

ROLE OF PROMOTER IN ESTABLISHING A COMPANY: AN ANALYSIS

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Abstract

There is a lot of hue and cry to decide the legal status of promoter and his liability for pre-incorporation contracts as he is not the agent because there is no company yet in existence and he is not a trustee because there is no trust in existence. But it does not mean that the promoter does not have any legal relationship with the proposed company. The Position of the promoter is quasi legal as he stands in a fiduciary position towards the company about to be formed. Thus, the aim of the paper is to examine the various characteristics of promoter of a company and understand the different kinds of promoter in a company. Also, to trace out the various, functions, duties and liabilities of promoters and analyse the legal position of promoter with regard to company, and to give suggestions with regard to liability of promoter and the company.

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INTRODUCTION

“A promoter is the one, who undertakes to form a company with reference to a given object and sets it going and takes the necessary steps to accomplish that purpose.”

- Justice C.J. Cokburn

The term ‘Promotion’ is of wide importance denoting the preliminary steps taken for the purpose of registration and floatation of the company and the persons who assume the task of promotion are called ‘Promoters’. A promoter may be individual, syndicate, association, partner or company.¹ A promoter conceives an idea for setting-up a particular business at a given place and performs various formalities required for starting a company. A promoter may be an individual, firm, association of persons or a company. The persons who assist the promoter in completing various legal formalities are professional people like Counsels, Solicitors, Accountants etc. and not promoters. Typically, a promoter takes care of all the essential activities that help to establish a company. The promoter acquires and invests the initial capital for the company. Once all the formalities are completed, the promoter hands over the authority to the directors.

Chronologically, the first persons who control or influence the company’s affairs are its promoters. It is they who conceive the idea of forming the company, and it is they who take the necessary steps to incorporate it, to provide it with share and loan capital etc. when these things have been done, they handover the control of the company to its directors, who are often themselves under a different name. On handing over the control of the company the promoter’s fiduciary and common law duties cease, and he is thereafter subject to no more extensive duties in dealing with the company than a third person who is unconnected with it.

MEANING & SIGNIFICANCE OF PROMOTER IN A COMPANY

When an individual has an idea for a new business venture, he or she may set about interesting others in the venture and persuade them to contribute capital to a company to be incorporate for the purpose of carrying on the venture. The individual will then be described as ‘promoter’ of the company. Then the question arises that who really are promoters of a company, the most important work of a promoter is in the formation of a company. The whole process of the

¹ A.K. Majumdar, Dr. G.K. Kapoor and Sanjay Dhamija, ‘Company Law and Practice’, Taxman Publications Pvt. Ltd., p 92

formation of a company may be divided into four stages, namely,² Promotion, Registration, Floation and Commencement of business.

A company is born only when it is duly incorporated. For incorporating a company various documents are to be prepared and other formalities are to be complied with. All this work is done by promoters. To be a promoter one need not necessarily be associated with the initial formation of the company; one who subsequently helps to arrange floating of its capital will equally be regarded as a promoter. However, a person assisting the promoters by acting in a professional capacity do not thereby became promoters themselves.³ The relationship between a promoter and the company that he has floated must be deemed to be fiduciary relationship from the day the work of floating the company starts and continues up to the time that the directors take into their hands what remains to be done in the way of forming the company. The status of the promoter is generally terminated when the Board of Directors has been formed and they start governing the company.

A promoter is a generic term associated with the person who starts a business. In common parlance, this person is also referred to as the founder of the business. A promoter typically is responsible for raising capital, targeting initial leads and chasing initial business opportunities, entering into the initial contracts for the business formation and incorporating the company.

