

Chapter 2: Company Formation

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Aims of this Chapter

This chapter will enable you to achieve the following learning outcome from the ILEX syllabus:

- 4 Understand the promotion and formation of the company

2.1 Introduction

The process by which a company is set up is referred to as “incorporation”. This chapter reviews the steps that are required to incorporate a company. It also considers other issues that arise on the incorporation of a company, such as the responsibilities and liabilities of those who decide to set up a company, known as the promoters.

	07/08	08/09	09/10
New incorporations:			
All companies	371	330	362
Total number of registered companies:			
Private companies	2412.7	2260	2315
Public companies	10.5	9.5	9.0

Source: Companies Register Activities 2009–2010; available at <http://www.companieshouse.gov.uk/about/companiesRegActivities.shtml>

2.2 Company promotion

The promoter

Every company is formed or “promoted” by someone, known as a promoter, whose role was defined in *Twycross v Grant [1877]* 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”. This classic definition includes anyone who:

- **either** takes the procedural steps necessary to form the company; or
- sets up the company’s business (involving entering into pre-incorporation contracts);

- **but does not include** those who act merely in a professional capacity acting on the instructions of a promoter, for example, a solicitor or an accountant.

The 19th century saw some notorious company flotations in which unscrupulous promoters benefited themselves at the expense of the investors, as illustrated by *Erlanger v New Sombrero Phosphate Co [1878]*. Erlanger, the promoter, acquired on his own account but in the name of another (a “nominee”) the lease of a phosphate mine in the West Indies for £55,000. He then proceeded to sell the mining rights to the newly formed company for £110,000. The purchase was approved by the board of directors of the company, who had been appointed by Erlanger and were either under his influence or, as in the case of one of the directors, who was the Lord Mayor of London, simply did not have time to give to the enterprise. The prospectus that offered the company’s shares to the public did not disclose the promoter’s profit. When the original board of directors was replaced, the new directors, on discovering the swindle, sued Erlanger to have the contract for the sale of the mining rights rescinded.

It was held that the contract should be rescinded because the profit made by Erlanger had not been properly disclosed (in this case to an independent board) and therefore could not be kept by him.

This case illustrates the **fiduciary** nature of the promoter’s role, which puts him very much in the same position of quasi-trusteeship as a company director. A key feature of this status is that such a fiduciary must not make a **secret profit**. The promoter can avoid contravening this requirement in a number of ways.

- (1) By making a proper disclosure of any profit he has made (thus removing any element of secrecy) to **either** an independent board of directors **or** to the existing or prospective members of the company.

Where such a disclosure is made, then the promoter may be permitted to keep any profit he has made. Otherwise, the company may elect to rescind the contract concerned (as was the case with Erlanger) or may, where the right to rescind is not available, ask the promoter to **account** for his profit (i.e. return it to the company), as another promoter was required to do in *Gluckstein v Barnes [1900]*. Where, however, the promoter sells property to the company which he acquired without any view to company promotion (e.g. his “own” property acquired some years before), the company’s only remedy is rescission. It cannot then affirm the contract and claim the profits (*Re Cape Breton Company [1885]*).

- (2) In the case of a public company, compliance with the rules on prospectus disclosure is sufficient. The promoters in this circumstance also incur statutory liability to compensate any person who has acquired the securities to which the prospectus refers and suffers loss as a result of any untrue or misleading statement or omission in that prospectus (**s90 FSMA 2000**, as amended by the **Prospectus Regulations 2005**).

In reality, however, unless the flotation of a public company is involved, the question of whether the promoter has made a profit out of the promotion is irrelevant as the promoter is very often not only the first (and maybe even sole) director, but also the major shareholder as well (the *Salomon* model).

It should be noted, however, that where a promoter has committed an indictable offence in connection with the promotion or formation of a company, he may, by court order, be disqualified for up to 15 years from being involved in any respect in the management of any company (**s2 Company Directors Disqualification Act 1986**).

2.3 The legitimate transactions of promotion

Apart entirely from the issue of secret profits, the promoter may still incur expenses and liabilities which he will wish to pass on to the newly formed company. In the promotion of a private company, for example, the promoter will incur registration costs (see below) and may incur legal expenses, printing costs for stationery, the cost of leasing of new premises, advertising copy and so on. The promoter's rights and liabilities in this context may be summarised as follows.

