Pre-incorporation Transactions
- A Comparative Analysis -

by

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Abstract

Whether in common law jurisdictions or in German civil law, the issue of pre-incorporation transactions has always been the subject of considerable controversy. Concerned with the promoters, third parties, the company and its shareholders, the law has found it difficult to balance these frequently conflicting interests without neglecting the need for clear and simple rules. Common law courts, sometimes excessively committed to legal principles, have even come up with absurd results.

This survey looks at the various attempts made in order to reconcile legal principles and business requirements - legislative in most common law jurisdictions, juridical in Germany. It will critically examine the approaches taken in Anglo-Saxon jurisdictions and compare their results and reasoning with the solution found in German law. It will be seen that even among closely related legal systems, results differ considerably. The survey will illustrate how established rules of law have turned out to be largely incapable of meeting the challenge of pre-incorporation transactions. From a comparative point of view, some suggestions will be made in order to achieve a solution that is more satisfactory in result and reasoning.

Résumé

En Allemagne comme dans les pays de common law, la question des transactions pré-incorporatives a toujours suscité une vive controverse. Soucieux de la protection des promoteurs, des tiers, de la compagnie et des associés, le droit a toujours eu des difficultés à harmoniser ces intérêts fréquemment en conflit, sans perdre de vue le besoin pratique de disposer de règles simples et claires. Parfois excessivement portées à maintenir les principes légaux, les cours anglo-saxonnes sont même allées jusqu'à s'accommoder de résultats absurdes.

Cette étude considère les diverses tentatives faites dans le but de réconcilier les principes légaux et les réclamations de la vie commerciale. Elle analyse de façon critique les approches faites dans les différents pays prédominés de common law et compare les résultats et le raisonnement avec la solution adoptée en droit civil allemand. Elle révèle que les résultats diffèrent considérablement, même parmi les pays dont les systèmes légaux se ressemblent beaucoup. L'analyse met en relief la manière dont les principes légaux se sont montrés impropres à faire face au défi que le domaine des transactions pré-incorporatives représente. La perspective offerte par le droit comparé permet de faire des propositions visant à aboutir à une solution plus satisfaisante quant au résultat et au raisonnement sous-jacent.

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Abbreviations

A.	Atlantic Reporter
A.C.	Appeal Cases
Adel. L. Rev.	Adelaide Law Review
ADHGB	Allgemeines Deutsches Handelsgesetzbuch
AG	Aktiengesellschaft
AktG	Akiengesetz
al.	alii
Ala., S.C.	Supreme Court of Alabama
All E.R.	All England Law Reports
Am Jur	American Jurisprudence
Ariz., C.A.	Court of Appeals of Arizona
art.	article
Auckland U.L. Rev.	Auckland University Law Review
Austr. H.C.	High Court of Australia
Austr. Lawyer	Australian Lawyer
Austr. L.J. Rep.	Australian Law Journal Reports
BB	Betriebsberater
B.C.C.A.	British Columbia Court of Appeal
B.C.S.C.	Supreme Court of British Columbia
BGB	Bürgerliches Gesetzbuch
BGHZ	Entscheidungen des Bundesgerichtshofs in Zivilsachen
B.L.R.	Business Law Reports
B.R. (American law)	Bankruptcy Reports (U.S.)
B.R. (Québec law)	Recueil de jurisprudence de la Cour du Banc de la Reine (or Banc du Roi)
c.	Chapter
Ca.	California
C.A.	Court of Appeals or Cour d'Appel
Cah. de Dr.	Les Cahiers de droit (Université Laval)
Camb. L.J.	Cambridge Law Journal
C.B.C.A.	Canada Business Corporations Act
C.B.L.J.	Canadian Business Law Journal
C.C.L.C.	Civil Code of Lower Canada
Ch. D.	Chancery Division
C.J.	Lord Chief Justice
C.L.R.	Commonwealth Law Reports
Col. L. Rev.	Columbia Law Review
Colo., S.C.	Supreme Court of Colorado
Conv. & Prop. Law.	The Conveyance and Property Lawyer

C. P. (English law)	Common Pleas
C. P. (Québec law)	Cour provinciale
C.P.D.	Law Reports, Common Pleas Division
C.S.	Recueils de jurisprudence de la Cour supérieure
Ct.	Court
DB	Der Betrieb
Dist. Ct.	District Court
D.L.R.	Dominon Law Reports (Canada)
Duquesne L. Rev.	Duquesne Law Review
E. & B.	Ellis and Blackburn's Reports
ed.	edition
F.	Federal Reporter
Ga., S.C.	Supreme Court of Georgia
GmbH	Gesellschaft mit beschränkter Haftung
GmbHG	Gesetz betreffend die Gesellschaften mit beschränkter Haftung
GmbH-Rdsch.	GmbH-Rundschau
G.O.Q.	Gazette officielle du Québec
Harv. L. Rev.	Harvard Law Review
HGB	Handelsgesetzbuch
H.L.	House of Lords
I.C.L.Q.	International and Comparative Law Quarterly
i.e.	id est
Ill., S.C.	Supreme Court of Illinois
Ind., App. Ct.	Appeal Court of Indiana
Ind., S.C.	Supreme Court of Indiana
J.	Justice
J.B.L.	Journal of Business Law
JurA	Juristische Analysen
JuS	Juristische Schulung
JZ	Juristenzeitung
Kan., S.C.	Supreme Court of Kansas
Ktcky, C.A.	Court of Appeals of Kentucky
La., C.A.	Court of Appeal of Louisiana
L.J.	Lord Justice
L.J.Q.B.	Law Journal, Queen's Bench Report
LM	Lindenmaier-Möhring
L.R.	Law Reports
L.R.Q.	Lois refondues du Québec
L.Q.R.	Law Quarterly Review
Man. C.A.	Court of Appeals of Manitoba

Man. K.B.	Manitoba King's Bench
Marquette L. Rev.	Marquette Law Review
Mass., S.J.C.	Supreme Judicial Court of Massachusetts
McGill L.J.	McGill Law Journal
Md., C.A.	Court of Appeals of Maryland
Mich. L. Rev.	Michigan Law Revue
Mich., S.C.	Supreme Court of Michigan
M.L.R.	Modern Law Review
Mont., S.C.	Supreme Court of Montana
n.	note
N.C., S.C.	Supreme Court of North Carolina
N.E.	Northeastern Reporter
Nev., S.C.	Supreme Court of Nevada
Nfld. S.C.	Supreme Court of Newfoundland
N.H., S.C.	Supreme Court of New Hampshire
N.J. Ct. of Ch.	New Jersey Court of Chancery
NJW	Neue Juristische Wochenschrift
N.L.J.	New Law Journal
N.S.S.C.	Supreme Court of Nova Scotia
N.S.W., F.C.	New South Wales, Full Court
N.S.W.S.R.	New South Wales State Reports
N.S.W.W.N.	New South Wales Weekly Notes
N.W.	Northwestern Reporter
N.Y., C.A.	Court of Appeals of New York
N.Y.S.	New York Supplement
N.Z. L.R.	New Zealand Law Reports
N.Z.L. Rev.	New Zealand Law Review
N.Z., S.C.	Supreme Court of New Zealand
N.Z.U.L. Rev.	New Zealand Universities Law Review
OLG	Oberlandesgericht
Ont. C.A.	Ontario Court of Appeals
Ont. H.C.	Ontario High Court
Ont. S.C.	Supreme Court of Ontario
Or., S.C.	Supreme Court of Oregon
Otago L. Rev.	Otago Law Review
O.W.N.	Ontario Weekly Notes
P.	Pacific Reporter
para.	paragraph
Pa., S.C.	Superior Court of Pennsylvania
P.C.	Privy Council
Q.B.D.	Queen's Bench Division
R.P.	Rapports de Pratique de Québec
R.D.I.	Revue de droit immobilier

R. du B.	Revue du Barreau
R. du N.	Revue du Notariat
RGZ	Entscheidungen des Reichsgerichts in Zivilsachen
Rocky Mountain L. Rev.	Rocky Mountain Law Review
R.S.P.E.I.	Revised Statutes of Prince Edward Island
R.S.S.	Revised Statutes of Saskatchewan
R.S.Y.	Revised Statutes of the Yukon Territory
Rutgers L. Rev.	Rutgers Law Review
s.	section
S.A.	Statutes of Alberta
Sask. C.A.	Saskatchewan Court of Appeals
Sask. Q.B.	Saskatchewan Queen's Bench
Sask. R.	Saskatchewan Reports
S.C.R.	Supreme Court Reports (Canada)
S.E.	Southeastern Reporter
S.M.	Statutes of Manitoba
S.N.	Statutes of Newfoundland
S.N.B.	Statutes of New Brunswick
So.	Southern Reporter
S.O.	Statutes of Ontario
Southwestern L.J.	Southwestern Law Journal
suppl.	Supplement
Sydney L. Rev.	Sydney Law Review
S.W.	Southwestern Reporter
Tenn., C.A.	Court of Appeals of Tennessee
T.L.R.	Times Law Reports
Tulane L. Rev.	Tulane Law Review
U.B.C. L. Rev.	University of British Columbia Law Review
U.B.C. L. Rev. - Cah. de Dr.	University of British Columbia - Les Cahiers de Droit (Université Laval): Centennial Edition 1967
U. Det. L.J.	University of Detroit Law Journal
U.K.	United Kingdom
U. Pa. L. Rev.	University of Pennsylvania Law Review
U. Queensl. L.J.	University of Queensland Law Journal
U.S.C.A.	United States Court of Appeals
U.T. Fac. L.Rev.	University of Toronto Faculty of Law Review
U.W. Austr. L. Rev.	University of Western Australia Law Review
v.	versus

