
ENFORCEABILITY OF PRE-INCORPORATION CONTRACTS IN INDIA

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Abstract

Companies cannot be allowed to escape the liabilities conferred on them by their conceivers. According to the common law, the pre incorporation contracts are the contracts that were entered by promoters on behalf of the company with other parties before incorporation of the company. These contracts are not enforceable against the company nor could the company enforce them against the other party, as the company was not party to it. Presently According to Sections 51(h) and 19(e) of Specific Relief Act, 1963 pre incorporation contracts can be enforced against the companies if they are essential as per the terms of incorporation and if they are accepted and the same is communicated by the company. These contracts can also be accepted by novation, by the company. Promoters are personally liable if company doesn't take up the responsibility. Incorporation brings a company into existence and the contracts made for the sake of companies prior to their incorporation by their promoters are very beneficial for the company but lack formal legal enforceability. Though certain provisions have been incorporated through various statutes for enforceability of pre incorporation contracts on company but yet courts have at different times given different interpretation in this regard. This creates problems in defining the limits enforceability of these contracts. The laws in relation to the pre-incorporation contracts are not definitive in India. Pre incorporation contracts should be made enforceable against the companies and the companies should be able to enforce them against the other party in the contract without requirement novation of that contract.

Keywords- *Companies, Enforceability, Liable, Pre-Incorporation Contracts, Promoters.*

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I. Introduction

Pre-incorporation contracts usually lack formal legal binding on the company as they are entered by promoters on behalf of the company before the actual incorporation of the company. These contracts are essential for the as they are the basis on which a company could be established and lay down the foundation for the business to further flourish.

The pre-incorporated contracts are neither defined in company's act nor are they defined in any other act. Formal doctrines like doctrine of agency or ratification are not applicable of these contracts as for both the cases the principal entity has to be in existence while the contract has been entered into. The promoters are the parties to the contract hence the promoters were held entirely liable under common law. But in India Specific Relief provides two provision which enable the company to choose to be liable or benefit from these contracts. But time and again the enforceability these contracts is contested. The courts have used these provisions of the specific relief act as well as the decisions given by the courts of common law and decided whether the company can be held liable for the benefits received or the company is eligible to receive the benefit of the contract.

Many times, when the company wants to enforce the contract the formal legal problems like privity of contract stops a company from doing so. If a company is already using the benefit of a property or the property itself which it received as a result of the promoter's contract the other party to the contract can still challenge the title of the company over such property etc. The promoter becomes liable for to breach of any contract even if the company has already used the benefit.

II. Meaning and Concept

According to Indian Contract Act 1872 all agreement are contracts if they are made by free consent of parties competent to contract, for a lawful consideration and with a lawful object, and are not hereby expressly declared void. This act¹ also defines the meaning of competent persons. But with this definition it is clear that contract can be between two or more parties. These parties are in existence while they are entering into the contract.

¹ The Indian Contract Act, 1872, Act No. 9 of 1872, (India).

A company is a separate legal entity it means it has some of the attributes of a natural citizens. This distinct characteristic of the company makes it capable of entering into contracts with others. The promoters of the company enter into contracts on behalf of the company before the company is incorporated. Promoters are the people who take the initiative to start the company and do the necessary work required for the purpose of giving the company a kick start. These Contracts that are entered by the promoters before incorporation on behalf of the company are the pre-incorporation contracts. The basic meaning of pre-incorporation is the contract entered by the promoter of a company with other party for benefit the company before its incorporation.

Pre-incorporation contracts perform a valuable function. By permitting valid and binding legal commitments with third parties, nascent companies are able to secure significant and sometimes essential services necessary to become a fully capitalized and stable corporation².

These contracts are not entered into by the companies and are entered before its incorporation hence the company is not party to the contract and as per the Indian contract act a contract is enforceable only when it is made with the consent of the parties. Hence it is not enforceable by the company or against the company. In most of the cases the promoter is personally liable.

The concepts like agency and ratification are not applicable on these types of contracts as the principle that is the company which had to give authority for the purpose of the promoter enter into these pre-incorporation contracts is non-existent. For the purpose of ratification the person must be in existence when the contract was actually entered, hence the company cannot ratify nor adopt such contract. But it can accept such contract according to the provisions of specific relief act voluntarily.

