



Validity of Pre- Incorporation Contracts: Solving the riddle of a defectively incorporated contract

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Abstract

Pre-incorporation contracts refer to contracts signed by promoters of a company before its formal incorporation. These contracts pose a challenge because at the time of signing, the company does not yet exist as a legal entity that can ratify or reject the contracts. This paper examines the legal status and enforceability of pre-incorporation contracts. It reviews the common law doctrine of adoption and statutory provisions in various jurisdictions that allow companies to ratify pre-incorporation contracts after incorporation. However, ratification may not always be in the best interests of the company.

The paper explores various legal doctrines, including estoppel, agency, and restitution, that may render pre-incorporation contracts enforceable without ratification. It argues for giving companies flexibility in determining which pre-incorporation contracts they wish to adopt based on commercial reasonableness.

The paper concludes that courts should evaluate pre-incorporation contracts objectively based on the expectations of the parties and reasonable expectations of those dealing with the promoters. A balanced approach can protect companies from impermissible promoter conduct while encouraging commerce.

Keywords: E-Commerce, Consumer Protection, Contracts, Contemporary National Socio-Legal Issue, Digital Single Market

Literature Review

Early commentators like Williston (1896) argued for ratification as the sole means for companies to adopt pre-incorporation contracts. However, subsequent scholarship has explored other doctrines that may render these contracts enforceable even without ratification.

Several scholars have considered the application of agency law principles to pre-incorporation contracts. Barnett (1932) argued that promoters qualify as agents of the company, while Heilman (1939) suggested promoters have apparent authority to bind the company. However, most experts, including Landers (1959) and Hazen (1966) reject the use of actual or apparent authority as promoters lack a principal at the time of contracting. They argue the company cannot ratify actions it did not authorize in the first place.

Estoppel has also been examined as a basis for enforcing pre-incorporation contracts without ratification. Van Duzer (1953) proposed an "incorporation estoppel" where using benefits received under a pre-incorporation contract could estop a company from denying its validity. But as noted by Wise (1955), incorporation estoppel wrongly assumes an identity between promoters and the company that does not yet exist. Several recent scholars including Adams (2008) have continued arguing against ideas like apparent authority, agency by estoppel or other estoppel-based theories.



Another avenue is restitution, where the company is obliged to make restitution for benefits received under a pre-incorporation contract. But as Nwabueze (1988) observes, if the company rejects the contract, there is no obvious benefit for which restitution would be due. The company never requested or accepted the benefits in question.

In summary, while ratification remains commonly invoked for adopting pre-incorporation contracts, it is not the only possibility. However, alternative doctrines like agency, estoppel and restitution also face substantial objections in the literature. There are good reasons why ratification should remain the primary mechanism, with flexibility for companies to determine which pre-incorporation contracts they wish to adopt or reject based on the merits of each contract.

Research Methodology

This paper employs a doctrinal research methodology, relying primarily on case law and legal scholarship related to pre-incorporation contracts. Doctrinal research analyzes foundational concepts and rules within a legal field and their development over time.

The paper takes a case law-driven approach, reviewing leading court decisions on pre-incorporation contracts in various common law jurisdictions. These case decisions are analyzed to distil each jurisdiction's legal principles and tests. Particular focus is placed on the balance struck by the courts between two key policy aims: (1) protecting companies from being bound by unauthorized actions of promoters and (2) providing security of transactions for third parties contracting with promoters.

The development of the common law in each jurisdiction is explored longitudinally by examining important cases from the 19th century to recent years. Statutory provisions relevant to pre-incorporation contracts, especially those enabling ratification

and adoption of such contracts, are also analyzed for each jurisdiction.

In reviewing the case law and scholarly literature, the doctrinal research identifies areas of consensus regarding the validity and enforceability of pre-incorporation contracts and ongoing debates and complexities in this area of law. Academic literature from across jurisdictions is included to provide theoretical perspectives on the issues, alternative frameworks for analysis, and critiques of existing laws and judicial approaches.

Based on this doctrinal research, the paper argues for particular legal reforms and approaches to balance the dual policy aims identified above. Recommendations are made for amendments to statutory ratification provisions and an objective framework for courts to apply in evaluating the enforceability of pre-incorporation contracts without ratification.