Va., S.C.A.	Virginia Supreme Court of Appeals
vol.	volume
Wash., C.A.	Court of Appeals of Washington
Wash., S.C.	Supreme Court of Washington
WM	Wertpapier-Mitteilungen
W.W.R.	Western Weekly Reports
Yale L.J.	Yale Law Journal
ZGR	Zeitschrift für Gesellschaftsrecht
ZIP	Zeitschrift für Wirtschaftsrecht und Insolvenzpraxis

I. Introduction

"What are the roots that clutch, what branches grow out of this stony rubbish?", asks Leon Getz, quoting from T.S. Elliot's "The Waste Land" at the beginning of his article on pre-incorporation transactions[1]. The law of pre-incorporation transactions has developed considerably since Leon Getz wrote his article more than twenty years ago. Whereas most American jurisdictions have never followed the common law approach, the courts of many other common law jurisdictions, which had originally adopted the common law rules, have subsequently enacted modifying statutory provisions in the last two decades. We will look at what Leon Getz seems to consider as a "stony rubbish" and ask if the recent developments in the law of pre-incorporation transactions justify this view. We will cast a look at the German approach and compare it with the approach taken in common law jurisdictions.

This analysis is not only of academic, but also of practical interest. Contracts made in the pre-incorporation period raise basic questions of law. Fundamental principles of contract, agency and corporate law are at issue, challenged by the businessman's need for simple and easily applicable rules for situations that occur daily. Usually, making contracts during the pre-incorporation period is unavoidable. Equipment has to be bought, workers have to be employed, premises have to be provided, etc. before a business can be started. In order to benefit from profitable opportunities one may

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1 Leon Getz, "Pre-incorporation Contracts: Some Proposals" (1967) U.B.C.L. Rev. - Cah. de Dr. 381.

need to enter into binding agreements before incorporation. The opportunity could be lost if the businessman waited for the day the incorporation becomes effective. The need for clear and simple rules has not progressed with the increasing speed in which a company can be incorporated in common law jurisdictions today. There being no official valuation test of non-cash contributions, incorporation can be completed within a few weeks[2] or even within a couple of days[3] whereas, in Germany, where non-cash contributions must be so valued, registration proceedings usually take one to three, or sometimes even up to six months or longer[4]. We do not share the opinion[5] that the problems arising in the context of pre-incorporation agreements become more and more obsolete due to the short time in which incorporation can be achieved. There can still be circumstances in which a binding agreement has to be made immediately in order to avoid situations where a third party contracts with someone else. Immediately binding agreements also make sense from the third party's point of view: it can never be sure that incorporation will take effect - at the predetermined time or ever. Finally, pre-incorporation transactions will remain significant regardless of the shortening of the delay in becoming incorporated because one must first determine if the business prospects are favourable in order to incorporate and this may frequently require the entering into of pre-incorporation contracts (employment agreements,

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2 M.R. Bucknill, "*Pre-incorporation Contracts*" (1986) 12 N.Z.L. Rev. 27 at 48.

3 F.H. Buckley & M.Q. Connelly, *Corporations - Principles and Policies*, 2nd ed. (Toronto: Emond Montgomery, 1988) at 136.

4 G. Derwisch-Ottenberg, *Die Haftungsverhältnisse der Vor-GmbH* (Berlin: Duncker & Humblot, 1988) at 19.

5 M.R. Bucknill, *supra*, note 2 at 47.

purchase contracts, leases etc.). Furthermore, since all of them are "interdependant" in the sense that the business cannot be started without any of them, a large number of contracts have to be made before incorporation is filed, no matter how short the delay for incorporation is[6].

Pre-incorporation contracts still being of considerable practical importance, the legal rules established to settle this issue cannot be understood without looking at the potentially conflicting interests of the parties that are directly or indirectly involved in the making of pre-incorporation agreements. Those who actually make the agreement on the future company's behalf are interested in binding the contracting party immediately, but they do not want to incur personal liability - quite understandable because they do not consider themselves beneficiaries of the contractual undertakings. If personal liability cannot be avoided, then at least they want to have the possibility of having recourse against the company. The third party's interest, of course, may be in conflict with the acting person's interest. Assuming that the company may be bound in advance, it will nevertheless appreciate personal liability very much because it is far from clear whether the company will have enough assets to cover the debts. But it is not only the creditor's well-known wish to have as many debtors as possible that makes him interested in personal liability. Whatever the reason may be, it might happen that the company will never be incorporated. Should the third party be left without any recourse?

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6 F.J. Nugan, "Pre-incorporation Contracts" in J.S. Ziegel, ed., *Studies in Canadian Company Law* (Toronto: Butterworths, 1967) at 197; R.L. Simmonds & P.P. Mercer, *An Introduction to Business Associations in Canada* (Toronto: Carswell, 1984) at 449; M. Martel & P. Martel, *La Compagnie au Québec*, vol. 1, *Les aspects juridiques* (Montréal: Wilson & Lafleur/Martel, 1989) at 95.

The creditors of the once incorporated company will not object to the personal liability of persons who made contracts before the company was incorporated. But they will strongly disagree with the company's liability for pre-incorporation contracts because such liability could jeopardize their own chance to recover against the company which possibly does not have sufficient assets to satisfy all creditors. Inasmuch as the law recognizes the creditor's interests in preserving the company's initial assets, their interests have to be taken into account all the more when formulating rules for pre-incorporation transactions. The compnay itself will also be opposed to binding contracts made before it came into existence because its shareholders are not necessarily identical with the persons who actually made the contracts. It is true that the latter will usually hold shares of the company or be its directors. But as there might be additional shareholders and other directors, the company's approval of the pre-incorporation activities is not certain. On the other hand, it must be observed that the company might be interested in entering into contracts that appear profitable. It will therefore not reject liability for pre-incorporations per se, but accept it if the contract seems to be advantageous.

In view of the fact that the parties that are involved in some way or another in pre-incorporation transactions have such conflicting interests, it does not surprise that the approaches taken to resolve the problems result sometimes in completely diverging solutions.

II. Pre-incorporation Transactions at Common Law

1. The Liability of the Company

When dealing with pre-incorporation transactions two questions have to be distinguished, the liability of the company and the liability of the so-called promoter. We will look at the company's liability first because the agreements are made with the company in mind, not in the interest of the person who acted during the pre-incorporation period.

a. Locus Classicus: *Kelner* v. *Baxter*

For a long time now, *Kelner* v. *Baxter*[7] has been cited as the leading case in the context of pre-incorporation transactions. The facts of this case, decided in 1866, are simple: Baxter and his associates decided to form a corporation to operate a hotel. The plaintiff, a dealer in wines, offered to sell wine to the defendant and his associates "on behalf of the *proposed* Gravesend Royal Alexandra Hotel Company Limited". Baxter and his associates accepted the offer all signing "on behalf of the Gravesend Royal Alexandra Hotel Company Limited" The word 'proposed' the plaintiff had used was omitted. After incorporation, the company 'ratified' the contract. Soon afterwards, it went bankrupt. The plaintiff who had never been paid sued Baxter and the other signatories - with success as we will see later. The chances for success would possibly have been less if the company was bound by the contract, either from the outset or by stepping in after

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[7] (1866), L.R. 2 C.P. 174 (emphasis added).

incorporation thus replacing the defendants as contracting partners. Both possibilities were rejected by the Court. The defendants having no authority from a principal who at the time the contract was made was not yet in existence could not bind the future company merely by declaring that they acted on behalf of the company. The Court also rejected the idea that the company could have been bound by declaring that it 'ratified' the contract. As Willes J. stated, "ratification can only be by a person ascertained at the time of the act done - by a person in existence either actually or in contemplation of law"[8]. The statement is in accordance with the idea the principle of ratification is based on: ratification is supposed to be an "equivalent to an antecedant authority"[9]. It is intended to fill the gap that arises from lack of authority, whether the agent acted without any authority or just exceeded it. Since its effect is confined to remedying the lack of authority, the principle of ratification does not go so far as to create a principal where there has never been one[10]. In the result, at common law, a company can only benefit from a pre-incorporation contract made on its behalf if it makes, on the same terms as the old, a new contract with the third party[11]. An express contract is not required. It is sufficient that the

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8 *Kelner v. Baxter* (1866), L.R. 2 C.P. 174 at 184, Willes J.

9 *Koenigblatt v. Sweet* (1923), 2 Ch. 314 (C.A.) at 325, Lord Sterndale M.R.