The expression 'promoter' has not been defined under the Companies Act, 1956, although the term is used expressly in sections 62, 69, 76, 478 and 519⁴. Section 62 of Companies Act, 1956 defines 'promoter' for the limited purpose of that section only. Section 62(6)(a) defines the expression 'promoter' to mean a promoter who was a party to the preparation of the prospectus or of a portion thereof containing the untrue statement, but does not include any person by reason of his acting in a professional capacity in procuring the formation of the company. Even in English law, no general statutory definition of 'promoter' is available. In the old Companies Act, 1956 there was no static definition of promoter although it was mentioned in various sections, but Section 2(69) in the new Companies Act, 2013 defines promoter. The expression '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

² *Ibid*

³ Proviso to section 2(69) of the Companies Act, 1956

⁴ The Companies Act, 1956

- 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:

Provided that nothing in sub-clause (c) shall apply to a person who is acting merely in a professional capacity.

The term is used expressly in sections 35, 39, 300 and 317⁵. The term promoter is also defined under the SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2009⁶ under Regulation 2 (1) (za)- “Promoter” includes:

- i. the person or persons who are in control of the issuer;
- ii. the person or persons who are instrumental in the formulation of a plan or programme pursuant to which specified securities are offered to public;
- iii. the person or persons named in the offer document as promoters:

Provided that a director or officer of the issuer or a person, if acting as such merely in his professional capacity, shall not be deemed as a promoter:

Provided further that a financial institution, scheduled bank, foreign portfolio investor other than Category III foreign portfolio investor and mutual fund shall not be deemed to be a promoter merely by virtue of the fact that ten percent or more of the equity share capital of the issuer is held by such person;

Provided further that such financial institution, scheduled bank and foreign portfolio investor other than Category III foreign portfolio investor shall be treated as promoter for the subsidiaries or companies promoted by them or for the mutual fund sponsored by them;

The SEBI (Substantial Acquisition of Shares Takeovers) Regulations, 2011 also states about the term promoter⁷ having the same meaning as above.

⁵ The Companies Act, 2013

⁶ Definition Clause: Regulation 2(1) (za): Promoter

⁷ Definitions clause: Regulation 2(1) (s) - promoter has the same meaning as in the Securities and Exchange Board of India (Issue of Capital and Disclosure Requirements) Regulations, 2009 and includes a member of the promoter group;

In USA, the Securities Exchange Commission Rule 405(a) defines promoter as a person who, acting alone or in conjunction with other persons directly or indirectly takes the initiative in founding or organizing the business enterprise.

Cockburn CJ., in *Twycross v. Grant*⁸ described 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.’ Bowen L.J., in the case of *Whaley Bridge Printing Co. v. Green*⁹ observed that the term promoter is ‘a term not of law but of business’ usefully summing up in a single word, i.e. promotion means a number of business operations familiar to the commercial world by which a company is brought into existence. In *Lagunas Nitrate Co. v. Lagunas Syndicate*¹⁰ it was stated that ‘to be a promoter one need not necessarily be associated with the initial formation of the company; one who subsequently helps to arrange floating of its capital will equally be regarded as a promoter.’ In *Official Liquidator v. Velu Mudaliar*¹¹ a person who does not take a prominent part may also have so acted in the formation of a company as to bring himself under the term promoter.

A person who acts in a professional capacity like solicitor, accountant etc. is not a promoter. But any such person may become a promoter if he helps the formation of the company by doing an act outside the scope of his professional capacity. A person cannot however become a promoter merely because he signs the memorandum as a subscriber for one or more shares.

In conclusion, it may be said that word ‘promoter’ is used in common parlance to denote any individual, syndicate, association, partnership or a company which takes all the necessary steps to create and mould a company and set it going.

Therefore, the difficulties in defining the term led the judges to state that the term promoter is not a term of art, nor a term of law, but of business.

TYPES OF PROMOTER

The promoters may be professional, occasional, financial or managing promoters.¹²

⁸ [1877] 2 C.P.D. 469 p.541 C.A.

⁹ [1880] 5 B.D. 109 at p.111

¹⁰ [1899] 2 Ch.392 p.428, C.A.