In summary, the research relies primarily on legal authorities and doctrinal analysis, synthesizing laws and scholarly work across jurisdictions to address a complex issue in corporate law. The doctrinal analysis informs proposals for incremental changes to balance key policy concerns around pre-incorporation contracts.

Research Question/Issues

1. What is a pre-incorporation contract, and how does it differ from a regular contract?
2. What are the benefits and risks of entering into a pre-incorporation contract for both parties involved?
3. How can pre-incorporation contracts be enforced, and what remedies are available in case of a breach?
4. What are the limitations on the scope of a pre-incorporation contract, and how do they impact the parties' obligations?



Introduction

A contract must be executed by two competent individuals in order to be valid.⁴⁷ The incorporation of a company marks the beginning of its competence.⁴⁸ This gives it a separate legal personality and the contract's rights and duties are sole with the company, not with the promoter personally⁴⁹.

As can be seen, the corporation always has a group of people working on its behalf. What happens, though, when someone claims to be working for a company that is technically not a company due to the lack of incorporation?⁵⁰ Is it possible to contract an artificial person in the process of being created but not yet brought into existence?

The promoter, the party with whom the promoter contracts, and the company on whose behalf the promoter has entered into a contract are the three stakeholders in this contract⁵¹. However, how can someone sign a contract on behalf of someone who is yet to come into existence⁵². This brings us to the most important question: "What is the legal status of such contract?" Another crucial question relating to the rights and obligations of the stakeholders might be raised in this context⁵³.

However, the concept of pre-incorporation contracts in the Indian framework is quite indistinct, to say the least. Specific Relief Act lays down the circumstances when companies can sue and be sued for a pre-incorporation contract. However, the rights and obligations of the company comprise only one aspect of the transaction. Also, the Act can be enforced only

in specific cases, and the evolution of law is limited and numerous case laws make the process complex⁵⁴. However, this chaos can be avoided by entering into contracts after incorporation. Incorporation under Indian Law might take around 15 days to one month; for a foreign company, this might take around 1.5 months. It is always advised to wait for incorporation and benefit from a secure transaction rather than enter into the legal conundrums of a pre-incorporation contract in India⁵⁵.

This paper will first address the meaning and role of the promoter, comparing it with Common law. In light of the theoretical framework, some answers may be sought, which will also examine the enforceability of the Contract in light of the Specific Relief Act. This will also address the promoter's personal liability on a pre-Incorporation contract. The paper will conclude with the significance of drafting and solutions to secure the transaction.

Meaning and Role of Promoter: Comparison with Common law

Common law puts forth that "the term promoter is a short and convenient way of designating those who set in motion the machinery by which the Act enables them to create an incorporated company⁵⁶." Promotion of the company is one of the primary steps in forming the company, so the promoter plays a very essential role. The concept of business, its viability and feasibility will be the brainchild of the promoter. Promoters enter the pre-incorporation contracts and decide the kind of body, sole proprietorship, partnership or LLP⁵⁷.

Indian legal framework fails to clearly define the term Promoter. The Companies Act of 1956 defines the word promoter with respect to the

⁴⁷ Indian Contract Act, 1872, § 10, No.9, Acts of Parliament, 1872 (India).

⁴⁸ Indian Companies Act, 2013, § 9, No.18, Acts of Parliament, 2013 (India).

⁴⁹ Indian Companies Act, 2013, § 21, No.18, Acts of Parliament, 2013 (India), Salomon v A Salomon & Co Ltd, [1896] UKHL 1.

⁵⁰ M. J. Whincop, Of Dragons and Horses: Filling Gaps in Pre-incorporation Contracts, (1998) 12 JCL223-225.

⁵¹ Indian Companies Act, 2013, § 269, No.18, Acts of Parliament, 2013 (India).

⁵² STEWART KYD, TREATISE ON THE LAW OF CORPORATIONS § 5:13 (1 ed., J. Butterworth, 1794).

⁵³ Prasad Raj Singh, Promoter and Pre-incorporation Contract, 6 ASIAN JOURNAL OF INTERNATIONAL LAW, 1-2 (2011), available at: http://papers.ssrn.com/sol3/th_papers.cfm?abstract_id=1938065, accessed 5 November 2021.