10 F.M.B. Reynolds, *Bowstead on Agency*, 15th ed. (London: Sweet & Maxwell, 1985) at 51.

11 *Howard v. Patent Ivory Co.* (1888), 38 Ch. D. 156; *Touche v. Metropolitan Ry. Warehousing Co.* (1871), L.R. 6 Ch. App. 671; *Melhado v. Porto Alegre Rly Co.* (1874), L.R. 9 C.P. 503; *Re Empress Engineering Co.* (1880), 16 Ch. D. 125 (C.A.) at 128.

new contract can be inferred from the company's behaviour after incorporation[12].

b. The Common Law Rule - An Appropriate Solution?

The common law rule on the company's liability for pre-incorporation transactions appears to respect basic legal principles[13]: it is in accordance with the rules of contract law that a contract has to be made by two existing parties and that a third party cannot interfere with a contract made by other parties. The common law seems also to comply with fundamental agency rules to the extent that ratification cannot remedy the lack of a principal not in existence when the contract was made. And finally, it corresponds to one of the basic ideas of corporate law: the idea of the company as a *separate* legal entity. A legally sound solution - but is it an appropriate solution? Of course, legally sound rules may claim the presumption to be just and adequate solutions. In the context of pre-incorporation transactions, however, this presumption has been frequently put in question. Indeed, there is enough reason to doubt whether the common law position reflects the subject matter it governs properly. With regard to the interests of the parties directly or indirectly involved in pre-incorporation transactions, the common law position does not appear convincing. It is admitted that a solution to the effect that all pre-incorporation contracts bind the company automatically is, at least per se,

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12 *Re Empress Engineering Co.* (1880), 16 Ch. D. 125 (C.A.) at 128; *Re Rotherham Alum. and Chemical Co.* (1883), 25 Ch. D. 103 (C.A.).

13 M.H. Ogilvie, *Case Comment* (1983) U.B.C.L. Rev. 321 at 332.

problematic because it binds the company without giving it a chance to decide whether it wants to be bound or not. The creditors of the incorporated company, too, would object since a solution for the automatic transfer of contractual obligations on the company puts at risk their chance of payment. It is not evident, however, why the company should not be entitled to step into contracts that appear profitable Such a right would not affect the new creditor's justified interests because the company could make a new contract instead; against the company making contracts, new creditors are never protected. Also from the point of view of those who actually entered into a contract, the right of the company to step into pre-incorporation contracts unilaterally would not affect their interests. The company is not a stranger that interferes with contractual relations of third parties. Only under such circumstances the contracting parties would be entitled to protection. In the case of pre-incorporation contracts as in *Kelner* v. *Baxter*, however, it is understood between the contracting parties that the company, not the person that acted on its behalf, should take the benefit. Therefore, the company cannot be looked upon as a stranger to the contract.

The common law rule is not only unsatisfactory because it does not properly reflect the interests of the partners involved. It is also highly objectionable in view of the manner it has been developed by the courts. As mentioned above, assuming a new contract between the company and the third party does not require an express contract; it is sufficient that mutual consent can be inferred from the parties' behaviour. In most cases, the parties do not enter into a formal agreement, but simply act as if the contract was made between the company and a third party: services are

rendered, goods delivered and money is paid. The company shows that it considers itself to be bound contractually. The third party, usually at least, does not mind because it has made the contract in view of the future company. Considering that the courts will mostly have to look at the parties' behaviour for want of an express agreement, the common law requirement for a new contract does not appear to be far away from mere 'ratification'[14] always provided, of course, that the third party is willing to consider the company as its contracting party. Unfortunately, what seems to be evident at first glance is not the state of the law as it emerges from the cases.

In *Re Northumberland Avenue Hotel Co. Ltd.*[15], the company took possession of land that had been leased on its behalf, started construction works and acted on the agreement: circumstances that appear to justify that the company wanted to be bound by the lease. Quite wrong according to the Court of Appeal! It argued that acting on the old agreement did not imply that the company entered into a new contract. Putting much emphasis on the requirement of a new contract, it drew a sharp line between the intention to make a new contract and the belief that it is still the old contract the parties act upon. This subtle distinction has been confirmed in other cases[16]. The distinction being of a very subjective nature it is clear that it becomes very difficult to establish a new contract inasmuch as its making

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14 N.N. Green, "Security of Transaction After Phonogram" (1984) 47 M.L.R. 671 at 687.

15 (1886) 33 Ch. D. 16 (C.A.).

16 *Bagot Pneumatic Tyre Co.* v. *Clipper Pneumatic Tyre Co.* (1901), [1902] 1 Ch. 1346 (C.A.); *Natal Land Co.* v. *Pauline Colliery Syndicate* (1903), [1904] A.C. 120 (P.C.).

is often inferred from the parties' behaviour. As it appears from *Northumberland*[17], even variations on the old contract's terms are not considered to be sufficient indicia for the intention to enter into a new contract although they clearly indicate that new negotiations must have taken place. In an earlier case[18], modifications of the contract's terms had been taken as sufficient evidence of the parties' intention to enter into a new contract. Considering these uncertainties, the requirement for a new contract virtually amounts to the need for a formal agreement; in view of the courts' fine distinction, there is not much room for the application of the general contract rule that contracts can also be made implicitly.

Besides these more practical objections against the common law rule, there might even be reasons to call into question the legal arguments the common law rule is based upon. It is admitted that in denying the company's right to ratify the contract the underlying principle is applied correctly. But this might still be purely legalistic because it is far from clear if the reasoning behind the rule fits the situation. Generally, it is quite justified to deny a third party the right to interfere with a contract between two parties; this would amount to imposing a contracting party without the other party's consent. In the area of pre-incorporation transactions, however, the situation is different: the contract is made on behalf of the future company. If the company accepts to step into the contract, it cannot be said that a stranger is imposing himself as a contracting party on a third party that has

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17 *Supra*, note 15.

18 *Howard v. Patent Ivory Manufacturing Co.* (1888), 38 Ch. D. 156.

never heard of him. Therefore, the telos of the ratification principle does not require its literal application on pre-incorporation transactions[19]

The foregoing analysis illustrates quite clearly that the common law rule regarding the company's liability for pre-incorporation transactions cannot be considered to be an appropriate one, either from a commercial point of view or in legal terms.

c. Equitable Devices

(i) Adoption

It is not surprising that the courts have looked for devices in order to evade the calamities caused by strict application of the rule in *Kelner* v. *Baxter*. It was held that equity would enforce pre-incorporation contracts if the company 'adopted' them[20]. To give the company the right to step into the contract, of course, avoids the difficulties created by the common law rule. But looked at it closely, there can be no doubt that it is nothing but a semantic device[21]. Technically, adoption and ratification mean the same. There appears to be no reason why they should not be treated the same way from a legal point of view. With reference to the synonymous meanings of

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19 L. Getz, *supra*, note 1 at 383.

20 *Re Hereford & South Wales Waggon and Engineering Co.* (1876), 2 Ch. D. 621; *Spiller* v. *Paris Skating Rink Co.* (1878), 7 Ch. D. 368 (P.C.).

21 L. Getz, *supra*, note 1 at 383.

he two notions, subsequent Privy Council decisions withdrew this approach[22].

(ii) Trust

The common law does not recognize contracts to the benefit of a third party[23] because there is no privity of contract. But this does not mean that it is generally impossible to confer a benefit upon a third party. Apart from the possibility of assigning the contractual rights the contracting parties may set up a trust in favour of the third party. By virtue of the trust agreement, the third party is entitled to get the benefits from the contract, incurring at the same time all burdens[24] The claim has to be asserted against the trustee. There is no direct claim against the trustee's contracting party, nor can the latter enforce the contract against the beneficiary. All that the trust scheme allows is to give the beneficiary a right to the subject matter of the trust. Nonetheless, the application of a trust scheme to pre-incorporation transactions appears to be promising for, at least, it would resolve the problem that, at common law, the company cannot step into the contract unilaterally. It is amazing, however, that the trust device has not been widely used[25].

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22 *Re Empress Engineering Co.* (1880), 16 Ch. D. 125; *Re Rotherham Alum & Chemical Co.* (1883), 25 Ch. D. 103; *Natal Land Co.* v. *Pauline Colliery Syndicate* (1903), [1904] A.C. 120 (P.C.); *North Sydney Investment and Tramway Co.* v. *Higgins* (1899), A.C. 263 (P.C.).

23 *Dunlop Pneumatic Tyre Co. Ltd.* v. *Selfridge & Co. Ltd.* (1914), [1915] A.C. 847 (H.L.).

24 *Hardoon* v. *Belilios* (1900), [1901] A.C. 118 (P.C.) at 123.

25 N.E. Palmer, "Pre-incorporation Contracts and the Implied Warranty of Authority", (1975) 9 U. Queensl. L.J. 123 at 124 n. 10.