III. Issues and problems

Since the existing laws do not give importance to the intention with which the parties enter into the contract. Even if both the parties are aware that a specific contract is made for the benefit of a company and the members who are entering on behalf of the company are its promoters the company

² Article on Pre-incorporation contracts available at <https://www.legalserviceindia.com/legal/article-9585-pre-incorporationcontracts.html#:~:text=Pre%2Dincorporation%20contracts%20perform%20a,fully%20capitalized%20and%20stable%20corporation>. Last seen on 15/12/23

is also made about the it being able to gain the benefit arising out of such yet the contract cannot be enforced against the company unless the company voluntarily communicates the acceptance to the other party. The company cannot ask for the benefit of a particular contract made prior to its incorporation as it was not party to it.

The present law related to pre-incorporation contracts is based on the law of contracts rather than it being considered as a special type of contract made for benefit of the company and a contract to which a non-existent member directly becomes a party soon after its incorporation. The non-enforceability of such contracts by the company is creating problems for the companies as they are not able to receive the benefits that the promoters wanted them to enjoy by entering such contracts. The companies have been dragged into litigation challenging their title over a property which was given to them by the promoters as a result of a pre-incorporation contract. The amount of profits that were decided between the company and its incorporators also becomes a problem as the contract was entered into when the contract was not in existence. The formal concepts like doctrine of privity of contract and agency do not fully fill the needs of the corporation to begin the business. There is no provision which allows the promoter to be reimbursed from the company when he sues for the pre-incorporation contract the benefit of which the company has already enjoyed. The law with regards to the enforcement of these contracts is very vague the contracts according to The Specific Relief Act Section 19 and 15³ are only enforceable by and against the companies only if the company accepts and then communicates the acceptance to the other party, the law allows the companies the complete discretion in accepting or not accepting the contracts. Also the terms should be warranted by the terms of incorporation the Act does not define what it means to be warranted by the terms of incorporation.

The formal ratification is not allowed as the company was not in existence at the time of the making the contract as according to contract Act the person may ratify the act which were done on their behalf without their consent according to Section 196 of The Indian Contract Act 1872⁴. But as the English law holds that the ratification is not possible with a non-existent entity.

³ The Specific Relief Act, 1963, No. 47, Act of Parliament 1963, § 15, 19 (India)

⁴ The Indian Contract Act, 1872, Act No. 9 of 1872, § 196 (India).

This allows the company to escape the liability created by the contract even after accepting the benefit of the contract as implied ratification is not possible. These laws are inadequate to make such huge corporations responsible for the benefits that they have received and because of which they were capable of commencing their business.

IV. Enforcement Of Pre-Incorporation Contract Historical Perspective

A. Common Law Perspective

The courts of England previously have held that the pre-incorporation are binding neither on the company not on the promoters. This view of courts was based on two doctrines, the doctrine of privity of contract and the law of agency⁵. In the case of *Kenler v. Bexter*⁶ the promoters of the Company 'Gravesend Royal Alexandra Hotel' before its incorporation entered into a contract for purchase of liquor. The liquor was consumed before the price for it as paid. The company went into liquidation. The promoters were sued for recovery of the amount of the liquor. The question before the court was that whether the company can be made liable for this contract or the liability lies with the promoters. The court held that the promoters are personally liable. Erle CJ in this case held that "where a contract is signed by one who professes to be signing "as agent," but who has no principal existing at the time, the contract would be wholly inoperative unless binding upon the person who signed it...and a stranger cannot by a subsequent ratification relieve him from that liability."⁷ It was also held ratification was also not possible as a third party cannot subsequently ratify the contract in order to relive the promoters from their liability. Thus making all the promoters personally libable for this pre-incorporation contract.

The principle that was formulated in this case was that the pre-incorporation contracts are entered by the agents while the company was not in existence which means before it came into existence, the promoters entering into the contracts are not acting on behalf of the company as there is no company at the time. They cannot be considered as entering as agents on behalf of the company as there is not in existence which could be have been the principle.

⁵ Oluwadara Omolaja, *Comparative Analysis of the Laws of Delaware and U.K Company Law on Enforcement Pre-Incorporation Contracts*, SSRN (March. 2,2018), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3117638

⁶ *Kenler v. Bexter* (1866) LR 2 CP 174

⁷ *Id*

There cannot a contract of agency cannot be created without principle; the company cannot be said to have given consent as it was not in existence. Ratification of those contracts was also not possible. If the promoter is not made liable then the whole contract will not be enforceable.

