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Understanding the Position of Promoters under the Companies Act, 2013: Finding the true meaning of 'Secret Profits'

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In corporate law, the term 'promoter' is used very frequently, however, the Indian Companies Act of 2013 defined it for the first time. The term was only used in the Companies Act, of 1956 to impose liability on promoters. The author takes the reader through the evolution of the definition of 'promoter' from a stage where it was considered after several attempts that it is a business term but not a legal term to its current position. It also examines the promoter's duties and the fact that a promoter is an individual who holds an edge or control over the company's affairs, has a fiduciary relationship with the company, and is required to disclose his interest in corporate transactions in which he is involved, as well as the current laws in this regard. The author also stresses the need to clarify the roles of promoters post-incorporation of a company, because the definition under the Act is still subjective to an extent and the legislation does not describe the role of promoters post-incorporation.

Keywords: *promoters, companies act, duties, fiduciary relationship, secret profits.*

INTRODUCTION

India is already the fastest-growing economy in the world, having clocked 5.5% average gross domestic product growth over the past decade and it is believed that by 2027, India will become

the third largest economy in the world and third largest stock exchange by 2030¹. Along with the growth of the economy in the past decades, corporate laws in India have also developed a lot and are still developing at a fast pace and it is needless to say that there will be an increase in investments and corporate transactions, both domestic and international and also increase in complexity in corporate transactions. The fact that Indian companies are mostly either promulgated or interlinked amongst the family or promoter-driven companies, makes it very important to understand the position of 'promoter' in India who has an advantageous position on the affairs of the company throughout. This article analyses the development of the definition of 'promoter' and the need of defining it (Part II), the development and position of corporate laws in India relating to promoters (Part III & IV), and lastly, in it analyses a very important duty of a promoter i.e disclosure of personal interest in corporate transactions.

DEFINITION OF 'PROMOTER'

The word 'Promoter' primarily is a business term and yet has been repeatedly used in company matters and "*yet it has never been clearly defined either judicially or legislatively*"². Even judges have been unable to provide a legal definition of the term promoter, and the majority of definitions are based on the work that they do. To understand the current position of the promoter and the purpose of defining it statutorily, it is important to know how it evolved. The first attempt at defining promoter traces back to 1877, in which Cockburn, C.J, observed that a promoter, undertakes the responsibility to form a company concerning a certain project, and takes the required necessary steps to accomplish that purpose.³ This definition of promoter according to me is the simplest definition from a managerial or business perspective.

In *Emma Silver Mining Co. v Lewis*⁴, Lindley J. pointed out that the "*term promoter has no very definite meaning*"⁵ and defined it as the idea of exertion to set up and start a company, and also the idea of some duty towards the company imposed by it arising from the position which the

¹ Morgan Stanley, 'India's Impending Economic Boom' (*Morgan Stanley*, 8 November 2022) <<https://www.morganstanley.com/ideas/investment-opportunities-in-india>> accessed 10 January 2023

² Joseph H Gross, 'Who is a Company Promoter' (1970) 86 LQR 493

³ *Twycross v Grant* (1987) LR 2 CPD 496

⁴ *Emma Silver Mining Co v Lewis* (1879) LR 4 CPD 396

⁵ *Ibid*

so-called promoter assumes towards it.⁶ In the case of *Whaley Bridge Calico Printing Co. v Green*,⁷ Bowen LJ observed that the term promoter is a term not of law but of business, usefully summing up in a single word several business operations familiar to the commercial world by which a company is generally brought into existence.⁸