What are the reasons? To be valid a trust has to meet the three certainties requirement. There has to be certainty of intention, of subject matter and of object. Provided the parties made clear that they intended to set up a trust, only the certainty of object requirement seems to be problematic for at the time the agreement is made the beneficiary is not yet in existence In general, equity does not give effect to trusts that lack of a beneficiary who could enforce the trust. For that reason, purpose trusts are declared void[26] with the exception of charitable trusts which are enforced by the Crown. The rule that personal trusts are valid only if there is a beneficiary has not been applied to trusts created in favour of an unborn child, however. There seems to be no convincing reason why this rule should not apply to an unborn company analogously. In the case of an unborn child, the exception is justified on the ground that the beneficiary is, although not described with certainty, at least ascertainable by reference to his parents. It could be argued similarly in the case of an unborn company[27]. Name and founders of the company are known. Therefore, from a theoretical point of view there seems to be no reason why it should be impossible to set up a trust for a company that is not yet in existence[28]. In view of the "wait and see" rule, the application of the trust scheme is not objectionable even under the rule against perpetuities[29]. The obvious analogy between an unborn child and an unborn company did not escape the courts' notice. In a different context, it

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26 *Re Astor's Settlement Trusts* (1952), 1 Ch. 534.

27 B. Welling, *Corporate Law in Canada - The Governing Principles* (Toronto: Butterworths, 1984) at 286; P.D. McKenzie, "The Legal Status of the Unborn Company" (1973) 5 N.Z.U.L. Rev. 211 at 216.

28 M.R. Bucknill, *supra*, note 2 at 32.

29 P.D. McKenzie, *supra*, note 27 at 216.

was said in *Leeds and Henley Theatres of Varieties Ltd.*[30]: "Though a man cannot be an agent for a non-existent company, may he not be a trustee for it? There can be a trust for unborn children."

Nevertheless, as it appears from the cases, the trust device has not received much support by the courts. Several decisions[31] dealing with the company's liability after adoption of a contract made by a trustee miss the trust point totally[32] focussing only on agency principles[33] The essential question whether a company can claim the benefits under a trust agreement was dealt with only in an early Canadian case[34]. The court denied the question relying on privity of contract arguments: as the company cannot be bound by pre-incorporation contracts, it follows that it cannot receive the benefits either. Without expressing it, the court seems to be reluctant to set aside the rule in *Kelner* v. *Baxter* just by recognizing the trust device. The strict application of agency principles as put forward in *Kelner* v. *Baxter* has been given priority over equally compelling trust rules - a decision that is hard to understand and fairly unsatisfactory[35].

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30 (1902), 2 Ch. 809 (C.A.) at 819, Romer L.J.

31 *Re Northumberland Avenue Hotel Co.* (1886), 33 Ch. D. 16 (C.A.); *North Sydney Investment and Tramway Co.* v. *Higgins* (1899), A.C. 263 (P.C.); *Re National Motor Mail Coach Co., Clinton's Claim* (1908), 2 Ch. D. 515; *Official Assignee of Motion* v. *N.Z. Sero-Vaccine Ltd.* (1935), N.Z.L.R. 856 (N.Z., S.C.).

32 B. Welling, *supra*, note 27 at 287.

33 P.D. McKenzie, *supra*, note 27 at 219.

34 *Cass* v. *McCutcheon* (1905), 15 Man. L.R. 669 (Man. K.B.).

35 In Canada, there were and there still are statutory provisions dealing with pre-incorporation trusts. They will be discussed later.

d. Remedies Outside the Law of Contracts

Although there is no contractual basis for mutual claims between the company and the third party, it is as a matter of fact still possible that benefits are conferred upon the company. It would be unjust to allow the company to keep benefits it received by the acquisition of goods or the performance of services without compensating the third party. One would be inclined to say that keeping the benefits implies the making of a contract. As has been seen above, however, this is too a superficial way to look at the problem bearing in mind that the courts accept a new contract only under very narrow circumstances. Trying to avoid unjust results the courts resorted to restitutionary claims.

In *Re Hereford & South Wales Waggon Co.*[36], it was held that remuneration for pre-incorporation services can be claimed on equitable grounds. In *Re Empress Engineering Co.*[37], it was recognized that the third party can sue the company for a quantum meruit. Looking at further cases, one has to state that later decisions do not follow this view. In *Re Rotherham Alum. & Chemical Co.*[38], a solicitor claimed remuneration for services he had rendered to the company. The court dismissed the cause arguing that getting the benefit of work done for someone else, i.e. the person who actually made the pre-incorporation contract, did not mean that the benefitted person is

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[36] (1876), 2 Ch. D. 621 (C.A.).

[37] (1880), 16 Ch. D. 125 (C.A.).

[38] (1883), 25 Ch. D. 103 (C.A.).

liable to pay for it. Later decisions[39] on the issue took a similar view arguing again that getting a benefit does not necessarily give rise to an obligation to pay for it. Although it should be noted that in any event the plaintiff can get remuneration on a quantum meruit basis for services rendered *after* incorporation[40], it has to be concluded that in view of differing judgments the law is confusing and far from being satisfactory[41]. It is amazing to see how clear principles of justice like the idea of restitution are abandoned in order to uphold, at any price, the effect of the rule in *Kelner* v. *Baxter*. The fear of counteracting the rule that the company comes only into play when it wants to is the reason why many courts feel reluctant to recognize claims based on unjust enrichment.

2. The Liability of the Promoter

a. The Term "Promoter"

Given the lack of a statutory definition of the term "promoter", reference has to be made to judge-made definitions. A comprehensive definition, however, has never been given by the courts. But, at least, some guidance can be taken from various decisions. In *Whaley Bridge Calico Printing Co.* v. *Green*[42], for instance, it is emphasized that the term "promoter" is not a

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39 *Re English & Colonial Produce Co.* (1906), 2 Ch. D. 435 (C.A.); *Re National Motor Mail Coaches Ltd.* (1908), 2 Ch. D. 515 (C.A.).

40 *Re Dale and Plant Ltd.* (1889), 61 L.T. 206 (Ch.D.).

41 L. Getz, *supra*, note 1 at 391; R.R. Pennington, *Company Law*, 4th ed. (London: Butterworths, 1979) at 90; B.S. Markesinis, "The Law of Agency and Section 9(2) of the European Communities Act 1972" (1976) 35 Camb. L.J. 112 at 115 n. 19.

42 (1880), 5 Q.B.D. 109.

term of law, but of business, covering "a number of business operations familiar to the commercial world by which a company is generally brought into existence"[43]. Thus, many persons can qualify as promoters[44]. Legal qualifications like agent or director are immaterial. The classification is always a question of fact[45], for promoter can be everyone "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..."[46].

b. The Problem of Determining the Common Law Rule

Whereas the common law position as to the company's liability is clear and unequivocal, the rules governing the promoter's liablity are not easy to determine, although *Kelner* v. *Baxter*[47] - leading case in this area as well - seems to state the law peremptorily: "The cases referred to in the course of the argument fully bear out the proposition that where a contract is signed by one who professes to sign 'as agent' and who has no prinicipal existing at the time, and the contract would be altogether inoperative unless binding on the person who signed it, he is bound thereby"[48]. In a similarly clear

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43 *Ibid*

44 L.C.B. Gower et al., *Gower's Principles of Modern Company Law*, 4th ed. (London: Stevens, 1979) at 325.

45 J.H. Gross, *Company Promoters* (Tel Aviv: The Israel Institute of Business Research, 1972) at 21.

46 *Twycross* v. *Grant* (1877), 2 C.P.D. 469 (C.A.) at 541.

47 (1866), L.R. 2 C.P. 174.

48 *Ibid* at 183, Earle C.J.

manner, Lord Justice Denning (as he then was) suggested, although in an obiter dictum, that "... if [a man] signs 'as agent' and has no principal, the words 'as agent' are rejected and the contract held to be a good contract between the parties..."[49]. Apparently as a matter of law[50], promoters are held to be bound by pre-incorporation contracts thus implying liability and also the right to enforace the contract.

The latter, however, was not the result in another English Case, *Newborne* v. *Sensolid (Great Britain) Ltd.*[51]. Summarized briefly, the facts of this important case are as follows: The plaintiff, Mr. Newborne, was the promoter of a company called Leopold Newborne (London) Ltd. Before the company was registered, he entered into a contract to supply tinned ham to the defendant. The contract was signed "Leopold Newborne Ltd.". The plaintiff wrote his name underneath. Neither he nor the defendant company were aware that Newborne Ltd. was not yet registered. They both thought that the company was in existence. As the market prince of ham fell, the defendant refused to accept the goods. Newborne Ltd., then registered, issued a writ claiming damages. After the writ was issued, it was discovered that the company had not yet been in existence at the time the contract was made. Mr. Newborne in his personal capacity was substituted as plaintiff. At trial[52], it was recognized that the rule as stated in *Kelner* v. *Baxter* did not only affect the promoter's liability, but also his right to

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49 *Nicolene Ltd.* v. *Simmonds* [1953], 1 Q.B. 543 at 551.

50 M.H. Ogilvie, *supra*, note 13 at 324.

51 (1953), [1954] 1 Q.B. 45 (C.A.).

