Chapter 2 – Promotion of the company and pre-incorporation contracts

Andrew and Cathryn Sims are a married couple and partners in a business that sells video games hardware and software. The business proves to be extremely successful, and they open up a number of branches. In order to limit their liability, they instruct their solicitor to incorporate the business, calling the new company Sims Gaming Ltd.

Around the same time, MicroTech is about the release a new games console – the GamePlayer. Andrew and Cathryn are keen to acquire as many of these consoles as possible. Andrew hears of a potential source (Halo Ltd) and is offered fifty consoles. Eager to purchase the consoles, Andrew does not wait until the company is incorporated and enters into a contract with Halo Ltd ‘for and on behalf of Sims Gaming Ltd. Cathryn is also offered a number of consoles and, prior to the company being incorporated, she enters into a contract with Players Ltd for forty consoles. She signs the contract ‘Sims Gaming Ltd pp. Cathryn Sims (a director).’

The certificate of incorporation is issued and, at the first board meeting of Sims Gaming Ltd, Andrew and Cathryn ratify both contracts. Andrew and Cathryn both have extensive software libraries. Andrew sells to Sims Gaming Ltd a number of games that he acquired prior to engaging in the company’s formation. Cathryn sells to the company a number of games that she acquired whilst the company was being formed.

Shortly thereafter, Halo Ltd refuse to sell Andrew the fifty consoles promised, as it believes that it can sell all the consoles to the public for a higher price. Cathryn is concerned that Players Ltd will also refuse to sell the forty consoles promised.

A shareholder of Sims Gaming Ltd, William, discovers the above and seeks your advice regarding whether or not any breaches of the law have occurred. Would your answer differ if Sims Gaming Ltd had been an off the shelf company purchased by Andrew and Cathryn?

Introduction

- This question requires you to discuss a number of issues, namely:
  1. Is the contract between Andrew and Halo Ltd enforceable?
  2. Is the contract between Cathryn and Players Ltd enforceable should Players Ltd refuse to sell her the consoles?
  3. If the answer to the above two questions is no, does the fact that the company ratified the contracts make any difference?
  4. By selling items to Sims Gaming Ltd, have Andrew or Cathryn breached their duties as promoters?
  5. Would the answers to any of the above questions differ if Andrew and Cathryn purchased their company off the shelf?
- As an introductory issue, you may wish to state what a promoter is and to establish why Andrew and Cathryn would be regarded as promoters.
Purchase of games consoles

- Both Andrew and Cathryn have purchased games consoles on behalf of Sims Gaming Ltd, but, at the time the contracts were entered into, Sims Gaming Ltd had not been fully incorporated. Therefore, Sims Gaming lacked the capacity to enter into contracts. The question is are the contracts invalid, or can they be enforced.
- You may wish to briefly discuss what the position would have been at common law. Normally, when answering a problem question, you should discuss the current law, but if it is appropriate, feel free to discuss if the current law is preferable to the prior law or not. Under the common law, it would be likely that the contract between Andrew and Halo Ltd would be binding between Andrew and Halo Ltd, as the courts stated that a binding contract would exist between a promoter and a third party if the promoter signed the contract on behalf of the company-to-be (*Kelner v Baxter (1866)*). Accordingly, Andrew will be able to enforce the contract.
- Under the common law, it is likely that no contract will exist between Cathryn and Players Ltd, as the courts stated that no contract will exist where the promoter signs the contract using the company’s name (*Newborne v Sensolid (Great Britain) Ltd [1954]*). Accordingly, should Players Ltd refuse to sell Cathryn the consoles, she will be unable to enforce the contract.
- The common law position was criticized for being overly complex and based on an artificial distinction that was often difficult to apply in practice. Accordingly, the *Companies Act 2006, s 51(1)* now provides that, in cases such as above, a contract will exist, in all cases, between the promoter and the third party. Therefore, Andrew and Cathryn will be able to enforce the contract. You may wish to discuss why this results in a much fairer and effective outcome that was achieved under the common law (e.g. increased protection to third parties).

Ratification

- Upon incorporation, Andrew and Cathryn cause the company to ratify both contracts. This will make no difference, as s 51(1) does not allow a company to adopt pre-incorporation contracts (*Re Northumberland Avenue Hotel Co (1866)*). If the company wishes to adopt the contracts, they must be novated.
- Many academics¹ have criticized this, and have argued that companies should be able to adopt pre-incorporation contracts (as was permitted under Art 7 of the First EC Company Law Directive). Problem questions are primarily assessing your ability to apply the law, but if the opportunity to criticize the law’s application arises, you should take it and discuss whether or not the correct application of the law would lead to an appropriate result. Back up your contentions with academic authority.

Off the shelf companies

• If Sims Gaming Ltd was purchased off the shelf by Andrew and Cathryn, then, providing that the company existed at the time the contracts were entered into, valid contract would exist between Sims Gaming Ltd and Halo Ltd, and between Sims Gaming Ltd and Players Ltd.

Promoters’ duties

• Company promoters are under a number of duties in relation to the companies they are promoting, with the principal duty being that promoters are not permitted to make a profit out of the company’s promotion, unless the nature and extent of the profit are disclosed.
• Both Andrew and Cathryn have entered into contracts with Sims Gaming Ltd for the sale of games. The games that Andrew sold were acquired by him prior to entering into the contract. Cathryn acquired the games, whilst the company was being promoted. Accordingly, both have made a profit. Whether the fact that the games were acquired by Andrew and Cathryn at different times would make a difference is unclear, although it could be argued that Cathryn is more likely to have breached her duties given that she acquired the games during the promotion of the company.
• There is no indication that Andrew or Cathryn disclosed this profit. Even if they disclosed the profit to each other, this disclosure might not be sufficient as the courts have stated that disclosure will only be valid if it is made to persons who are independent (Erlanger v New Sombrero Phosphate Co (1878)). Disclosure must be made to an independent body of directors or members.