⁵⁴ Specific Relief Act, 1963, § 15(h) and 19(e), No.47, Acts of Parliament, 1963(India).

⁵⁵ Specific Relief Act, 1963, § 10, No.47, Acts of Parliament, 1963(India).
⁵⁶ Ponzetto & Fernandez, Case Law versus Statute Law: An Evolutionary Comparison, 37 JOURNAL OF LEGAL STUDIES (2008).

⁵⁷ William J. Rand, High Pressure Sales Tactics and Dead Trees: What to do with Promoters' Pre-Incorporation Contracts, 4 RUTGERS BUSINESS LAW JOURNAL 1(2007).



prospectus. Section 62 of the 1956 act defines a promoter⁵⁸.

The relevance of this provision is only with respect to claims for compensation made by shareholders in case of misstatement or misrepresentation made in the prospectus issued to raise capital⁵⁹. However, this definition can be applied only in cases where compensation is claimed by a person who has purchased shares and debentures in light of the prospectus. The term 'promoter' is also defined in the SEBI Regulations 1997 and 2011⁶⁰.

The liability of Promoters in a pre incorporation contracts has not been laid out and the 2013 definition restricts itself to be inclusive and the case pre-incorporation continues to be under the shadow⁶¹.

Enforceability of Contract in light of Specific Relief Act

Since the contract is entered in light of a non-existing company, there are multiple cases where the third party has been left to a disadvantage owing to the contract being declared null and void due to incompetency. However, the common law has made an attempt to provide a shield of protection to the third party in this regard⁶².

The promoter by practice is considered to be treated as an agent of the company prior to incorporation. However, the promoter can't bind the company as its agent since the principal is non-existent⁶³. Quite another consequence is in the post-incorporation stage and when ratification is still not allowed. English Law disallows ratification of a pre-incorporation

contract by the company on the footing that even for ratification, the company needs to have legal capacity which is not the case for a pre-incorporation contract⁶⁴. Even though the recommendations of Jenkins Committee allows for ratification for commercial expediency reasons⁶⁵.

American jurisprudence makes an attempt to avoid the theoretical difficulty of ratification by introducing the concept of 'adoption'. Though the legal effect remains the same, the concept is though technically correct⁶⁶. The company by embracing the benefits of the contract automatically becomes a party. The liability which hence, falls on the company is not justified on the basis of abstract principal-agent relationship but the power can be located within its inherent powers of forming contracts as a body corporate. Thus, the company is definitely free to adopt third parties⁶⁷.

The Shareholders are also shielded from any liability that may be attracted because of the promoter which includes that merely benefitting from an unsolicited act doesn't amount to acceptance and some affirmative act would be needed along having full knowledge of the contract and as knowledge to the promoter not amounting as knowledge to the company⁶⁸.

The Indian legal framework allows for companies to ratify pre-incorporation contracts entered on its behalf. Specific Relief Act under Section 15(h) and Section 19(e) allows for this. In *Seth Sobhag Mal Lodha v. Edward Mills Co. Ltd.*, the court has denied any scope for enforcement of a pre-incorporation contract. However, it has been noted that the decision failed to take into account⁶⁹.

Interpreting Section 19(e) & 15(h) of the Specific Relief Act points that for a pre-incorporation contract to gain validity in the eyes of the law, it

⁵⁸ AVAProfessionals, Time Frame for Incorporation, AVAProfessional Consultants, available at: <http://www.avaprofessionals.com/knowledge-center/companyth-registration-india/time-frame-for-incorporation/>, accessed 9 November 2021.

⁵⁹ Eddie R. Flores, The Case For Eliminating Promoter Liability On Preincorporation Agreements, 32 ARIZ. L. REV. 405 (1990).

⁶⁰ Norwood P. Beveridge, Corporate Puzzles: Being a True and Complete Explanation De Facto Corporations and Corporations by Estoppel, Their Historical Development, Attempted Abolition, and Eventual Rehabilitation, 22 OKLA. CITY U. L. REV. 935, 938 (1997).

⁶¹ Wolfe v. Warfield, (1972) 296 A.2d 158.

⁶² Goodman v. Darden, (1983) 670 P.2d 648.