This case became the basis of many judgements given in India, Australia and South Africa.in Re colonial case the layer was not able to recover his expense from a company which was in existence at the time of contract. In the case *Newborn v Sensolid*⁸ the plaintiff entered into a contract on behalf of the company which was yet to be incorporated (he had signed for that company).The market fell down and the buyer refused to accept the delivery the plaintiff sued the defendant believing that the principle of *Kenler v Bexter*⁹ would be applied. But the court held that the contract was not enforceable as the contract was entered on behalf of a non-existent company and the plaintiff all of a sudden cannot claim that it was his contract. This particular judgment received criticism. The two above mentioned two cases involve doctrine of privity of contract as it cannot be enforced against third party as well as try to explain the aspects of contract of agency.

In case *Smallwood v Black*¹⁰ A contract was entered for purchase of land. The defendants entered in to contract on behalf of the company that was not incorporated, as its directors. The plaintiffs sued the defendants for the specific performance of the court held that defendants were responsible personally as it cannot be inferred that they did not intended to not be personally liable. This decision of this case was based on intention of the directors who entered into the contract, to incorporate the company. As they knew that they were entering on behalf of non-existing principle hence they could be made personally liable for the contract.

⁸ *Newborn v. Sensolid* (1945) 1 QB 45

⁹ *Kenler v. Bexter* (1866) LR 2 CP 174

¹⁰*Black v Smallwood* (1966) 117 CLR 52

B. Indian Perspective

Indian law is based upon the laws of England. The pre-incorporation contracts in India is mostly dealt by provisions of Specific relief Act¹¹. Before enacting the new Act the old Act of the 1877¹² which was based on the New York Civil code as well as the principles developed by courts of equity in England contained the provision allowing the enforcing of pre-incorporation of contract under which Clause (h) of Section 23 and Section 27(e) of the specific performance of pre-incorporation contract.

The Ninth report of law commission¹³ on specific relief act suggested to retain the provisions with regard to pre-incorporation contract. The report said that “there would appear no reason why the company should not be entitled to choose to take benefit or burden of a contract made on its promoters on its behalf”. But these provisions were to be extended to all the companies as opposed to only public companies previously, it was also suggested to remove the words ‘ratification and adoption to be removed’.

V. Current Provisions In India For Enforcement Of Pre-Incorporation Contracts

A. Specific Relief Act

In India the Specific relief Act, 1963¹⁴ provides certain provisions with related to performance of pre-incorporation contracts. The Section 15(h) and section 19(e) speaks about the contracts made by the promoters prior to incorporation of companies. Section 15 (h) of the States that:

“Except as otherwise provided by this Chapter, the specific performance of a contract may be obtained by the company when 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 the incorporation, the company: Provided that the company has accepted the contract and has communicated such acceptance to the other party to the contract¹⁵.”

¹¹ The Specific Relief Act, 1963, No. 47, Act of Parliament, 1963 (India)

¹² The specific relief Act, 1877

¹³ 9th Law Commission Report On The Specific Relief Act, 1877(1958)
<https://patnahhighcourt.gov.in/bja/PDF/UPLOADED/BJA/MISC/258.PDF>

¹⁴ The Specific Relief Act, 1963, No. 47, Act of Parliament, 1963 (India)

¹⁵ *id* at §15(h)

Section 19(e) of the Act States that :Except as otherwise provided by this Chapter, specific performance of a contract may be enforced against the company when the promoters of a company have, before its incorporation, entered into a contract for the purpose of the company and such contract is warranted by the terms of the incorporation, the company: Provided that the company has accepted the contract and communicated such acceptance to the other party to the contract¹⁶.

Section 15(h)¹⁷ states that a company may obtain specific performance of a contract that is entered into by the promoters of that company for it before its incorporation, if the contract is warranted by the terms of incorporation of the company, only if the company has accepted the contract and communicated the same to the other party.

Section 19(e)¹⁸ states that the pre-incorporation contract may be enforced against a company if the contract is warranted by the terms of incorporation and the company has accepted the contract and has communicated the same to other party.

The meaning of the “warranted by the terms of incorporation” is said to be understood as to not be ultra vires of the object¹⁹. It means that it should not go against the sole object of the company for which it has been incorporated but it could covers a purpose which is essential to the object of the company.

B. Novation Of The Contract

According to Section 62 of The Indian Contract Act, 1872²⁰ in case of novation, rescission, and alteration of contract, the original contract need not be performed. According to this if two parties of the original contract mutually decide to substitute the terms of the original contract with a new terms or substitution of one of the parties with other another party the original contract need not be performed, the newly formed contracts need to be performed or the party which has substituted the previous one needs to perform the contract.

