Online Chapter

Promotion of the company

Key facts

- Certain persons who are involved in the formation of a company are known as 'promoters'.
- A promoter owes fiduciary and statutory duties to the unformed company, notably a promoter cannot make a secret profit out of the company's promotion.
- A promoter will usually be personally liable on a contract entered into on behalf of a company if that company had not been incorporated at the time the contract was entered into.

Introduction

Company law is not solely concerned with what happens once a company has been created as legal issues can arise prior to a company's creation. This chapter looks at the legal position of persons in the process of incorporating a company, and the legal relationship that exists between them and the unformed company, and with any third parties who contract with the promoters or the company prior to it being incorporated.

Promotion of the company

Persons who wish to create a company may need to undertake various activities in order for the company to be able to commence business (e.g. preparing incorporation documents, hiring or buying premises, obtaining supplies or operating capital). Such persons, who usually go on to become the company's first directors, are known as '**promoters**' of the company and their activities are closely regulated by the law.

What is a promoter?

The law has not sought to define precisely what a promoter is, lest persons try to take themselves out of the definition in order to avoid regulation. However, the lack of a definition can be problematic, as determining whether or not a person is a promoter is crucial for several reasons:

- promoters owe **fiduciary** duties to the unformed company
- promoters can be made liable for acts engaged in on behalf of the unformed company, and
- the **CA 2006** imposes a number of obligations on company promoters, especially promoters of public companies.

Accordingly, the courts have offered guidance as to who is a promoter, with the classic statement being that of Bowen J in ***Whaley Bridge Calico Printing Co v Green* (1880)**:

> The term promoter is a term not of law, but of business, usefully summing up in a single word a number of business operations familiar to the commercial world by which a company is generally brought into existence.

Accordingly, the word 'promoter' is a general word that refers to those persons involved in the formation of a company based upon the particular facts of the case. However, not all persons involved in the company's formation will be categorized as promoters. For example, persons involved in the formation of a company by virtue of their professional duties (e.g. solicitors or accountants who provide the promoters with advice) will not be generally regarded as promoters (***Re Great Wheal Polgooth Co Ltd* (1883)**).

Looking for extra marks?

In problem questions concerning the promotion of the company, students often forget to discuss whether the persons concerned are promoters, usually because they feel the issue is obvious. Even

where a person is clearly a promoter, you should establish this with reference to authority. For a discussion of the authority relating to the identification of promoters, see Joseph H Gross, 'Who is a Company Promoter?' (1970) 86 LQR 493.

Duties of a promoter

A promoter occupies a dominant position in relation to the unformed company and, to prevent that position being abused, the promoter will owe the unformed company a number of duties. Two broad categories of duty can be identified, namely the fiduciary duty and duties imposed by statute.

Fiduciary duty

A promoter occupies a fiduciary position in relation to the unformed company. Accordingly, he is not permitted to make a profit out of the company's promotion, unless he discloses the nature of his interest and the profit made. Should he fail to disclose the profit, the transaction in question will be voidable and so can be rescinded by the company (***Erlanger v New Sombrero Phosphate Co* (1878)**). If rescission fails to recover the value of the profit or if the right to rescind is lost, then the promoter can be made to account to the company for the value of the profit (***Emma Silver Mining Co v Grant* (1879)**). So, for example, if upon incorporation, a promoter sells to the newly formed company an asset that he acquired during the company's promotion, he will not be permitted to keep the proceeds of the sale, unless he discloses the nature of the interest and the extent of the profit made. However, disclosure will only be valid if the persons to whom it is made are independent, as the following case demonstrates.

***Erlanger v New Sombrero Phosphate Co* (1878) LR 3 App Cas 1218 (HL)**

Facts: Erlanger headed a syndicate that, for £55,000, acquired a lease to certain mining rights. The syndicate set up a company to take advantage of the mining rights. Five directors were appointed, but

two were abroad, one was the Lord Mayor of London (and so could devote little time to the company), and the remaining two had strong links to Erlanger. Through one of the directors with links to Erlanger, the lease was sold to the company for £110,000. Full details of the transaction were not disclosed to the company's members.