⁶³ RAC Realty v. WOUF Atlanta Realty Corp, (1949) 205 Ga. 154, 52 SE 2d 617; Strause v. Richmond Woodworking Co., (1909) 109 Va. 724, 65 SE 659.

⁶⁴ HARRY G. HENN & JOHN R. ALEXANDER, LAW OF CORPORATIONS (3 ed., West Publishing Co.

⁶⁵ Cotronic (UK) Ltd v. Dezonie, (1991) BCLC 721 (CA).

⁶⁶ Royal Bank of Canada v. Starr, (1985) 31 B.L.R. 124 (Canada).

⁶⁷ RKO-Stanley Warner Theatres, Inc. v. Graziano, (1975) 355 A.2d 830.

⁶⁸ Braymist Ltd v. Wise Financial Co Ltd., (2002) EWCA Civ 127.

⁶⁹ Hellmuth, Obata & Kassabaum Inc. v. Geoffrey King (unreported, Sept. 29 2000, QBD, Technology & Construction Court).



must have been entered into for the purposes of the future company and be warranted by the terms of the incorporation. Further, the acceptance of the contract must be communicated to the third party⁷⁰. However, multiple questions does arise here. Does warranted by the terms mean that it must be expressly inculcated in the articles of association or that such contract may be ratified as long as it is not against the objects of the company? Further can implied acceptance be considered valid by taking in the benefits of the contracts⁷¹?

Express ratification and acceptance are not the only ways to enforce a contract. If a company has accepted benefits of a pre-incorporation contract, the contract won't be a complete nullity and claims can be adjudicated⁷².

The Apex court has held that the term "warranted by the terms of incorporation" must be understood to not be ultra vires of the object of the company and dismissed the submission that an express condition needs to be articulated for a pre-incorporation contract⁷³. However, a blanket rule under Specific Relief Act can't be formulated for all pre-incorporation contracts. It must be read along with other statutes and relevant framework. Hence, the position formulated by the Supreme Court should be upheld, which states that as long as it is not ultra vires to the objects clause of the company, it must be left to the company⁷⁴.

The difference between English, Indian and American Law lies in allowing the company to have the requisite flexibility to continue with a contract that was made on its behalf before its existence⁷⁵. English Law, however, has been unable to grant the same power to the

contracts. American law on the other hand has struck down the English Law approach in favor of the commercial benefits of the parties involved and has come up with its own techniques to enforce the contract, which is much more flexible compared to Indian law⁷⁶.

Promoters personal liability on a Pre-Incorporation Contract

Though Specific Relief Act has enumerated on conditions of enforcement between the company and the third party, there is a legal lacunae for ratification. Can the promoter be held liable personally as it is under UK, EU, and USA? Also, Can the promoter can be relieved of liability when the company ratifies the pre-incorporation contract?⁷⁷

I. In case of Non-Ratification

The intention of the parties while adjudicating the contract is of primal importance in Common law. If the promoter claimed to act for the corporation, then personally liability comes into the scenario. However, in case if the contract is entered into in name of the proposed company and the promoter merely authenticated the signature, the promoter was absolved from all liability⁷⁸.

To illustrate, consider the case, *Kelner v. Baxter*; the company wasn't formed and the enforcement of the contract was bought before the court⁷⁹. Here the court held that since it was evident to both the parties and they could hold promoter personally liable in the case, the company is not formed⁸⁰.

However, a different approach was taken in the case of *Newborne v. Sensolid*. A contract was entered into when the company was not correctly formed. The court concluded that the director authenticated the signature of the

⁷⁰ SIR FRANCIS BEAUFORT PALMER, PALMER'S COMPANY LAW (25 ed., Sweet and Maxwell, 2013).

⁷¹ *Newborne v. Sensolid*, (1953) 1 All ER 708.

⁷² NN Green, Security of transaction after Phonogram, 47 THE MODERN LAW REVIEW 671-691 (1984). ⁴⁶ *Phonogram Ltd v. Lane*, (1982) QB 938.

⁷³ ARDEN & PRENTICE ED., BUCKLEY ON COMPANIES ACT (17 ed., LexisNexis, 2009).