The Indian courts have also considered the above definitions in a couple of their judgment. In *Weavers Mills Ltd v Balkis Ammal*,⁹ the Madras High Court followed the definition given by Cockburn CJ in the *Twycross Case*¹⁰, and various other judgements have summed up the definition of promoter as “A 'Promoter' therefore, is a compendious term given to a person who undertakes, does and goes through all the necessary and incidental preliminaries, keeping in view the objects, to bring into existence an incorporated company. This process leading to the genesis of a company may include a variety of things, not the least of them, I think, being some of the steps taken by a promoter to ensure commencement, within a reasonable time, of the business, for the carrying on of which the company is formed. He makes the purchase of moveable and immoveable assets, enters into contracts involving rights and obligations and applies to authorities for a variety of things, all on behalf of the company to be formed”¹¹

In *C Thiruvenkatachariar v A T Velu Mudaliar*¹², the Madras High Court relied on Lindley J's definition in *Emma Silver Mining Co Case*¹³ while deciding that the respondent, in this case, is not a promoter because he does not meet Lindley J.'s definition of a promoter. From the above discussion, it can be safely concluded and the words of Joseph H. Gross can be agreed - “the difficulties in defining the term led the judges to state that the term ‘promoter’ is not a term of art nor a

⁶ *Ibid*

⁷ *Whaley Bridge Calico Printing Co v Green* (1880) LR 5 QBD 109

⁸ *Ibid*

⁹ *Weavers Mills Ltd v Balkis Ammal* AIR (1969) Mad 462

¹⁰ *Twycross* (n 3)

¹¹ *Weavers Mills* (n 9)

¹² *C Thiruvenkatachariar v A T Velu Mudaliar* AIR (1938) Mad 154

¹³ *Emma Silver* (n 4)

term of law, but of business"¹⁴ and was just a synonym to refer to persons involved in promoting or promotion of business and operations of the company.¹⁵

There was no statutory definition of a promoter, because if legislation tries to define it then someone might find a loophole and escape from the liability who otherwise enjoys the position of promoter but not coming under the definition¹⁶ or not having a definition increases the scope of judicial interpretation.¹⁷ In *Jacobus Marler Estates Ltd v Marler*¹⁸ that it was observed that "*it is advantageous to keep the definition flexible in terms of duties performed by them to bring only those under strict duties of promoters who will fulfill the functional concept of the definition.*"¹⁹

I do not fully agree with both propositions, because the sole purpose of an inclusive definition is to widen the scope, it could have been kept so wide that the chances of not coming under the definition would be minute and there is always a scope of judicial interpretation which, if necessary, could have widened the definition of promoter even more. Moreover, there was a need for statutory intervention because there was a need for purposive legislation to impose liability on promoters and if we look at the trend of judicial definitions there is a lack of legal viewpoint in it. Even though the definition of a promoter in *Twycross* and other cases mentioned above is the simplest and most accurate definition, but only from a business perspective and not from a legal perspective.

PROMOTER IN THE PRE-2013 ERA

The Companies Act of 1956 did not define the term 'promoter,' but it did make the promoter liable. Sections 62 and 63 of the Companies Act of 1956 imposed civil and criminal liability on the promoter for any false or misleading statement in the prospectus, respectively. The provision defined promoter but only for Sections 62 and 63, as 'promoter' refers to a person who participated in the creation of the prospectus or the section of it that contained the false

¹⁴ Gross (n 2)

¹⁵ Harpreet Kaur, 'Promoters and Corporate Governance under the Companies Act, 2013 and allied Acts in India' (2018) 3(1) Journal of National Law University Delhi, 53-70

¹⁶ Gross (n 2)

¹⁷ *Ibid*

¹⁸ *Jacobus Marler Estates Ltd v Marler* (1913) 85 LJPC 167

¹⁹ *Ibid*

statement but it excluded any person acting in a professional capacity in such preparation²⁰. For the first time, the word promoter was defined inclusively in Regulation 2(z a)²¹ of Securities Exchange Board of India (Issue of Capital and Disclosure Requirements) Regulations, 2009 [herein after referred to as SEBI (ICDR) Regulations, 2009] as –

