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Roles and Responsibilities of Promoters in Company Law

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ABSTRACT

In this research paper, an emphasis will be laid upon the role of promoters in the incorporation of a company. The research paper will also deal with the scope of promoters, that is to say, who can be a promoter. The duties that a promoter owes to the company shall be discussed in the paper and also the right and liabilities of a promoter towards the company shall be discussed. An analysis of the relevant judgments shall be made for the purpose of clear understanding of the research topic. Position worldwide of the promoters will also be analysed by comparing the Company Law in India with the Company Law in other countries.

I. INTRODUCTION

The process of the incorporation of a company is primarily divided into four stages which includes Promotion, Registration, Floatation and lastly, Commencement of Business.² Promotion is the primary step involved in the formation of a company. The term promotion has a wide ambit and denotes the preliminary steps taken for the purpose of registration and floatation of the company. The persons who assume the task of promotion are called promoters. A promoter may be an individual, syndicate, association, partner or company.³

(A) WHO IS A PROMOTER?

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 instructions the Board of Directors of the company is accustomed to act: Provided that nothing in sub-clause (c) shall apply to a person

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²G.K. KAPOOR & SANJAY DHAMIJA, COMPANY LAW AND PRACTICE 110 (23rd ed. 2018) [*hereinafter* Kapoor]

³ Id.

who is acting merely in a professional capacity.⁴

A promoter is a person who brings about the incorporation and organisation of a corporation.⁵ Cockburn CJ in *Twycross v. Grant (1877)* defined promoter as one who undertakes to form a company with reference to a given project, and to set it going, and who takes necessary steps to accomplish that business.⁶ In this case the court said that “The defendants were the promoters of the company from the very beginning. They framed the scheme, they not only provisionally formed the company, but in fact, to the ends its creators, they found the directors, and qualified them, they prepared the prospectus, they paid for printing and advertising, and the expenses incidental to bringing the undertaking before the world.”⁷

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.⁸ But the persons assisting the promoters by acting in a professional capacity do not thereby become promoters themselves like a solicitor or an accountant.⁹

(B) WHAT DOES A PROMOTER DO?

A promoter is basically associated with various activities prior to the coming into existence of a company. A promoter conceives the idea of formation of company after a thorough study of the business world. He draws up the scheme and determines the object of a future company. He prepares the Memorandum of Association, the Articles of Association and the Prospectus. He gets together the able directors who shall act for the company. As discussed earlier, he bears all the preliminary expenses and also finds the suitable financiers to back up the company. Besides this, he makes arrangements with vendors, legal advisers and other persons required for floating a company. He takes the pain for filing the necessary documents with the Registrar of companies for the certificate of incorporation. In simple words, a promoter paves the way for a company to stand in its own feet.¹⁰

II. POSITION OF PROMOTERS:

A promoter stands in a fiduciary relation towards a company which he is engaged in forming. He is neither an agent nor a trustee of a future company.¹¹ The reason being that for the existence of agency, there shall be a principle-agent relationship, but a promoter can be the

⁴ The Companies Act, Act 18 of 2013 §2(69).

⁵ AVTAR SINGH, COMPANY LAW 135 (17th ed. 2016) [*hereinafter* Avtar]

⁶ SARAH WORTHINGTON, TEXT CASES & MATERIALS IN COMPANY LAW 498 (11th ed 2013) [*hereinafter* Sarah]

⁷ Avtar *Supra* note 4 at 136.

⁸ *Lagunas Nitrate Co. v. Lagunas Syndicate* (1899) 2 Ch. 392.

⁹ Kapoor *Supra* note 4 at 110.

¹⁰ H.K. SAHARAY, COMPANY LAW 17 (6th ed. 2012) [*hereinafter* Saharay]

¹¹ *Id.* at 18.

agent because the company is not yet into existence. It may be noted that fiduciary relation means a relation of trust, confidence and good faith.¹²

(A) LEGAL POSITION OF PROMOTERS

The position of promoters in relation to a company was explained by LORD CAIRNS in *Erlanger v. New Sombrero Phosphate Co.*¹³ in the following words, “Promoters in my opinion stands undoubtedly in a fiduciary position. They have in their hands the creation and moulding of the company. They have the power of defining how and when, in what shall and under what supervision the company shall start into existence and begin to act as a trading corporation.”