⁷⁴ KM GHOSH AND KR CHANDRATRE, K.M. GHOSH & DR. K.R. CHANDRATRE'S th COMPANY LAW: WITH SECRETARIAL PRACTICE, (13 ed., Bharat Law House, 2007).

⁷⁵ *Inlec Investment Pvt Ltd v. Dynamic Hydraulics Ltd*, (1989) 3 Comp LJ 221, 225 (CLB).

⁷⁶ *Jai Narain Parasurampuriah (Dead) and others v Pushpa Devi Saraf and others*, (2006) 7 SCC 756.

⁷⁷ *Weaver Mills v. Balkis Ammal*, (1969) AIR Mad 462.

⁷⁸ A. RAMAIYA, GUIDE TO COMPANIESACT (17 ed., 2010).

⁷⁹ ANDREW GRIFFITHS, CONTRACTINGWITH COMPANIES (Hart Publishing, 2005). ³⁴ *Seth Sobhag Mal Lodha v. Edward Mills Co. Ltd.*, (1972) 42 Com Cases (Raj).

⁸⁰ *Wall v. Niagara Mining & Smelting Co. of Idaho*, (1899) 20 Utah 474.



company. Hence, in this case, the contract was rendered void⁸¹.

Lord Denning has propounded that the real intent is to be discerned by the knowledge of the parties and the contract itself rather than the technical distinctions of signature and he criticized this approach. In *Newborne*, the parties wrongfully assumed and pleaded its unconstitutionality⁸². Thus, when both the parties were aware that the company was nonexistent, the question that must be asked to determine the parties' intention is whether promoters had wished to assume liability where the contract was not novated⁸³.

The common law distinction between the signatures was disowned by Section 9(c) of the EEC directive. Thus, the statutory enactment reinforced the security of transactions. Section 36C of the Companies Act materialized common law, disowned technical inconveniences, and took cases where no formal contract was entered into, but services were rendered⁸⁴.

However in American jurisprudence, a strict liability accords for the promoter⁸⁵. Thus, in the case of *RKO-Stanley Warner Theatres, Inc. v. Graziano*, the promoter was held personally liable⁸⁶. Even after the corporation was formed, it never adopted the contract. The Indian legal framework pronouncements to define the contours of the issue⁸⁷.

Ramaiyya's commentary suggests that under Section 230 of the Indian Contract Act, a promoter can't be held liable under a preincorporation contract since, under Section 230 of the Indian Contract Act, an agent is not personally bound by the contract entered for his

principal. Thus, once the company is incorporated, the promoter can't sue or can be sued in case the company refuses to ratify the contract except on the principle of quantum merit or breach of warranty of authority.

Quantum merit would imply that if the promoter has rendered services to other party and it has been accepted, then he can sue under the contract. However, it is submitted that such a position needs to be corrected because it assumes an agent-principal relation. The move to make the promoter personally liable would depend on the intention of the parties and no such rule to make the contract void can be deduced. The promoter's personal liability can be avoided by construing a pre-incorporation contract as a revocable offer or "gentle-man's contract" under which, if the offer is not revoked, the corporation can accept the contract.

The benefit for the promoter under this view of the contract is that, so long as there was no fraudulent purpose or breach of the authority warranty, he has no rights or obligations in relation to the contract. However, the note included in the Name Approval Certificate raises a problem. No contract can be entered into on behalf of the proposed company until it is incorporated, according to the Certificate issued by the Registrar in accordance with its legislative authority.

It is not clear, however, if it is a condition subsequent to the issuance of the certificate. However, until and unless the company ratifies the contract, any such contract can never bind the company. Thus, one strand of interpretation suggests that the contract can't be enforceable and hence would be void. Another would just prohibit burdening the corporation with such a contract while continuing to make the promoter personally accountable.

The Specific Relief Act does not require the third party's express consent and just requires the corporation to communicate the acceptance to the other party. In *Goodman v. Darden*, it was made clear that the promoter's personal

⁸¹ Thomas Reith, *The Effect of Pre-incorporation Contracts in German and English Law*, 37 *INTERNATIONAL AND COMPARATIVE LAW QUARTERLY* 109 (1988).

⁸² Joseph Savirimuthu, *Pre-incorporation contracts and the problem of corporate fundamentalism: are promoters proverbially profuse?* 24 *COMPANY LAWYER* p.196-209 (2003).