Held: The contract for the sale of the lease was voidable at the company's instance. The directors may have known the details of the transaction, but this disclosure was insufficient as the key directors were mere puppets who, according to Lord Blackburn, had not given the transaction the 'intelligent judgment of an independent executive'. The company therefore rescinded the lease, and recovered the £110,000 paid.

Accordingly, in order for disclosure to be valid, there must be an independent board of directors or an independent body of members to hear the disclosure and, if necessary, to act upon it.

Statutory duties

In addition to the common law fiduciary duty, promoters are also subject to statutory duties. For example, **s 598 of the CA 2006** states that a non-cash asset cannot be sold to a public company by a person who is a subscriber to the company's memorandum, unless the non-cash asset has been independently valued, and the members have approved the sale.

Pre-incorporation contracts

Prior to incorporation being completed, the promoters of the unformed company will likely need to enter into contractual agreements with third parties in order to cater for the company's future needs (e.g. hiring premises, taking on employees, purchasing supplies or equipment). A company has the **capacity** to enter into contracts with such persons, but not until it is fully incorporated (see p 51, 'The capacity of a company'). If the promoters attempt to contract on behalf of, or in the name of, the un-

formed company, are such pre-incorporation contracts valid or not?

Common law

Prior to the UK joining the European Economic Community (now the European Union (EU)), the answer was to be found in case law, but it was based on determining the intent of the parties, as revealed in the contract (***Phonogram Ltd v Lane* [1982]**)—a process which proved to be notoriously difficult and which resulted in significant confusion in the law and a perception that cases in this area could turn based on complex and technical distinctions.

Revision tip

For an example of the distinctions drawn, contrast the cases of ***Kelner v Baxter* (1866)** and ***Newborne v Sensolid (Great Britain) Ltd* [1954]**. In ***Kelner***, the promoter signed the contract 'on behalf of' the unformed company, and it was held that a binding contract existed between the promoter and the third party. In ***Newborne***, the promoter signed the contract using the company's name and added his own signature underneath. It was held that the contract was between the promoter and the unformed company and, as the company had no contractual capacity, no contract existed.

Statute

As a consequence of the UK's entry into the EU, it was obliged to implement the **First EC Company Law Directive**, of which **Art 7** states:

> If, before a company has acquired legal personality . . . action has been carried out in its name and the company does not assume the obligations arising from such action, the persons who acted shall, without limit, be jointly and severally liable therefore, unless otherwise agreed.

Article 7 has been implemented by **s 51(1) of the CA 2006**, which states:

> A contract that purports to be made by or on behalf of a company at a time when the company has not been formed has effect, subject to any agreement to the contrary, as one made with the person purporting to act for the company or as agent for it, and he is personally liable on the contract accordingly.

Accordingly, a promoter is personally liable for the pre-incorporation contract in all cases to which **s 51** applies. This clearly benefits third parties who contract with the promoter, as they will be able to sue the promoter should the terms of the pre-incorporation contract be breached.

Looking for extra marks?

Section 51 makes it clear that a promoter will be personally liable for the pre-incorporation contract, but does not indicate whether or not the third party can be liable to the promoter in the event of the third party breaching the contract. In ***Braymist Ltd v Wise Finance Co Ltd* [2002]**, it was held that a promoter could sue a third party, but the fact that judicial clarification was required demonstrates a flaw in the drafting of **s 51** that you might wish to bring up in a possible essay question on the effectiveness of **s 51**.

The courts have clearly stated that a company, once incorporated, cannot ratify or adopt a pre-incorporation contract made on its behalf (***Re Northumberland Avenue Hotel Co* (1886)**). The only way that a company can take advantage of a pre-incorporation contract is for the promoter and third party to discharge the pre-incorporation contract and the company then to enter into a new contract with the third party in respect of the same subject matter (***Howard v Patent Ivory Manufacturing Co* (1888)**). This process of substituting one contract with another is known as 'novation'.