Similarly, in *Lagunas Nitrate Co. v. Lagunas Syndicate* (1899) the Court held that “the promoters stand in a fiduciary relation to the company they promote and to those persons, whom they induce to become shareholders in it.”

Promoters are fiduciaries. A contract between the promoter and the company is voidable at Company’s option unless the promoter has disclosed all material facts relating to that contract to an independent board, and the company has freely agreed to the terms.¹⁴ The legal position of promoters will further be discussed in his duties and the contracts entered by a promoter in the behalf of company.

III. DUTIES AND RESPONSIBILITIES OF PROMOTERS:

The Companies Act, 2013 contains no statutory provisions regarding the duties of promoters. But the act imposes a liability upon the promoters for any misconductlike in Sections 34, 35 and 339 of the Act.¹⁵ However, the Courts have played a significant role in determining the duties of promoters because there have in several instances where the promoters have tried to seek personal advantages at the cost of Company.

(A) DUTY TO DISCLOSE SECRET PROFITS:

The most common way by which the promoters used to make secret profits was by purchasing business or property themselves and then selling it to company at higher price. A promoter is not forbidden to make profits, but to make secret profits. He may make a profit out of promotion with the consent of the company just like an agent can keep profits with his principal’s consent.

GLUCKSTEIN V. BARNES (1900) AC 240.

In this case it was emphasised that a promoter shall disclose his interest and profits to the

¹²R.L. NOLAKHA, COMPANY LAW AND PRACTICE 5.3 (1st ed. 2015).

¹³*Erlanger v. New Sombrero Phosphate Co.* (1878) LR 3 AC 1218.

¹⁴ Sarah *Supra* note 5 at 499.

¹⁵ Kapoor *Supra* note 4 at 113.

shareholders of the company. The facts of the case are “a syndicate of persons was formed to raise a fund, buy a property called OLYMPIA and resell it to a company. They brought the property for €1,40,000 and formed a limited company and then resold the property for €1,80,000 to the company, of which they were first directors. They issued a prospectus inviting applications for shares and disclosing the two prices of €1,40,000 and €1,80,000 but not the profit of €20,000.¹⁶

It was held that the promoters ought to have disclosed to the company the profit of €20,000. Halsbury L.C. said that “it is too absurd to suggest that a disclosure to the parties to this transaction is a disclosure to the company. They were there by the terms of the agreement to do the work of the syndicate, that is to say, to cheat the shareholders.”¹⁷

(B) ISSUE OF PROSPECTUS:

Section 26, Companies Act, 2013 requires particulars regarding legal actions against promoters of the company to be disclosed in the prospectus.¹⁸ Every promoter is under a duty to disclose any litigation or legal action pending or taken against him during the last five years immediately preceding the year in which the company issues the prospectus.¹⁹

Therefore, the promoter is under a statutory liability for ensuring that all particulars are stated in the prospectus as per the section. He also has to ensure that all required reports are provided and declare that all compliances are made.

(C) DUTY OF DISCLOSURE OF INTEREST:

In addition to his duty of disclosure of secret profits, a promoter shall 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.²⁰

(E) WHOM TO MAKE THE DISCLOSURE?

As discussed earlier, a promoter is allowed to make a profit out of promotion but with the consent of the company. In Erlanger's (supra) case it was held that it would be sufficient if the disclosure is made to an independent and competent Board of Directors.²¹ However, at the time when promoters are involved, an entirely independent board of directors would be impossible

¹⁶ Gluckstein v. Barnes (1900) AC 240.

¹⁷ Avtar *Supra* note 4 at 139.

¹⁸ The Companies Act, Act 18 of 2013 §26.

¹⁹ Harpreet Kaur, *Promoters and Corporate Governance Under The Companies Act, 2013 And Allied Acts In India*, 3 J. Nat'l L.U. Delhi 62, 53-70 (2017).