As per this definition, a promoter can be put into three categories -

Person in control of the issuer²²- The words ‘Person in control of the issuer has made the scope of this definition very wide because the word ‘control’ is itself very wide. SEBI (ICDR) Regulations, 2009, defines control as it is defined in Securities Exchange Board of India (Substantial Acquisition and Shares Takeovers) Regulations, 2011[SEBI (SAST) Regulations, 2011]. According to it, control includes the *“right to appoint a majority of the directors or to control the management or policy decisions exercisable by a person or persons acting individually or in concert, directly or indirectly, including by their shareholding or management rights or shareholders agreements or voting agreements or in any other manner.”*²³ This thus derives that, now a person can become a promoter and can be included under the bracket of a promoter by their shareholding or agreements or rights even without starting a company or being engaged in the activity of ‘promotion’ of a company.

- Persons who are instrumental to prepare the plan through which securities are offered to the public. This category only covers promoters of a public company²⁴.
- Persons referred to as promoters in the offer document²⁵- Anyone who is referred to as a promoter in the offer document will be considered a promoter even if he does not fall

²⁰ Companies Act 1956, s 62(6)

²¹ Securities Exchange Board of India (Issue of Capital and Disclosure Requirements) Regulations 2009, reg 2(z a)

²² Securities Exchange Board of India (Issue of Capital and Disclosure Requirements) Regulations 2009, reg 2(z a)(i)

²³ Securities Exchange Board of India (Substantial Acquisition and Shares Takeovers) Regulations 2011, reg 2(e)

²⁴ Securities Exchange Board of India (Issue of Capital and Disclosure Requirements) Regulations 2009, reg 2(z a)(ii)

²⁵ Securities Exchange Board of India (Issue of Capital and Disclosure Requirements) Regulations, 2009, reg 2(z a)(iii)

into the first two categories. He will be held responsible for all of the promoter's responsibilities and liabilities.

Because SEBI Regulations only apply to listed companies, the Unlisted Public Companies (Preferential Allotment) Rules, 2003 defined and divided promoters into two categories:-

- Person or Persons having overall control over the company²⁶- The word control would have the same meaning as above²⁷.
- Person or persons who claim themselves as promoters.²⁸ This means that any person named as a promoter in the offer document is considered a promoter regardless of control or shareholding.

Before the Companies Act, 2013 came into force, this was the position of promoters in India.

POSITION OF PROMOTER UNDER THE COMPANIES ACT, 2013

A. Position

Companies Act, 2013 came into force on 12.09.2013. Section 2 (69)²⁹ of the Act defined promoters into 3 categories. The first category is any person who is named as a promoter in the prospectus or the annual returns.³⁰ The second category is any person whether as a director, shareholder, or otherwise can directly or indirectly control the affairs of the company³¹. The second category widens the scope of this definition to a great extent. The word 'control' has been defined under the Act³², the same as under the SEBI (SAST) Regulations, 2011³³. The first two categories were in some way similar to the previous definitions of the promoter. The third category of promoters was introduced in the 2013 Act. The third category includes any person under whose direction,

²⁶ Unlisted Public Companies (Preferential Allotment) Rules 2003, rule 3(2)(a)

²⁷ Unlisted Public Companies (Preferential Allotment) Rules 2003, rule 3(3)

²⁸ Unlisted Public Companies (Preferential Allotment) Rules 2003, rule 3(2)(b)

²⁹ Companies Act 2013, s 2(69)

³⁰ Companies Act 2013, s 2(69)(a)

³¹ Companies Act 2013, s 2(69)(b)

³² Companies Act 2013, s 2 (27)

³³ Securities Exchange Board of India (Substantial Acquisition and Shares Takeovers) Regulations 2011, reg 2(e)

guidance, or advice the Board of directors is accustomed to act.³⁴ This means that a person can be a promoter even if he did not act while the company was being promoted, or if he is not a director or shareholder of the company, but only if he has authority or control over the board of directors.