52 [1952], 2 T.L.R. 763 (Q.B.D.), Parker J.

enforce the contract. Although starting from the principles laid down in *Kelner* v. *Baxter*, the learned judge arrived at a different result. Mr. Newborne lost the action on the footing that he had not acted as an 'agent' therefore not fulfilling one of the requirements set out by *Kelner* v. *Baxter*. It was suggested that the contract was made by the company itself, Mr. Newborne's signature merely "authenticating" the company's signature. Therefore, according to the trial judge, Mr. Newborne could by no means become a party to the contract. This decision was affirmed by the Court of Appeal[53].

Kelner and *Newborne* have been the subject of considerable academic dispute. Stating the strong contrast between the conclusions made in both decisions[54] many writers have tried to reconcile both decisions on the ground of a common principle[55]. Others, however, suggested that both decisions were inconsistent[56]. The different positions taken in the academic discussions are reflected in the Australian case of *Black* v. *Smallwood*[57]. The case reveals, like various academic statements, that the

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53 (1953), (1954) 1 Q.B. 45 at 50.

54 G.H.L. Fridman, "Personal Liability of Agent" (1966) 116 N.L.J. 1605; Markesinis, *supra*, note 41 at 116; G.R. Sullivan, "The Liability of Promoter on Pre-incorporation Contracts - Turning the Tables Too Far?" (1983) Conv. & Prop. Law. 119 at 120; Ogilvie, *supra*, note 13 at 334.

55 L. Getz, *supra*, note 1 at 393 ff.; G.H.L. Fridman, *supra*, note 54 at 1605 ff.; R.D. Nicholson, "Contract and Non-Existent Companies" (1967) 3 Austr. Lawyer 1 at 4-5.

56 H.R. Gray, "The Contractual Capacity of Limited Companies" (1953) 17 Conv. & Prop. Law. 217 at 218-219; F.J. Nugan, *supra*, note 6 at 199; G. Shapira, "Directors Without a Company and Other Professing Agents" (1973-76) 3 Otago L. Rev. 309 at 315-316.

57 (1963) 81 N.S.W.W.N. (Pt. 1) 138 (1st instance); (1964) 65 N.S.W.S.R. 431 (N.S.W., F.C.); (1966) 39 Austr. L.J. Rep. (Austr. H.C.).

reasoning in *Newborne* v. *Sensolid* can hardly be said to have elaborated the common law rule as to the promoter's liability.

c. *Kelner* and *Newborne*: Consistent or Incompatible Concepts?

To reconcile both cases attempts have been made to distinguish them on their facts. In the *Kelner* case the contract had been executed, i.e., the goods had been delivered, whereas, in *Newborne's* case, the contract was merely executory: the plaintiff was still in possession of the goods because the defendant did not accept them[58]. This approach is based on the idea that a party should be compensated after having fulfilled its own obligation. Certainly this seems to be just and equitable. Nonetheless, to decide the case on the distinction between executory and executed contracts might turn out to be purely arbitrary: The need for protection of the third party might be the same in the case of executory contracts, for instance when the third party is compelled to cover the order by buying the goods elsewhere at a higher price[59]. On the other hand, it would not have been very convincing to deny the plaintiff's recovery in *Kelner* v. *Baxter* if this had been a case of an executory contract. The attempt to harmonize *Kelner's* and *Newborne's* case on the factual distinction between executory and executed contracts is therefore not persuasive[60].

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58 See G.H.L. Fridman, *supra*, note 54 at 1605; B.S. Markesinis, *supra*, note 41 at 117.

59 B.S. Markesinis, *supra*, note 41 at 118.

60 M.H. Ogilvie, *supra*, note 13 at 335.

Another way of distinguishing the cases is to emphasize the fact that in *Kelner* v. *Baxter* the promoter was sued whereas in *Newborne's* case he was the plaintiff. This would presume that the rule in *Kelner* v. *Baxter* stated merely that a promoter is liable on a contract but without having any rights under it. As previously mentioned, this is not the meaning of the rule; to declare an 'agent' bound by a contract implies necessarily that he is also entitled to the benefit of the contractual rights. This finding was expressly recognized by the trial judge in *Newborne's* case[61]. It is therefore hard to understand why in *Black* v. *Smallwood* - a case which raised the problem of reconciliation between *Kelner* and *Newborne* - the trial judge put much emphasis on the question whether the promoter was plaintiff or defendant[62]. As has been demonstrated, this is not an appropriate approach[63].

A third way to distinguish the cases would be to acknowledge two complementary rules to the effect that someone who acts as an 'agent' becomes bound by the contract whereas those who act as a 'director' do not. This seems to have been the ground on which *Newborne* was decided for there it was held that the plaintiff had not acted as an agent. According to the judgment, it was the company itself that made the contract. This distinction, however, creates considerable doubt. The use of the term 'agent' is not quite adequate because there is no principal on whose behalf the 'agent' could have acted. But this objection is not the crucial one for the court confronted with a pre-incorporation contract case would not look at

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61 See J.H. Gross, "Pre-incorporation Contracts" (1971) 87 L.Q.R. 367 at 384.

62 (1963) N.S.W.W.N. (Pt. 1) 138, Jacobs J.

63 M.H. Ogilvie, *supra*, note 13 at 336; J.H. Gross, *supra*, note 61 at 384.

the promoter's real legal status, but at the position he purports to have. The decisive objection is this: how can a court come to differing conclusions as to the alleged position of the acting person when it is clear from the outset that this person wanted to act for someone else? Not only Baxter purported to act as an agent as was found by the court. Newborne, too, purported to act as an agent. It is hardly understandable how it can be argued that the company made the contract itself because for a company there is no other way to make contracts than by agents. Hence, company directors "authenticating" the (future) company's signature purport to act as agents as well as do promoters who act on behalf of a "proposed" company[64]. There is no room for a secondary agency concept as appear to have been suggested by those who consider Baxter as 'agent', but Mr. Newborne as some kind of instrument[65].

Given the fact that on the ground of *Kelner* v. *Baxter*, Mr. Newborne can just as much be said to have purported to act as agent, does this lead to the conclusion that the cases should have been decided the same way? It would follow that the solution put forward in *Newborne's* case is not consistent with the rule in *Kelner* v. *Baxter*. This in fact has been the opinion of Mr. Justice Walsh, dissenting from the majority opinion delivered in the New South Wales Full Court decision of the *Black* v. *Smallwood* case[66]. His arguments, however, did not convince the Australian High Court which

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64 G.H.L. Fridman, *supra*, note 54 at 1606.

65 A.R. Emmett, "Pre-incorporation Contracts" (1967) 5 Sydney L. Rev. 486 at 489; see also B. Welling, *supra*, note 27 at 283; F.M.B. Reynolds, *supra*, note 10 at 471.

66 (1964) 65 N.S.W.S.R. 431 at 441.

preferred to follow the majority opinion. The case at issue was quite similar to *Newborne* v. *Sensolid* the only difference being that the promoters were not plaintiffs, but defendants. They had signed a purchase contract with the (future) company's name adding underneath their personal names and the word "directors". All parties wrongly believed that the company was incorporated when the contract was made. At trial, the plaintiffs were successful on the ground that, as opposed to *Newborne's* case, the promoters did not claim a right under the contract, but faced contractual liability. This distinction, as mentioned earlier, is not convincing and was not accepted by the Full Court of New South Wales or the Australian High Court. With the exception of Mr. Justice Walsh, both courts considered the solutions achieved in *Kelner's* and *Newborne's* case to be consistent. But they did not arrive at this result by relying on the distinction between agency and some lower degree of agency. The distinction drawn there was a different one: the liability of the promoter should not depend on the question whether he or in fact the company made the contract; the crucial question should be whether the promoter acted merely as an agent or the principal himself, the answer depending on the contracting parties' *intention* [67]. *Kelner* v. *Baxter*, on one hand, and *Newborne's* and *Black's* case on the other, were thus distinguished on the basis that in the first case the parties intended personal liability whilst in the latter they did not. This way to reconcile the cases, of couse, is only open if *Kelner* v. *Baxter* did not state a rule of law impeding a differing construction of the parties'

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[67] (1966) 39 Austr. L.J. Rep. 405 (Austr. H.C.) at 409, Windeyer J.

intention. This, in fact, was the argument made by Mr. Justice Walsh[68]. But looking at the judgments delivered in *Kelner* v. *Baxter* more closely, one has to assume that the judges did not intend to set up a rule of law. Thus, it was said by Willies J.: "... construing this document ut res magis valeat quam pereat, we must assume that the parties *contemplated* that the persons signing it would be personally liable"[69]. And further, by Byles J.: "... the true rule [i]s that persons who contracted as agents are *generally* personally liable ..."[70]. Even Earle C.J.'s reasoning makes it appear that the rule set out like a rule of law is meant to be a rule of construction[71] when the learned judge justifies the result with a view to the factual circumstances, notably the parties' contemplation[72].