¹⁶ *id* at §19(e)

¹⁷ *Supra* note 14, at §15(h)

¹⁸ *Supra* note 14, at §19(e)

¹⁹ Aysha Aazmy Moideen, *Validity of Pre- Incorporation Contracts: Solving the riddle of a defectively incorporated contract*, 1 ILE multidisciplinary journal.51,47-54(2023)

²⁰ *Supra* note 1

A pre-incorporation is made between the promoter and the other party, for the sake of the company. After the company is incorporated the company can replace the promoter in the original contract and become party to the contract. But it is essential that the third party agrees to this type of substitution.

VI. Judicial Interpretation On Enforcement Of Pre-Incorporation Contract In India

In case *Weaver Mills v. Bilkis Ammal*²¹ and Others the promoters of a company had purchased land for the company before its incorporation, the company had also started building certain structures on the land. There was a dispute with regards to whom the suit property belonged. The Madras high court held that the property belonged to the company and the property cannot be denied as it had already used the suit property.

In case *Murari Ganguly And Ors. vs Kanailal Garai And Ors*²² a property was to be leased in favour of a company yet to be incorporated by a unilateral document, but the company never came into existence, instead it was converted into a partnership firm. The question before the court arose whether the suit property belonged to the firm which was supposed to be company. The Calcutta High Court as per the Company's act the acceptance of the pre-incorporation contracts has to be communicated by the companies to the other parties, as there was no company in existence there was no question of communication of the acceptance and hence the contract was not enforceable.

*Narain Parasurampuriah v Pushpa Devi Saraf & Ors*²³ is a similar case in which the promoter purchased property for the benefit of the company and then on certain essential documents the company was shown as the owner of the property. When the dispute arose as to said property the Apex court referred to the case *Weaver Mill v Bilkis Ammal* had held that the company could not be denied the ownership of it.

²¹ *Weavers Mills v Bilkis Ammal And Ors.*, (1969) AIR 1969 MADRAS 462(India)

²² *Murari Ganguly And Ors. vs Kanailal Garai And Ors.*, (2002) AIR2003CAL105(India)

²³ *Narain Parasurampuriah v Pushpa Devi Saraf & Ors.*, (2006) AIR 1992 SC 1133(India)

In case *Seth Sobhag Mal Lodha And Ors. vs Edward Mills Co. Ltd. And Ors*²⁴. There as issue raised with regards to liability of a company for an agreement that was entered before its incorporation, by ratification. It was contended that as the company had agreed to it impliedly by incorporating the terms into its Memorandum of Association and Article of Association and acting accordingly. The Rajasthan High Court held that the MOA does not form a contract between the company and the third party named therein. It is up to company to enter into new contracts. There was no ratification Hence there was no contract which could be enforceable on company.

In case *The Commissioner Of Income Tax v City Mills Distributors*²⁵ the issue was whether the company was liable for paying the income-tax for the profits made by its promoter during its incorporation. The company had disclosed a certain income which it mad during a financial year and had filed a return on the same amount the IT officer also included the amount of profits made by its promoters as its pre- incorporation profits for the sake of tax, the court held that these profits cannot be included in company's profits as it wasn't existent at the time of gaining these profits.

The court also gave reasoning that "A company can enter into an agreement only after its incorporation. It is only after incorporation that a company may decide to accept that its promoters have carried on business on its behalf and appropriate the income thereof to itself. The question as to who is liable to pay tax on such income cannot depend upon whether or not the company after incorporation so decides. It is he who carried on the business and received the income when it accrued who is liable to bear the burden of tax thereon."²⁶

²⁴Seth Sobhag Mal Lodha And Ors. vs Edward Mills Co. Ltd. And Ors (1972), 42 Com.Cas 1 (Raj)

²⁵The Commissioner Of Income Tax v City Mills Distributors (1996) 132 CTR 0206

²⁶ *id*

VII. Conclusion

As the current position of the law is that a pre- incorporation contract can be enforced against a company only if it is warranted by the terms of incorporation as well as the communication of its acceptance is given to the third party. The courts have rejected the contentions of implied acceptance of these contracts. But they have also held that where the company had started to use the property arising out of the said pre-incorporation contracts, it cannot be denied the same afterwards. Therefore, the current position of the law in regards to the pre-incorporation contract is uncertain.

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