So, this being the position of promoters, it can be concluded and submitted that promoter still being a business term is no longer seen as one by the legislative point of view to impose duties and liabilities on a person. This reduces the chances of escaping the clutches of law to a great extent and also leaves space for judicial interpretation of determining whether a person is a promoter, especially in the second and third categories. Because, while the term 'control' has been defined, the legal question of what constitutes control under certain circumstances remains open, and it is dependent on the facts and circumstances of each case, as determined by the Supreme Court while setting aside the order of Securities Appellate Tribunal in *Subhkam Ventures Private Limited v Securities Exchange Board of India*.³⁵

B. Duties

Various provisions under the Companies Act, 2013, and various Regulations of the Securities Exchange Board of India impose duties upon the promoters. In this article, the scope would be restricted to that under the Companies Act, 2013. The provisions of the law are as follows-

Section 13 and 27 - Under both provisions, the promoter must give an exit opportunity to the dissenting shareholders when the company is undergoing the process of alteration of the objects clause of the memorandum of association³⁶ or while a variation of contracts or altering the objects in the prospectus³⁷ respectively.

Section 102 - Under this provision, the promoters are duty-bound to disclose their pecuniary or any other interest in a statement that needs to be annexed with notice for the general meeting in which items of special business are being transacted. Failure to disclose their interest attracts

³⁴ Companies Act 2013, s 2(69)(c)

³⁵ *Subhkam Ventures Private Limited v Securities Exchange Board of India* Civil Appeal No 3371 of 2010

³⁶ Companies Act 2013, s 13

³⁷ Companies Act 2013, s 27

a fine of fifty thousand rupees or five times the amount of benefit³⁸ which is secret profit, whichever is more.

Section 167 - Under this provision, the promoter shall appoint a director in a situation where all the directors vacate the office.

Section 284 - Under this provision, the promoters are duty-bound to cooperate with the company liquidators at the time of winding up, and failing to do so may attract imprisonment of a maximum term of six months or a fine up to Rs. 50,000 or both³⁹.

THE TRUE MEANING OF SECRET PROFIT

The relationship between promoters and the company, whether it is an agency relationship, or do the promoter have any liability towards a pre-incorporation contract is a well-settled law. This article will only shed light on the fiduciary relationship between a promoter and a company. The courts of various jurisdictions on various occasions have concluded that the promoters have a fiduciary relationship with the company. In *Erlanger v New Sombrero Phosphate Co*⁴⁰, Erlanger purchased an island that had phosphate mines for 55,000 pounds and then incorporated a company called New Sombrero Phosphate Co and sold the island to that company for 1,10,000 pounds. The company had five directors, two of them stayed abroad and two out of the other three were completely under Erlanger's control.

A prospectus was issued and many people purchased its shares the purchase of the island was ratified by the shareholders, but the true scenario of the purchase was not disclosed. The true picture came out when the company failed and went into liquidation and the liquidator sued the promoter (Erlanger) to refund the profit.⁴¹

Lord Cairns opined that promoters have a fiduciary relationship with the company because the power of defining how the company will be set up and start functioning lies in the hands of

³⁸ Companies Act 2013, s 102(5)

³⁹ Companies Act 2013, s 284

⁴⁰ *Erlanger v New Sombrero Phosphate Co* (1878) LR 3 AC 1218

⁴¹ Avtar Singh, *Company Law* (17th edn, Eastern Book Company 2022) 137-138

promoters⁴². This position was accepted by the Madras High Court in *Weavers Mills Ltd v Balkis Ammal*⁴³. A person who has a fiduciary relationship with the company owes the company a duty of good faith and is required to disclose his interests, i.e. the promoter must disclose all of his interests. In *Erlanger's Case*, it was held that a promoter shall fully disclose the character, value, and other information about the property, including personal interest in the property and the transaction. It is necessary because in such a situation there is a conflict of interest⁴⁴. The company is the buyer of the property whereas the promoter acts as a vendor of the same. The vendor would always try to overvalue the price of the property to earn a profit and the buyer would always try to purchase at the best or the lowest price possible.