In *Black* v. *Smallwood*, the judges were therefore right in supposing that the decision of *Kelner* v. *Baxter* left space for diverging results. It seems that by analyzing the parties' intentions a common principle was found capable of reconciling *Kelner's* and *Newborne's* case. To this extent, *Black* v. *Smallwood* has been widely recognized as a legally sound solution[73], also

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68 (1964) 65 N.S.W.S.R. 431 at 441 ff.; see also W.E.D. Davies, "Personal Liability of 'Directors' of Non-Existent Companies" (1964) 6 U.W. Austr. L. Rev. 400 at 405 (case comment on *Black* v. *Smallwood*, trial decision).

69 L.R.2. C.P. at 185 (emphasis added).

70 *Ibid* (emphasis added).

71 B. Welling, *supra*, note 27 at 283.

72 *Supra*, note 69 at 183.

73 L. Getz, *supra*, note 1 at 396; B.S. Markesinis, *supra*, note 41 at 118; H.K. Lücke, "Contracts Made By Promoters on Behalf of Companies Yet to Be Incorporated" (1966) 2 Adel. L. Rev. 388 at 391; H.K.Lücke, "Contracts Made by Promoters On Behalf of Companies Yet to Be Incorporated" (1967) 3 Adel. L. Rev. 102 at 103; B. Welling, *supra*, note 27 at 276 ff.; R.D. Nicholson, *supra*, note 55 at 4 ff.

followed by the courts as appears from *Phonogram* v. *Lane*[74]. The issue of pre-incorporation transactions is thus reduced to a pure contractual analysis[75].

d. The Contractual Analysis: Does It Make Sense?

The common law position based on the parties' intention has been praised as a technically sound solution, but many writers agree with the statement that the solution does not suit commercial purposes[76]. It has often been said that the Common law solution is hard to justify because it is based on a narrow distinction between two types of signature[77]. In fact, this seems to be the effect of *Kelner* and *Newborne*: whether or not the promoter will be liable depends on the way the contract was signed. But this finding does not address the issue. The main issue remains the parties' intention, and when looking at it the signature is merely part of the evidence, all the surrounding facts being taken into consideration[78]. Thus, Lord Denning was not quite right when saying in *Phonogram* v. *Lane* that the promoter's liability depended on the formula used in signing the contract[79]. Oliver L.J.,

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74 (1981) 3 All E.R. 182 (C.A.).

75 A.R. Emmett, *supra*, note 65 at 491; B. Welling, *supra*, note 27 at 276 ff.; G.R. Sullivan, *supra*, note 54 at 119.

76 L. Getz, *supra*, note 1 at 396; B.S. Markesinis, *supra*, note 41 at 119; G.R. Sullivan, *supra*, note 54 at 120; J. McMullen, "Preliminary Contracts By Promoters" (1982) 41 Camb. L.J. 47 at 48; N.N. Green, *supra*, note 14 at 674 ff.

77 See J. McMullen, *supra*, note 76 at 48.

78 J. McMullen, *supra*, note 76 at 48; N.N. Green, *supra*, note 14 at 676.

79 (1981) 3 All E.R. 182 at 187.

in his concurring judgment, set it right saying that the real question was not to look at the signature, but to ask in a general way what was the real intent of the parties[80]

But to release the common law rule from the suspicion that it relied - as it was said[81] - on pure technicalities does not render it less objectionable. Reference to the intention of the parties is praiseworthy because it leads to the root of the problem, i e. the determination of the contracting parties, but it does not necessarily address the real issue that is at stake. As has been pointed out in the introduction, rules governing pre-incorporation contracts have to take into account the businessman's need for simplicity and efficiency. A rule based on the parties' contemplations appears clear in theory; in practice, however, it gives rise to considerable problems. Knowledge of the non-existence of the company is generally considered a crucial factor in deciding whether the promoter is supposed to have bound himself or not[82]. If the third party knows about the non-existence as in *Kelner* v. *Baxter*, it will be inferred as a rule that the parties wanted the promoter to be bound. In those cases the agreement will operate as if someone bought corn "on behalf of my horses", as Willes J. so graphically put it[83]. In case the third party is not aware of the company's non-existence, there is said to be a strong indicia that it contemplated contracting with

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80 (1981) 3 All. E.R. 182 at 188.

81 G.H. Treitel, "The Law of Conract", 7th ed. (London: Stevens, 1987) at 555 n. 76.

82 *Contra*: R. Baxt, "Personal Liability of an Agent For an Unformed Company - *Kelner* v. *Baxter* Revisited" (1967) 30 M.L.R. 328 at 332.

83 *Kelner* v. *Baxter* (1866), L.R. 2 C.P. 174 at 185.

the company only; since the company is not yet in existence, there will be no contract at all. This will be so even when the promoter realizes that the company is not yet incorporated[84] However, to split up the Common law position in different rules focussing on the third party's knowledge does not provide a satisfactory answer either. As will be seen, the determination of the parties' intention is not as easy as it might appear from the foregoing. It is very doubtful if a distinction turning on the third party's knowledge meets the businessman's need for rules the application of which leads to predictable results.

The English case *Phonogram* v. *Lane*[85] illustrates this very well. The facts, briefly, are as follows: Mr. Lane was promoter of a company to be called "Fragile Management Ltd.". This company was set up to manage a Pop group called "Cheap, Mean and Nasty". Providing for financial resources, Mr. Lane made an arrangement with Phonogram Ltd. to invest £12,000 to be paid to a company called "Jelly Music Ltd.". The money transfer to this company was due to administrative convenience for Mr. Lane was director of this company. Phonogram sent a letter to "Brian Lane, Esq., Fragile Ltd." stating the terms of the contract; at the bottom it contained the following receipt formula: "signed by . . . . for and on behalf of Fragile Management Ltd.". The company was never incorporated, and Phonogram sought to recover from Mr. Lane personally. When the agreement was made, Phonogram was not aware of the fact that the company was not yet in existence. Although a statutory provision had been enacted in England in the meantime, the court dealt in

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84 L. Getz, *supra*, note 1 at 397.

85 (1981) 3 All E.R. 182 (C.A.).

detail with the application of the common law rules. On the basis of the intention test, it held that Mr. Lane had made the contract personally and was therefore obliged to repay the money. This finding, though hardly objectionable as a result[86], is surprising in the light of former cases like *Kelner, Newborne* and *Black*. The fact that Phonogram did not know about the non-existence of Fragile Management puts the case in line with *Newborne* and *Black*. The same impression seems to emerge from the fact that Phonogram's letter was addressed to Mr. Lane as director of Fragile Ltd and that Mr. Lane - from Phonogram's point of view - was supposed to sign as the director of a company presumed to be in existence yet. Hence, the case appears to be much closer to the *Black* and *Newborne* situation[87]. Mr. Lane's liability at common law can therefore hardly be explained on contractual grounds. After all, it has even been doubted if the solution found in *Kelner's* case is truly based on contractual principles[88].

Up to now, it has been taken for granted that the parties' intentions will differ according to the circumstances. If the third party knew about the non-existence of the company, it has often been said that a binding contract must have been contemplated with the promoters, for otherwise "the contract would be altogether inoperative"[89]. This is clearly a result-orientated argument, hard to understand in view of the fact that in cases

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86 B. Welling, *supra*, note 27 at 254.

87 B. Welling, *supra*, note 27 at 294-295; see also G.R. Sullivan, *supra*, note 54 at 124.

88 M.H. Ogilvie, *supra*, note 13 at 332.

89 *Kelner* v. *Baxter* (1866), L.R. 2 C.P. 174 at 183, Earle C.J.; see also *Newborne* v. *Sensolid* (1953), [1954] 1 Q.B. 45 at 47, Parker J.

like *Newborne* and *Black* the courts do not feel much reluctance against finding that there is no contract at all. Not much consideration has been given to the expectation that generally prevails in such cases: it is expected that the third party will look to the company, or, to say it in L. Getz' terms: ".... the very last thing the parties intend is that the promoter undertakes a personal liability"[90]. One could make the last statement more precise by acknowledging that at least originally neither party assumed the promoter to be liable[91] for the question of the promoter's liability arises only on a secondary level, i.e. in the event that it turns out that the company is not incorporated or does not dispose of sufficient assets. The question can only be whether the promoter becomes a substitute principal whose liability is contingent. Fridman called the promoter an "alternative party" saying that in *Kelner* v. *Baxter* "the proposed company was to be primarily responsible on the contract, but the directors were to be liable in the alternative"[92]. This statement reflects the parties' mind quite accurately but it is difficult to reconcile with basic contract principles since the company cannot be bound before incorporation[93]. In order to reach an immediately binding effect the promoter cannot be a mere "alternative party": he must be considered to be a party to the contract from the outset. This, however, is not intended, for the promoter does not want to acquire contractual rights or to incur contractual liabilities himself. It appears

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90 *Supra*, note 1 at 396; see also M.H. Ogilvie, *supra*, note 13 at 325 and 329; G. Shapira, *supra*, note 56 at 313; J.H. Gross, *supra*, note 51 at 386.