Looking for extra marks?

Students paying careful attention to **Art 7** will note that it permits companies to 'assume the obligations' of the pre-incorporation contract, whereas **s 51** does not. It could accordingly be argued that **s 51** does not fully implement **Art 7**, and that the failure to allow companies to assume the contract is an unnecessary restriction. Companies who wish to assume the obligations of the contract will need to undergo the discharge procedure previously discussed, which will likely be viewed as an undue waste of time and effort. On this, see Robert R Pennington, 'The Validation of Pre-Incorporation Contracts' (2002) 23 Co Law 284, who argues that English law should allow companies to adopt pre-incorporation contracts.

Where the promoters enter into a contract before purchasing an 'off the shelf' company (discussed at p 20, '"Off-the-shelf" companies'), then, providing that the company existed at the time the contract was entered into, **s 51** will not apply as the company is not one that 'has not been formed' and a valid contract will exist between the company and the third party. The same principle applies where a company changes its name, but the name change has not been registered at the time the contract is made (***Oshkosh B'Gosh Inc v Dan Marbel Inc Ltd* [1989]**). Similarly, **s 51** will not apply where a person contracts on behalf of a company that previously existed, but no longer exists at the time the contract was entered into (***Cotronic (UK) Ltd v Dezonie* [1991]**).

'Subject to any agreement to the contrary'

The imposition of liability under **s 51** is 'subject to any agreement to the contrary', which means that a promoter can avoid liability if he can show that he and the other party to the contract agreed that, upon incorporation, the promoter would be released from liability and the company would enter into a second contract with the other party on the same terms as the first contract (i.e. an agreement to novate the contract was present). The agreement can be express or implied, but the courts will require clear evidence that such an agreement exists (***Bagot Pneumatic Tyre Co v Clipper Pneumatic Tyre***

Co* [1902]**). In the absence of an express agreement, this will likely be difficult for a promoter to prove. Simply acting as a promoter or agent of an unformed company will not be enough to infer the existence of a contrary agreement (Phonogram Ltd v Lane* [1982]**).

Key cases

Case	Facts	Principle
***Erlanger v New Sombrero Phosphate Co* (1878)** LR 3 App Cas 1218 (HL)	The promoters of a company sold the company a lease. The details of the transaction were disclosed to the company's directors, but the key directors were nominees of the promoters.	The sale of the lease was voidable. Disclosure is only valid if made to an independent body of persons, and this was not the case here.
***Re Northumberland Avenue Hotel Co* (1886)** LR 33 ChD 16 (CA)	A promoter entered into a lease on behalf of a company that was not yet formed. Upon incorporation of the company the following day, the company purported to adopt the lease.	A company, once incorporated, cannot adopt or assume obligations entered into on its behalf at a time when it did not exist. The adoption was therefore invalid.

Key debates

Topic	Promotion of the company

Topic	**Promotion of the company**
Author/Academic	Joseph H Gross
Viewpoint	Discusses the courts' approach in determining whether or not a person is a promoter.
Source	'Who is a Company Promoter?' (1970) 86 LQR 493
Topic	**Pre-incorporation contracts**
Author/Academic	Joseph Savirimuthu
Viewpoint	Discusses the theories behind the common law and statutory rules relating to pre-incorporation contracts, and provides several possible suggestions for reform.
Source	'Pre-Incorporation Contracts and the Problem of Corporate Fundamentalism: Are Promoters Proverbially Profuse?' (2003) 24 Co Law 196
Topic	**Pre-incorporation contracts**
Author/Academic	Robert R Pennington
Viewpoint	Compares the common law and statutory rules relating to pre-incorporation contracts. Argues that statutory reforms are an improvement over the common law rules, but that companies should be able to assume pre-incorporation contractual obligations.
Source	'The Validation of Pre-Incorporation Contracts' (2002) 23 Co Law 284