²⁰ Kapoor *Supra* note 4 at 15.

²¹ Kapoor *Supra* note 4 at 14.

in case of a private company and many public companies. In such cases, the disclosure shall be made to the whole body of persons who provide the company with its initial capital.²²

Having taken a secret profit, a promoter may pursue one of four courses in order to secure corporate approval: (1) He may provide an independent board of directors, not under his control directly or indirectly, and make full disclosure to the corporation through them; (2) he may make a full disclosure to each original subscriber of shares in the corporation; (3) he may procure a ratification of the transaction after disclosing its circumstances by vote of the stockholders of the completely established corporation; and (4) he may be himself the real subscriber to all shares of capital stock contemplated as part of the promotion plan. Whatever course is followed, it should be noted that the ultimate objective of the promoter in securing corporate approval.²³

IV. LIABILITIES OF PROMOTERS:

The Companies Act, 2013 makes the promoters liable for their misconduct and various other activities involving making secret profits and giving wrong information in the prospectus of the company.

(A) LIABILITY FOR MIS-STATEMENTS IN PROSPECTUS:

Criminal liability for misstatement in the prospectus is provided by SECTION 34 of the Act. Under the section²⁴, a promoter will be jointly criminally liable if he authorised issue of prospectus containing untrue or misleading statement or included or omitted some information which becomes misleading for investors and such person shall be held liable under SECTION 447 of the Act which talks about Punishment for Fraud in the words “Without prejudice to any liability including repayment of any debt under this Act or any other law for the time being in force, any person who is found to be guilty of fraud [involving an amount of at least ten lakh rupees or one per cent. of the turnover of the company, whichever is lower] shall be punishable with imprisonment for a term which shall not be less than six months but which may extend to ten years and shall also be liable to fine which shall not be less than the amount involved in the fraud, but which may extend to three times the amount involved in the fraud.”²⁵

By a combined reading of section 34 and 447 of this Act, if a promoter plays fraud upon the company by the way of issuing misleading statements in the prospectus, he shall be liable under section 447 of the Act.

²² *Lagunas Nitrate Co. v. Lagunas Syndicate* (1899) 2 Ch. 392.

²³ J.H.J., *Corporations: Liability of Promoters for Secret Profits*, 34 MICHIGAN L.R. 1190, 1189-1195 (1936).

²⁴ The Companies Act, Act 18 of 2013 §34.

²⁵ The Companies Act, Act 18 of 2013 §447.

However, the directors cannot be held vicariously liable for signing of false, misleading prospectus by his duly authorised agent. The principle cannot be held liable for the unlawful acts done by his agents.²⁶

(B) CIVIL LIABILITY FORMIS-STATEMENTS IN PROSPECTUS:

SECTION 35 provides for civil liability for mis-statements in prospectus. Promoters may be held liable with all directors, experts and others who authorised issue of the prospectus of the company along with the company for compensation. Compensation is given to the person who trusting the mis-statement or omission or inclusion in the prospectus, invested in the securities and suffered loss or damage.²⁷

(C) LIABILITY FOR PRIVATE PLACEMENT:

The Companies Act, 2013 has provided for offer or invitation for subscription of securities on private placement for the first time under section 42. If such a private placement is in contravention of the section, promoters along with directors and company can be held liable for a penalty.

(D) ORDER OF EXAMINATION ON FRAUD:

Section 300 of the Act states that “where an order has been made for the winding up of a company by the Tribunal, and the Company Liquidator has made a report to the Tribunal under this Act, stating that in his opinion a fraud has been committed by any person in the promotion, formation, business or conduct of affairs of the company since its formation, the Tribunal may, after considering the report, direct that such person or officer shall attend before the Tribunal on a day appointed by it for that purpose, and be examined as to the promotion or formation or the conduct of the business of the company or as to his conduct and dealings as an officer thereof.”²⁸

(E) LIABILITY FOR FRAUDULENT CONDUCT OF BUSINESS:

Section 339 and 340 of the Act provides for the liabilities against the directors or any other person who is involved in some fraud. Section 339 provides that if at the time of the winding up of the company, if any of the activities is done to defraud the creditors or for any other fraudulent activity, such person shall be held personally liable for such fraudulent conduct²⁹. Section 340 creates liability for the delinquent acts which may be done during the promotion or formation of the company. If any person has misapplied or retained any of company property

²⁶CORPORATE LAW ADVISOR, GUIDE TO COMPANIES ACT, 2013 110 (3rd ed. 2015).