91 M.H. Ogilvie, supra, note 13 at 329.

92 G.H.L. Fridman, *supra*, note 54 at 1606.

93 *Kelner* v. *Baxter* (1866), L.R. 2 C.P. 174.

from the foregoing that the contractual analysis not only ignores commercial needs; in the context of pre-incorporation transactions, it is also unsound from a legal point of view. The traditional contractual approach is unable to govern pre-incorporation situations because the law tries to uphold legal principles at any price, whilst in the businessman's mind these barriers do not exist. To compare the promoter contracting for a proposed company with a man buying corn for his hourses might be legally accurate; the businessman, though, will find the comparison lame because usually at least he wants the third party to look first and foremost to the future company. Hence, it is clear that the law seeking for legally sound solutions has to rely on fictions when ascertaining the parties' intentions[94]. For that reason, it is not convincing to interpret the rule in *Kelner* v. *Baxter*, considered to be a rule of construction, as a rule of evidence to the effect that there is a strong presumption that the parties wanted the promoter to be a contracting party[95]. All that can generally be said is that the parties intend some kind of contingent liability, for first and foremost they look to the company to be incorporated. With this reasoning, the presumption - strictly speaking - is not contractual; all that can be presumed is that the parties want the promoter to be bound should the company not be incorporated, i.e. on a secondary level. In the very end, the promoter's liability is a matter of policy[96], but few judges had the courage to express

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94 G. Shapira, *supra*, note 56 at 313.

95 *Marblestone Industries Ltd.* v. *Fairchild* (1975) 1 N.Z.L.R. 529 (N.Z., S.C.); *Summergreen* v. *Porter* (1950) 80 C.L.R. 304 (Austr. H.C.) at 323-324, Fullager J.; A.R. Emmett, *supra*, note 65 at 491.

96 M.H. Ogilvie, *supra*, note 13 at 327 ff.; G. Shapira, *supra*, note 56 at 313; see also H.A.J. Ford, *Principles of Company Law*, 3rd ed. (Sydney et al: Butterworths, 1982) at 544.

this view[97]. The contractual approach is neither commercially appropriate nor legally sound. Considerations that might underly the promoters' liability will be discussed in the next chapters. Before doing so we should briefly mention another attempt made at common law in order to establish the liability of the promoter.

e. Breach of Warranty of Authority

It has frequently been suggested that the promoter's liability should be based on breacd of warranty of authority[98], a solution not approved of in the former case of *Newborne* v. *Sensolid* where Parker J. felt reluctant to recognize claims based on this concept[99]. He reasoned that someone cannot have warranted authority where no principal is in existence[100]. This, in fact, distinguishes the pre-incorporation contract cases from the facts in *Collen* v. *Wright* where actions based on breach of warranty of authority were originally recognized[101]. But contrary to Parker J., the factual difference does not compel differing solutions: someone who professed to act as an agent without having authority deserves to be held liable regardless of whether he lacks authority for want of a principal or just

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97 See *Marblestone Industries Ltd.* v. *Fairchild, supra*, note 95 at 541, Mahon J.

98 *Black* v. *Smallwood* (1965), [1966] 39 Austr. L.J. Rep. 405 (Austr., H.C.) at 409, Windeyer J.; *Wickberg* v. *Shatsky* (1969), 4 D.L.R. (3d) 540 (B.C. S.C.); *Royal Bank of Canada* v. *Starr* (1986), 31 B.L.R. 124 (Ont. Dist. Ct.) at 142 ff.

99 *Newborne* v. *Sensolid* (1953), [1954] 1 Q.B. 45 at 47.

100 *Ibid.*

101 (1857) 8 E.& B. 301 (C.A.).

exceeded the authority he in fact was given[102]. All that is decisive is that some kind of warranty can be inferred from the agent's behaviour: it does not matter if the acting person professes to have more authority than he really has or - going beyond that - that there is a principal who in fact does not exist. Although the principle is clear at the outset, its application raises problems that render the device doubtful.

First, it is not clear whether actions of breach of warranty are based on contract[103] or in tort[104]. The difference is important for several reasons, for instance the availability of defences such as contributory negligence[105].

An even more serious problem arises when trying to harmonize the approach with what was said in cases like *Newborne* and *Black*. By definition, claims based on breach of warranty of authority can only be asserted when the third party is ignorant of the fact that the company is not yet in existence. The typical feature of such cases will be quite similar to *Newborne* and *Black* where the third party did not know of the company's non-existence. In light of the arguments made in *Newborne*, it is hard to see to what extent authority was warranted when - as it was said - the contract was made by

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102 J.H. Gross, *supra*, note 61 at 386 ff.; N.E. Palmer, *supra*, note 25 at 125; A.R. Emmett, *supra*, note 65 at 492.

103 *Collen* v. *Wright* (1857), 8 E. & B. 301 (C.A.); F.M.B. Reynolds, *supra*, note 10 at 471; G. Shapira, *supra*, note 56 at 321; N.E. Palmer, *supra*, note 25 at 126.

104 *Hawkes Bay Milk Corporation* v. *Watson* (1974), 1 N.Z.L.R. 236 (N.Z., S.C.) at 279; see also B. Welling, *supra*, note 27 at 279.

105 See N.E. Palmer, *supra*, note 25 at 125-126.

the company itself, Mr. Newborne just authenticating the signature and therefore not professing to act as an agent[106]

But even without the difficulties, it seems to be quite problematical whether the third party can successfully sue on the basis of breach of warranty of authority. Damages are awarded according to the amount the third party could have recovered from the principal if the contract had been made with him[107]. Where the principal does not come into existence, no damage is deemed to have arisen because there is no recourse against a non-existent person[108]. Even if he does, recovery is uncertain because no damage can have arisen where the principal lacks sufficient assets to satisfy the creditors' claims. In *Wickberg* v. *Shatsky*[109], the court was therefore right in awarding only nominal damages. In the final analysis, the problem of the promoter's liability cannot be resolved by recourse to claims based on breach of warranty of authority.

f. The Common Law Position: Summary

The common law position as to pre-incorporation contracts is marked by the attempt to preserve fundamental principles of corporate, contract and agency law. From the point of view of the interests of the parties involved, the result is far from being satisfactory. With regard to the company's

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106 F.M.B. Reynolds, *supra*, note 10 at 471; G. Shapira, *supra*, note 56 at 320.

107 *Hughes* v. *Green* (1864), 33 L.J.Q.B. 35; *Godwin* v. *Francis* (1870), L.R. 5 C.P. 295.

108 L. Getz, *supra*, note 1 at 398.

109 (1969) 4 D.L.R. (3d) 540 (B.C.S.C.).

liability, one has to admit that the common law position accords perfectly with basic legal principles. To deny any possibility of binding the future company in advance respects fully the idea of the corporate entity as a separate unit. It complies also with the basic agency principle that there is no agency where a principal is not existent. The refusal to acknowledge the company's right to step into the contract after coming into existence follows from the contractual principle that no third party can interfere with the contractual relationships between other parties. Although clear and legally sound, the rule does not reflect the parties' interests accurately. From a commercial point of view, it is more desirable to facilitate the company's stepping into a contract made on its behalf by people who - at least in most cases - will be the company's shareholders or directors.

As far as the promoter's liability is concerned, the situation is more confusing. Turning on fine distinctions the basis of which never was precisely elaborated, the common law does not give clear guidelines. Tending to maintain a pure contractual analysis, the law loses sight of its own point of departure not realizing that looking at the "parties'" intention does not provide much guidance. The true reason for differing results remains in the dark. In its slavish obedience to legal maxims, the law goes so far as to label persons who obviously act on someone's else behalf as principals (*Kelner's* case) or mere instruments (*Newborne's* case) missing both times the simple fact that the parties look first of all to the company, the promoter merely being considered as a go-between, i.e. as an agent. Legally hazy solutions do not provide much assistance to people involved in pre-incorporation transactions, clarity being of primary importance in a stage where much is at stake. In different common law jurisdictions

modifications of the common law position have been called for - with differing outcomes as will be seen now.

III. The Common Law Position Revised

Legal rules cannot run contrary to commercial reality forever. It is not surprising therefore that attempts were made to avoid the harsh results achieved by strict application of the common law rules. This has been done by enacting statutory provisions or simply by not following the rule in *Kelner* v. *Baxter*. Two things are noteworthy: first, although legislatives have become very active throughout the common law world, some jurisdictions, especially in Canada, have preserved the common law rules. Secondly, where modifications have been considered to be necessary, the outcome varies from jurisdiction to jurisdiction: the solutions range from radical change to partial upholding of the common law position. Pre-incorporation transactions: a problem without an ideal solution?