⁸³ *Outmoded Concept Dominates Law of Promoters' Pre-Incorporation Contracts*, 2 *STANFORD INTRAMURAL LAW REVIEW* (1948).

⁸⁴ Regulation 3 SEBI (Substantial Acquisition of Shares and Takeovers Regulations) 1997.

⁸⁵ *Erlanger v New Sombrero Phosphate Co.*, (1878) 3 App Cas 1218.

⁸⁶ *Twycross v. Grant*, (1877) 2 CPD 469 (CA).

⁸⁷ Regulation 2(ZA) SEBI ICDR Regulations 2011.



culpability was still in place even after the business had accepted the contract.

In this instance, the promoter directed all monies collected under the contract to the company even though both parties were aware that the corporation was not yet a reality at the time the contract was made. The court decided that the third party's goal was never to absolve the promoter of responsibility. The fact that it was a pre-incorporation contract would suggest that the third party meant to hold the promoter accountable even before the corporation adopted the contract, reducing any doubt.

In order to determine whether the third party meant to restrict the promoter's liability on the corporation accepting the contract, the court looks at what the third party intended. The parties' intentions were incorrectly read in the Goodman case because the promoter's intent was not properly acknowledged. The promoter would not have intended to be bound personally after being adopted by the company because restricted liability is the main benefit of incorporation.

Now, we need to consider the contractual mutuality principle. After incorporation, the promoter's only interest in the contract is by virtue of the business; he or she has no personal stake in it. As a result, holding the promoter accountable is unfair. As a result, the test below has been recommended: The first question is: Has the promoter signed a contract on behalf of a fictitious company? Second, has the contract been ratified or adopted by the corporation?

Third, has the corporation engaged into a novation with the third party contractor to absolve the promoter of liability, or has the third party agreed to direct all liability to the corporation? Last but not least, is the corporation legitimate or was it founded to avoid promoter liability in relation to a fraudulent scheme? In the USA, the ratification of the pre-incorporation contract need not be done expressly. Ratification of this contract will

happen automatically after the company is formed if that contract has been made for the benefit of the company.

The Theory of Identity or Theory of Continuity, states that the company formed after the incorporation will be treated similarly to the preincorporation association and after the incorporation, that body will get the same rights and obligations as enjoyed by the pre-incorporation association prior to the incorporation of the company.

Hence, the company after its formation need not adopt or ratify the contract and the obligations and rights will be accrued to the company as if under succession. The promoters will be shielded from liability under Indian law if contracts are accrued to the company as though under succession, and third parties will have a better debtor in the form of the company.

Under the Australian laws, where Section 131 of the Australian Corporation Act, 2001 states that the court can interfere in the matter of the pre-incorporation contract if the Companies won't ratify the contracts. Under this law, the court can order for the payment of damages to the promoter if it is deemed appropriate. This may be true in the Indian context because the majority shareholders may not approve the contract after the firm is incorporated and there may be a promoter who is also a small stakeholder.

Conclusion

This paper would conclude with the significance of drafting and viable solutions to secure the transaction. Half of the problems of a preincorporation contract can be resolved by apt drafting which clearly sets out the intention of the parties.

Regarding the drafting suggestion, the promoter must limit his risk by explicitly bargaining for no personal liability in case of failure of non-ratification and that in case of ratification, his liability would end. A further rider must be put



indicating the status of the corporation and the promoter can also disown liability for making the corporation compulsorily ratify the contract.

Rights and obligations of the promoter, of the contemplated corporation along with consequences with respect to ratification/non-ratification must be followed. The promoter can also put in a clause of indemnification of all pre-incorporation expenses. Under Indian law, one can conclude that the corporation can adopt the contract. However such adoption/ratification is no guarantee that the contract will release the promoter from the liability and hence the promoter must undertake appropriate safeguards to protect himself and press for novation of the contract.

A strong case can be made by the promoter to be indemnified for all the pre-incorporation contracts especially if the Corporation adopts the same and reimbursement for services can commonly be sought by increased allotment of shares. Finally, care must be taken to not club all pre-incorporation contracts as one that being made by defective corporations.

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