Since a Promoter is a fiduciary to the corporation and as such is not entitled to make any secret profit out of transactions in which he acts in his fiduciary capacity.⁴⁵ Therefore, it was stated that the chief duty of the promoter as a fiduciary agent is to disclose his interest, profit, and position in the property which the company is buying or selling.⁴⁶ If the disclosures are not made properly, the transaction will be void and the promoter has to compensate for the loss. Therefore, any undisclosed profit made by the promoter by being in an advantageous position is called 'secret profits'.

The law does not prohibit promoters to earn profit⁴⁷ but the only restriction imposed upon the promoter is that of disclosure. It was held in *Erlanger's Case* that the interest of the promoters should be disclosed to an independent board. However, it is not always possible for a company to have an independent board of directors. This position was clarified by the House of Lords in *Gluckstein v Barnes*⁴⁸, where the court opined that if a company is not able to constitute an

⁴² *Erlanger v New Sombrero Phosphate Co* (1878) LR 3 AC 1218 (Lord Cairns)

⁴³ *Weavers Mills Ltd* (n 9)

⁴⁴ *Erlanger* (n 42)

⁴⁵ ESB, 'Fiduciary Capacity of Promoters. Liability to Corporation for secret profits' (1910) 58(4) University of Pennsylvania Law Review 226-230

⁴⁶ Avtar Singh (n 41) 137

⁴⁷ *Omnium Electric Palaces Ltd v Baines* (1914) 1 Ch 332

⁴⁸ *Gluckstein v Barnes* (1900) AC 240

independent board of directors, the promoter shall disclose his interest, position, and profit to all the shareholders of the company⁴⁹.

In the United States, the courts have had a similar view. In *Old Dominion Copper Mining Co v Bigelow*⁵⁰,

*“the court lays down four methods by which a promoter might, notwithstanding his fiduciary relation, make his transaction with the corporation lawful and binding: (1) a full disclosure to an independent board of officers in no manner under his control; (2) a disclosure to each original subscriber; (3) a ratification of the contract by the stockholders of the completely established corporation; (4) by becoming to the real subscriber to all the capital stock contemplated”*⁵¹

Now, by the Companies Act, 2013⁵² and also the Securities Exchange Board of India (Listing Obligations and Disclosure Requirements) Regulation, 2015⁵³, ratification by the shareholders in the general meeting has been made mandatory for these kinds of transactions, which are also known as related party transactions. If a company meets certain criteria set by the rules which get amended as required, it has to mandatorily pass a special resolution before entering into such a contract or after entering into it. The SEBI regulations are stricter in this regard, which imposes a duty on independent directors of the audit committee to approve these transactions if it exceeds a material threshold. Also, under Section 102 of the Companies Act, 2013 as discussed earlier.

CONCLUSION

Thus, from the above discussion, it can be concluded that the definition of ‘promoter’ has been incorporated purposively in both the Companies Act, 2013 and the SEBI Regulations and is very wide, but the law is still not clear on the role a promoter has post-incorporation. In India, most companies are family-owned or promoter-driven companies, although they have contributed

⁴⁹ *Ibid*

⁵⁰ *Old Dominion Copper Mining Co v Bigelow* (1909) 203 Mass 159, 178

⁵¹ LBB, ‘Promoters: Liability of Promoter to Corporation for Secret Profits’ (1925) 13 (3) California Law Review 240-245

⁵² Companies Act 2013, s 188

⁵³ Securities Exchange Board of India (Listing Obligations and Disclosure Requirement) Regulation 2015, reg 23

the most to the growth of India's economy in the past decades, but, there have been many cases of malpractice, manipulation, and fraud by the promoters, which can be reduced by making the roles of promoter post incorporation of the company more clear and by imposing more duties and liabilities on them.