2.3.1 Pre-incorporation contracts

A pre-incorporation contract is any contract entered into by the promoter for the business of the company that he is forming. The main legal problem here is that the company on whose account the contract has been made does not exist until the promotion procedure is completed on registration. Therefore, the promoter cannot be treated at law as an agent because no principal exists (***Kelner v Baxter [1866]***). Previous uncertainties in the law are now resolved by **s51 CA 2006**, which provides:

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.

The key points arising out of **s51** may be summarised as follows.

Any agreement entered into by the promoter **either on behalf of or as** the company (e.g. XYZ Ltd, countersigned by Promoter) will impose personal contractual liability and, ordinarily, also correlative rights of enforcement, on the promoter.

This rule may be avoided by any "agreement to the contrary". ***Phonogram Ltd v Lane [1981]*** confirmed that such a provision must be expressly and unambiguously included in the agreement and will not be implied (see "Cessation of liability clause" at **2.3.2(3)**). This case was decided under a prior enactment of **s51**. A record company advanced £6,000 to Mr Lane under a contract with a company that was to be incorporated with the name Fragile Management Ltd. The company was due to manage a new pop group and the contract was accompanied with a letter which clearly anticipated a contract being signed within a month for the recording of a new LP record. It used words to the effect that Mr Lane undertook to repay the advance if the contract was not signed within a month. Mr Lane returned a copy of the covering letter signed by himself "for and on behalf of Fragile Management Ltd". The company was never formed and the question arose who, if anyone, was liable to repay the £6,000. The Court of Appeal rejected the argument that the words "for and on behalf of Fragile Management Ltd" that Mr Lane had used amounted to words "subject to any agreement to the contrary" for the purposes of the statutory provision. Therefore, Mr Lane was unable to avoid personal liability under the agreement. The court held that there should be a clear and express exclusion of liability otherwise the statutory provision should be given its full effect, so, where a person purports to contract on behalf of a company not yet formed, then, however he expresses his signature, he will himself be personally liable on the contract.

Phonogram v Lane also established that it is not relevant that the third party **knows** that the company is not formed. The section is concerned only with establishing a certain basis of liability.

The classic view of the purpose of **s51** is that it provides for the right of a third party to enforce a pre-incorporation contract against the person who purports to act as the agent of the company which is yet to be incorporated. The decision in **Braymist Ltd v Wise Finance Co Ltd [2002]**, however, illustrates how the section may be used by the agent to enforce the contract when the third party seeks to avoid its effect. Two of the three Court of Appeal judges resolved the claim of the agent in this case by the application of **s36C CA 1985**, the predecessor to **s51 CA 2006**, whose wording is the same as **s51**. Briefly, the facts were that the defendant contracted to purchase a plot of land from Braymist Ltd, a company which had yet to be incorporated. The contract was signed by solicitors on behalf of Braymist Ltd. The defendant failed to secure planning consent to develop the land and sought to avoid the contract. The solicitors claimed breach of contract on the part of the defendant, who responded by denying any contractual obligation under the agreement on the basis of the non-existence of Braymist Ltd at the time that it was signed. The Court of Appeal disagreed, holding that **s36C(1)** (now **s51**) provides remedies for, and imposes obligations on, a party who enters into a contract with a company when it has not been incorporated and those obligations can be enforced by the agent of the unformed company. One reason for this conclusion was the literal interpretation of the section adopted by the court: the section states that the contract *has effect* which must mean that the obligations of both parties have effect.



(8) If you were a promoter of a company, would you enter into a contract on behalf of the company before it was formed, knowing that you might be running the risk of being held liable under **s51** for a breach of that contract?

2.3.2 Transfer of liability from the promoter to the newly formed company

The certainty of **s51** may not represent the wishes of the promoter, who will typically wish to transfer his contractual liability to the company as soon as possible. This process is hindered by the agency principle that the company cannot ratify – that is, retrospectively adopt – any contract made on its behalf before it was incorporated (**Kelner v Baxter [1866]**). This rule is illustrated by **Natal Land & Colonization Co v Pauline Colliery Syndicate [1904]**, in which a company was prevented by the court from enforcing a pre-incorporation contract made on its behalf, and extended by **Re English & Colonial Produce Co Ltd [1906]**, in which it was held that, even where the company received the benefit of the contract, it could not be made liable on that contract.

There are, however, ways in which the promoter may transfer his liability to the company.

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