¹¹ [1938] 8 Comp. Case 7

¹² DeeKay, Kinds of Promoters in Business, Available at: <http://dailyjojo.com/articles/kinds-of-promoters-in-business.html> (Accessed on 03/11/2016 at 04:14 PM)

Professional promoters are those who handover the company to the shareholders when the company starts. Unfortunately, such promoters are very scarce in the developing countries. They have played an important role in many countries and helped the business community to a great extent. In U.K., Issue house; in U.S., Investment Bank and in Germany, Joint Stock Banks have played the role of promoters very significantly.

Occasional promoters are those whose main interest is the floating of companies. They are not in promotion work on regular basis but take up promotion of some companies and then go to their earlier profession. For example, engineers, lawyers etc. may float some companies.

Financial promoters do the task of promoting the financial institutions. They generally take up this work when financial environment is favorable at the time.

Managing promoters played a significant role in promoting new companies and then got their managing agency rights.

In the developing countries, promoters try to become managing directors of the companies promoted by them, so they do not charge anything separately. In other countries, promoters may be given lump sum amount for their services or they may also be allotted shares or debentures too. They may even be offered some kind of commission that is linked to the purchase price of the business. A promoter is neither an agent nor a trustee of the company as it is a non-entity before incorporation. Some legal cases have tried to spell out the standing of promoters.¹³

FUNCTIONS OF PROMOTER

In their capacity as promoters, they perform the following functions in order to incorporate a company and to set it going.

- To originate the scheme for formation of the company.
- The first persons who conceive the idea of business.
- To carry out the necessary investigation to find out whether the formation of a company is possible and profitable.
- To organize the resources to convert the idea into a reality by forming a company.
- To settle and ascertain the name the name of the company.
- To nominate the directors, bankers, auditors and etc.

¹³ *Supra Note 14*

- To decide the place where registered office (head office) have to be situated.
- To prepare the Memorandum of Association, Prospectus and other necessary documents and file them for incorporation.

The promoters, in accordance with whether they want to incorporate a private or public company, try to secure the cooperation of persons needed to form the company. Depending upon the form chosen, the promoters may decide upon the number of primary members. The company has a system of representative management and is managed by individuals appointed as directors. The first directors of the company are, however, generally appointed by the promoters. The promoters seek the consent of some individual whom they seem appropriate so that they agree to be the first directors of the proposed company. The promoters have to seek the permission of the Registrar of companies for selecting the name of the company.¹⁴

DUTIES & LIABILITIES OF PROMOTER

The early companies' acts contained no provisions regarding the duties and liabilities of promoters, and even today legislation is largely silent on the subject, merely imposing liability for untrue statement in listing particulars or prospectuses to which they are parties.¹⁵ The promoters occupy an important position and have wide powers relating to the formation of a company. It is, however, interesting to note that so far as the legal position is concerned, he is neither an agent nor a trustee of the proposed company. But it does not mean that the promoter does not have any legal relationship with the proposed company. The promoters stand in a fiduciary relation to the company they promote and to those persons, whom they induce to become shareholders in it.

Duties of the promoters

Duty to disclose secret profits

In case of *Re Cape Breton Co.*¹⁶ the commonest way in which professional promoters used to make secret profit was by purchasing property or business themselves and reselling it to the company at an enhanced price. But the difference between the two prices in such a case shall be a secret profit only if the promoter has begun to promote the company at the time he buys the

¹⁴ Rahul Pandey, Promoters of company, Available at: <http://www.legalindia.com/promoters-of-company> (Accessed on 05/11/2016 at 07:00 PM).