²⁷*Supra* note 18 at 62.

²⁸ The Companies Act, Act 18 of 2013 §300.

²⁹ The Companies Act, Act 18 of 2013 §339.

which is unaccounted or has been guilty of any misfeasance or breach of trust, shall be held liable and would be liable to repay such amount.³⁰

V. PRE-INCORPORATION CONTRACTS BY PROMOTERS:

Sometimes, contracts are made on behalf of a company even before it is duly incorporated. But no contract can bind a company before it becomes capable of contracting by incorporation.³¹ But, there have been several changes after the passing of the Specific Performance Act, 1963. Section 15(h)³² of the Act provides that where the promoters of a public company have made a contract before incorporation for the purposes of the company, and if the contract is warranted by the terms of its incorporation, the company may enforce it. Warranted by its terms of incorporation means that within the scope of company's object stated in the memorandum.

VI. PROMOTERS WORLDWIDE:

The status of the promoters of a Company are generally same throughout the globe. Even the Indian Company law is a compilation of various foreign laws and judgments. But there are little differences too. For instance, under the Massachusetts rule the promoter's duty of disclosure extends not only to those persons who were stockholders at the time of the transaction complained of, but also to future stockholders within the pale of the original promotion plan. However, under the federal rule announced in *Old Dominion Copper Mining & Smelting Co. v. Lewisohn*, if all of the then existing stock holders have assented to the promoter's profit with full knowledge of the facts, the issue of corporate approval is closed, and the rights of the corporation are not changed by the fact that innocent members may be subsequently induced to come in.³³ Under the English system, the law relating to pre-incorporation contracts is that the promoters would be held personally liable for the contracted by them on the behalf of the company. The reasoning given by English court in the case of *Kelner v. Baxter*³⁴ is that "But as there was no corporation in existence at the time, the agreement would be wholly inoperative, unless it was held to be binding on the defendants personally. The cases referred to in the course of the argument fully brought out the proposition that where a contract was signed by one who professes to be signing as *agent*, but who has no principal existing at the time, and the contract would be wholly inoperative unless binding upon the person who signed it, he is bound thereby; and a stranger cannot by subsequent ratification

³⁰ The Companies Act, Act 18 of 2013§340.

³¹ Kapoor^{Supra} note 4 at118.

³² The Transfer of Property Act, Act 4 of 1882 § 15(h).

³³ ^{Supra} note 22 at 1192.

³⁴ *Kelner v. Baxter*, (1866) LR 2C 174.

relieve him from that responsibility.”³⁵

VII. CONCLUSION

After a careful analysis of the research, it can safely be concluded that a promoter is one of the most important persons behind the existence of a company. It is the promoter, who sets the idea of incorporation of a company. But the promoters remain into existence only till the time prior to incorporation. Once a company comes into existence; the role of promoters ends and they are replaced by the directors. The promoters can be the shareholders or the directors. One of the most important factors that must be kept in mind about the promoters is that they are in a fiduciary relation with the company. Fiduciary relation is one of trust and confidence. Thus, the promoters have a duty to maintain complete transparency and zero secrecy. The promoters can make extra profits on a promotion but with the consent of the company. But the Company Law in India will hold a promoter individually liable if he is involved in any misconduct or misfeasance as we have seen in the Section 34 and 35 of the Act and the punishment has been mentioned in Section 447. With respect to the promoters right in pre-incorporation contract, that contract may become operable of the company after incorporation ratifies such act. And this will happen when the contract is not against the objects stated in the Memorandum of the Company.

³⁵Manfred W. Ehrlich & Lucille C. Bunz, *Promoters' Contracts*, 38 *YALE L.J.* 1013, 1011-1046 (1929).

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