhoomi.com/correlation-between-rights-and-duties-in-jurisprudence/>

<sup>16</sup> B.K. GOYAL, COMPANY LAW, 3.9(16<sup>th</sup> edition, 2022)

on the pre-incorporation contract are quite baffling in nature and it needs to be reformed. When the law says that: ignorance of the law is no excuse, it should not be perplexing in nature. Pre-Incorporation contracts are essential for a company's formation and growth, and hence the laws should recognize the rights of the parties involved in the best possible manner. The present scenario is no less than a hindrance for the promoters, as it puts liability on the shoulders of promoters without acknowledging their contribution and rights in an appropriate manner.



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