¹⁵ Gower & Davies, 'Principles of Modern Company Law', 8th Edition, Thomson, Sweet & Maxwell, 2008, p.107

¹⁶ [1885]29 Ch.D 795

property or business, so that he owes a duty to the company at the time not to profit on a re-sale to it. *A promoter is not forbidden to make profit but to make secret profit.* He may make a profit out of promotion with the consent of the company, in the same way as an agent may retain a profit obtained through his agency with his principal's consent. In *Gluckstein v. Barnes*¹⁷ a syndicate of persons was formed to buy a property called Olympia and re-sell this Olympia to a company to be formed for the purpose. The syndicate first bought the company itself £1,40,000. Out of the money provided by themselves, the debentures were repaid in full and a profit of £20,000 made thereon. They promoted a new company and sold Olympia to it for £ 1,80,000. The profit of £40,000 was revealed in the prospectus but not the profit of £ 20,000. Held, profit of £ 20,000 was a secret profit and the promoters of the company would be bound to pay it to the company because the disclosure of the profits by themselves in the capacity of directors of the purchasing company was not sufficient.

Duty of disclosure of interest

In addition to his duty for declaration of secret profits, a promoter must disclose to the company any interest he has in a transaction entered into by it. This is so even where a promoter sells property of his own to the company, but does not have to account for the profit he makes from the sale because he bought the property before the promotion began. Disclosure must be made in the same way as though the promoter was seeking the company's consent to his retaining a profit for which he is accountable.¹⁸

Duty under the Indian Contract Act

Promoter's duties to the company under the Indian Contract Act have not been dealt with by the courts in any detail. They cannot depend on contract, because at the time the promotion begins, the company is not incorporated, and so cannot contract with its promoters. It seems, therefore, that the promoter's duties must be the same as those of a person, who acts on behalf of another without a contract of employment, namely, to shun from deception and to exercise reasonable skill and care. Thus, where a promoter negligently allows the company to purchase property, including his own, for more than its worth, he is liable to the company for the loss it suffers. Similarly, a promoter who is responsible for making misrepresentations in a prospectus may be held guilty of fraud under section 17 of the Indian Contract Act and consequently liable for

¹⁷ [1900] AC 240

¹⁸ *Re Lady Forest-(Murchison) Gold Mine Co. Ltd.* [1901]1Ch.582

damages under section 19 of the Act.¹⁹

Termination of Duties

A promoter's duties do not come to an end on the incorporation of the company, or even when a Board of directors is appointed. They continue until the company has acquired the property or business which it was formed to manage and has raised its initial share capital and the Board of directors has taken over the management of the company's affairs from the promoters. When these things have been done, the promoter's fiduciary and contractual duties cease.²⁰

Remedies available to the company against the promoter for breach of his duties

Since a promoter owes a duty of disclosure to the company, the primary remedy in the event of breach is for the company to bring proceedings for rescission of any contract with him or for the recovery of any secret profits which he has made. *Rescission of contract*- So far as the right to rescind is concerned, this must be exercised on normal contractual principles, that is to say, the company must have done nothing to show an intention to ratify the agreement after finding breach involving non-disclosure or misrepresentation. *To recover secret profit*- If a promoter makes a secret profit or does not disclose any profit made, the company has a remedy against him.

Liabilities of Promoter

A promoter is subjected to liabilities under the various provisions of the Companies Act. The Section 26 of the Companies Act, 2013 lay down matters to be stated in a prospectus. A promoter may be held liable for non-compliance of the provisions of the section. Under section 34 and 35, a promoter may be held liable for any untrue statement in the prospectus to a person who subscribes for shares or debentures in the faith of such prospectus. However, the liability of the promoter in such a case shall be limited to the original allottee of shares and would not extend to the subsequent allottees. According to section 300, a promoter may be liable to examination like any other director or officer of the company if the court so directs on a liquidator's report alleging fraud in the promotion or formation of the company. A company may proceed against a promoter on action for deceit or breach of duty under section 340, where

¹⁹ The Indian Contract Act, 1872

²⁰ *Twycross v. Grant*, 1877 2 C.P.D. 469 p.541 C.A.; *Lagunas Nitrate Co. v. Lagunas Syndicate Ltd.* [1899] 2Ch.392 (p.428, C.A.)

the promoter has misapplied or retained any property of the company or is guilty of misfeasance or breach of trust in relation to the company. The Madras High Court in *Prabir Kumar Misra v. Ramani Ramaswamy*²¹ has held that to fix liability on a promoter, it is not necessary that he should be either a signatory to the Memorandum or Articles of Association or a shareholder or a director of the company. Promoter's civil liability to the company and also to third parties remains in respect of his conduct and contract entered into by him during pre-incorporation stage as agent or trustee of the company.

STATUS OF PRE-INCORPORATION OF CONTRACTS

The promoter is obligated to bring the company in the legal existence and to ensure its successful running and in order to accomplish his obligation he may enter into some contract on behalf of prospective company. These types of contract are called 'Pre-incorporation Contract. Nature of Pre-incorporation contract is slightly different to ordinary contract. Nature of such contract is bilateral, be it has the features of tripartite contract. In this type of contract, the promoter furnishes the contract with interested person and it would be 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 contract.

One might question that 'why is company not liable, even if it a beneficiary to contract' or one might also question that 'doesn't promoter work under Principal-Agent relationship. Answer to these entire questions would be simple. The company does not in legal existence at time of pre incorporation contract. If someone is not in legal existence then he cannot be a party to contract.

Before the passing of the Specific Relief Act 1963, the position in India, regarding pre-incorporation contract, was similar to the English Common Law. This was based on the general rule of contract where two consenting parties are bound to contract and third party is not connected with the enforcement and liability under the terms of contract. And because company does not come in existence before its incorporation, so the promoter signs contract on behalf of company with third party, and that is why the promoter was solely liable for the pre-incorporation contract.

However, the provisions of the specific relief Act, 1963 makes the pre-incorporation contracts valid. Section 15(h) and Section 19 (e) of the Specific Relief Act of 1963, deviate from the

²¹ [2010] 104 SCL 174

common law principles to some extent. Under section 15 (h) of the Specific Relief Act, 1963, except as otherwise provided by this Chapter, the specific performance of a contract may be obtained by, (a) any party thereto, (b) the representative in interest or the principal, of any party thereto.

Provided that where the learning, skill, solvency or any personal quality of such party is a material ingredient in the contract, or where the contract provides that his interest shall not be assigned, his representative in interest or his principal shall not be entitled to specific performance his part of the contract, or the performance thereof by his representative in interest, or his principal, has been accepted by the other party; 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.

Under Section 19 (e) of the Specific Relief Act, 1963, 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.

In *Weavers Mills Ltd. v. Balkies Ammal*²² the Madras High Court extended the scope of this principle through its decision. In this case, promoters had agreed to purchase some properties for and on behalf of the company to be promoted. On incorporation, the company assumed possession and constructed structures upon it. It was held that even in absence of conveyance of property by the promoter in favor of the company after its incorporation, the company's title over the property could not be set aside.

Promoters are generally held personally liable for pre-incorporation contract. If a company does not ratify or adopt a pre-incorporation contract under the Specific Relief Act, then the common law principle would be applicable and the promoter will be liable for breach of contract.

In *Kelner v. Baxter*²³, where the promoter in behalf of unformed company accepted an offer of Mr. Kelner to sell wine, subsequently the company failed to pay Mr. Kelner, and he brought the action against promoters. Erle CJ found that the principal-agent relationship cannot be in existence before incorporation, and if the company was not in existence, the principal of an agent cannot be in existence. He further explain that the company cannot take the liability of

²² AIR 1969 Mad 462

²³ (1866) LR 2 CP 174

pre-incorporation contract through adoption or ratification; because a stranger cannot ratify or adopt the contract and company was a stranger because it was not in existence at the time of formation of contract. So he held that the promoters are personally liable for the pre-incorporation contract because they are the consenting party to the contract.

In *Newborne v. Sensolid (Great Britain) Ltd*²⁴, Court of Appeal interpreted the finding of *Kelner* case in a different way and developed the principle further. In this case an unformed company entered into a contract, the other contracting party refused to perform his duty. Lord Goddard observed that before the incorporation the company cannot be in existence, and if it is not in existence, then the contract which the unformed company signed would also be not in existence. So company cannot bring an action for pre-incorporation contract, and also the promoter cannot bring the suit because they were not the party to contract.

This case created some amount of confusion that, if the contract was sign by the agent or promoter, then he will be liable personally and he has the right to sue or to be sued. But if a person representing him as director of unformed company enters into the contact then the contact would be unenforceable.

In *Natal Land Co. Ltd v. Pauline Colliery Syndicate Ltd*²⁵ N company agreed with Mrs. Carrey an agent of a syndicate before its incorporation that N company would grant a mining lease to the syndicate. The syndicate was incorporated as Pauline Colliery. Pauline Company discovered coal whereupon Natal Land Co. Ltd refused to grant the lease. It was held that there was no binding contract between Natal Land Co. Ltd and Pauline Company as the latter was not in existence when the contract was signed. If the company were allowed to ratify the contract it would mean that it contracted on the date the contract was formed. This in effect would mean that the company contracted before it was formed. If the company wishes to revive the abortive contract it must make a fresh offer and if the offer is accepted by the other party, a contract will come into existence from the moment of acceptance.

These principles were found applicable in Indian case. In *Seth Sobhag Mal Lodha v. Edward Mill Co. Ltd.*²⁶, the High Court of Rajasthan followed the approach of Common Law regarding liability of pre-incorporation contract. This case was criticized by A. Ramaiya in Guide to

²⁴ [1954] 1 QB 45

²⁵ [1904] AC 120 (PC)

²⁶ 1972 42 CompCas 1 Raj

Companies Act (Sixth Edition), he found that learned judges did not noticed the Specific Relief Act, 1963.

Although under common law promoter is personally liable for the pre-incorporation contract, but there are some scope where the promoter can shift his liability to company. He can shift to company his liability under the Specific Relief Act 1963 or he can go for novation under contract law. In *Howard v. Patent Ivory Manufacturing*²⁷, the English Court accepted the novation of contract.

In conclusion we can say that, a promoter is personally liable for the pre-incorporation contract, because at the time of formation of pre-incorporation contract, the company does not come in existence, so neither the principle agent relationship exist not the company become the party.

Company is not liable for the pre-incorporation contract when it come in existence, but under the arrangement of section 15(h) and 19(e) of the Specific Relief Act 1963, company can take the rights and liability of promoter. It is also found that promoter is personally liable for the pre-incorporation contract in American Law, English Law and Indian Law.

CONCLUSION AND SUGGESTIONS

The word 'Promoter' is used in common parlance to denote any individual, syndicate, association, partnership or a company which takes all the necessary steps to create and set it going. The Promoter originated the scheme for the formation of the company; gets together the subscribers to the memorandum; gets memorandum and prepared articles, executed and registered; finds the bankers, brokers and legal advisors; located the first directors, settle the terms of preliminary contracts with vender and agreement with underwriters and makes arrangements for preparation, advertisement and circulation of the prospectus and arrangement of the capital. So, Promoters act as a molding format for the company and gives it a shape which can exist in the world although they cannot take anything in this regard.

To conclude, it can be said that legal position of promoter is now quiet clear that the promoters occupy an important position and have wide powers relating to the formation of the company. He is neither an agent nor a trustee of the proposed company because there is no company yet in existence for him to be called as agent and no trust in existence for him to be called as trustee. But it does not mean that the promoter does not have any legal relationship with the proposed

²⁷ (1888) 38 Ch. D 156

company. The correct way to describe his legal position is that he stands in a fiduciary position towards the company about to be formed making it thereby that the position of the promoter is quasi legal as he stands in a fiduciary position towards the company about to be formed.