1. United Kingdom

In 1962, the Jenkins Committee dealing with the reform of company law suggested fundamental changes as to the rules governing pre-incorporation transactions[110]. The Committee criticized the common law point of view as to the company's and to the promoter's liability and recommended that the promoter be generally liable on pre-incorporation contracts and that the company be given the right to step into the contract. In 1972, Britain, being obliged to harmonize its national law with the other E.E.C. members' law, enacted the *European Communities Act*. Based on Art. 7 of the E.E.C. Council Directive of March 9, 1968, its s.9(2) provided: "Where a contract purports

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[110] See L.C.B. Gower, *supra*, note 44 at 737.

to be made by a company, or by a person as agent for a company, at a time when the company has not been formed, then subject to any agreement to the contrary, the contract shall have effect as a contract entered into by the person purporting to act for the company or as agent for it, and he shall be personally liable on the contract accordingly". This provision was later repealed, but was adopted word for word in the U.K. Companies Act 1985[111] at s. 36(4) so that it still constitutes the law in England. As a look at the writers' comments shows its ambit has not yet entirely been clarified. However, nobody followed Schmitthoff's early remark[112] that the provision has not substantially altered the common law at all[113] although it could get some support from an argument put forward by Prentice[114]. He had suggested interpreting the words "... and he shall be personally liable on the contrary accordingly" in the sense that the liability of the acting person should depend on whether or not the person purported to act as an agent as opposed to the situation where he merely "authenticated" the company's signature "accordingly" thus meaning "according to the factual circumstances"[115]. Though arguably, the approach has not been followed by others or even the author himself, for it appears from the provision's face and also from its context within the harmonization of European company law

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111 Companies Act (U.K.), 1985, c.6.

112 C.M. Schmitthoff, "The European Communities Bill" (1972) J.B.L. 85 at 86.

113 B.S. Markesinis, *supra*, note 41 at 116 n. 21; see also C.M. Schmitthoff, ed., "Palmer's Company Law", vol. 1, 24th ed. (London: Stevens; Edinburgh: Green, 1987) at 20-03 where the formerly expressed view is no longer followed.

114 D.D. Prentice, "Pre-incorporation Contracts" (1973) 89 L.Q.R. 530 at 531-532.

115 *Ibid* at 532.

that the subtle distinctions prevailing in previous English law as to the promoter's liability should be removed[116].

Quite obviously, the formula chosen by the legislator reflects the absurd common law distinction contrasted by *Kelner's* and *Newborne's* case. Stating that the contract should take effect between the acting person regardless in which capacity the person purported to act, the statute clearly sweeps away the common law rule thus rendering obsolete the often fallacious analysis of the parties' intentions. This is - as far as the acting person's liability is concerned - a change from the common law position. In *Phonogram* v. *Lane*[117], all judges agreed in finding that the former common law rules were overruled by virtue of statute.

It is left open whether s. 36(4) of the Companies Act (U.K.) and its predecessor change the common law as to the promoter's liability by replacing the rules or merely by ordering redress where recourse was not possible before. The later argument was made by Green[118] relying on Shaw L.J.'s ambiguous statement in *Phonogram* that s. 9(2) of the *European Communities Act* provided a remedy in a situation where the third party would be left without recourse[119]. There is no need to settle the controversy for in the end it is clear that basically the promoter is liable

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116 R.R. Pennington, *supra*, note 41 at 91; G.H. Treitel, *supra*, note 81 at 555; L.C.B. Gower et al., *supra*, note 44 at 336; F.M.B. Reynolds, *supra*, note 10 at 472; B.S. Markesinis, *supra*, note 41 at 126.

117 (1981) 3 All E.R. 182 (C.A.).

118 N.N. Green, *supra*, note 14 at 677.

119 *Supra*, note 79 at 187, 188.

whether his liability is based on a combination of common law and statute or solely on statute.

Only one author[120] does not agree with this finding suggesting quite a surprising interpretation of what is now s. 36(4) of the *Companies Act (U.K.)* In his view, the statute merely provides a remedy where the promoter has failed in informing the third party of the non-existence of the company. If the third party is aware that the company is not yet incorporated, he considers the courts to be free to ascertain the parties' intention. There seems to be no compelling reason to allow enforcement of a contract against a promoter when the third party, with full knowledge of the facts, was supposed to look only to the company[121]. Sullivan's view clearly differs from the reasoning in *Phonogram v. Lane*[122] where it was held that s. 9(2) of the *European Communities Act* applied also when both parties were aware of the non-existence of the company.

Although persuasive at first glance, there are several reasons why this point of view does not merit support. It misses completely the provision's purpose to liberate the law from narrow and often technical distinctions by re-introducing a contractual analysis in the field of the promoter's liability. Certainly, the situation would be clear if the third party was not aware of the non-existence of the company. But when there was this awareness, the law would be as vague as it had been before because again the judgments

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120 G.R. Sullivan, *supra*, note 54 at 121-122.

121 *Ibid* at 124.

122 *Supra*, note 74.

would turn on subtle distinctions purporting to reflect the parties' intentions. Even when one admits that the law as it stands fully takes account of the parties' intentions, the interpretation given by Sullivan is highly objectionable because it does not comply with the provision's pattern. It is true that the present law is not entirely indifferent towards the parties' intentions as it follows from the words "subject to any agreement to the contrary" But this does not support Sullivan's argument because it appears from the drafting of the provision that the contemplation of the parties' are relevant merely as a basis for a defence - to what extent will be seen later - but not - as Sullivan suggests - as a condition of liability. In principle, the promoter is liable regardless of whether the third party was aware of the company's non-existence or not[123]. Sullivan's approach, therefore, has to be disapproved of.

It sheds light, however, on some ambiguity in the provision's drafting. It is clear that as opposed to the common law position the *promoter* has to prove that personal liability was not intended. But the provision does not give any guidance as to what extent the promoter can assert an agreement to the contrary. Are there some qualified conditions to be fulfilled or does the provision merely shift the burden of proof, the factual analysis remaining substantially the same as at common law? In the latter case, the provision would operate merely as an evidentiary rule whereas in the former case the law would have been altered in substance. Although legally consistent, since based on the assumption that there are express and implied contracts,

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[123] L.H. Leigh, Y.M. Joffe & D. Goldberg, "Northey's and Leigh's Introduction to Company Law", 3rd ed. (London: Butterworths, 1983) at 35.

the broader interpretation has not had any support. Given the fact that in the light of the parol evidence rule few facts will be controversial, it does not create much change in the common law, at least as far as written contracts are concerned. On the contrary, it preserves the law as it stood prior to the statutory enactments because in the very end the promoter's liability would again depend on fine and subtle distinctions as illustrated by *Kelner's* and *Newborne's* case - a result the statute was supposed to avoid. It is therefore not sufficient that an agreement to the contrary may in some way be inferred from the circumstances, notably from the promoter's acting as an "agent"[124]. In *Phonogram* v. *Lane*, Lord Denning stated that the agreement to the contrary had to be express[125]. Most writers are satisfied if such an agreement can clearly and unambiguously be inferred from the other terms of the contract[126]. For the purpose of this analysis, it is immaterial which interpretation is preferable; all that is noteworthy is the fact that the statute does not allow the common law intention test to resurface. Although one could say that somewhat clearer drafting would have been desirable[127] it is beyond doubt that the statute now takes into account the uncertainties and absurdities the common law position had raised. As to the promoter's liability and the coherent issue of third party protection, the English law has now arrived at a more satisfying solution; it

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[124] J. McMullen, *supra*, note 76 at 49; J.G. Collier & L.S. Sealy, *Comment* (1973) 32 Camb. L.J. 1 at 6; N.N. Green, *supra*, note 14 at 681; D.D. Prentice, *supra*, note 112 at 533. *Contra* G.R. Sullivan, *supra*, note 54 at 123; see also *Elder* v. *Al Sanea* (27 April 1983, Q.B.D.), cited by N.N. Green, *supra*, note 14 at 681.

[125] (1981) All E.R. 182 at 187 (C.A.).

[126] J. McMullen, *supra*, note 76 at 50; C.M. Schmitthoff, *supra*, note 113 at 20-03; D.D. Prentice, *supra*, note 114 at 533; B.S. Markesinis, *supra*, note 41 at 126 is unclear.

[127] J. McMullen, *supra*, note 76 at 50.

is incomprehensible why Markesinis considers that present English law fails in achieving one of its major objectives, i.e. the protection of the third party's interests[128].

Lack of clarity being the major objection against the statute as far as it provides a basis for recovery against the promoter[129] the criticism against the English statute is much more vehement as to the statute's treatment of the company's liability. Although the Jenkins Report[130] had recommended that the company have the right to step into the contract, neither the *European Communities Act* nor the *Companies Act (1985)* followed the recommendation. Only in 1973 was an attempt made to enact a provision in the *Companies Act* allowing adoption by the company, but it never came into force[131]. One wonders why English law did not recognize the company's right to step into the contract despite strong support by the legislative committee. The only explanation could be that the requirement for a new contract was not considered to be fatal[132]. Admittedly, it would not be fatal to oblige the company to enter into such a new contract with the third party. Nevertheless, the English approach does not constitute an ideal solution because of its inconvenience for commercial life. Preserving a basic legal principle like the idea of the company as a separate entity, it

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128 B.S. Markesinis, *supra*, note 41 at 126.

129 It should be mentioned in passing that s. 36(4) of the Companies Act (U.K.) 1985 is conceived of as also covering the promoter's right to enforce the contract; see F.M.B. Reynolds, *supra*, note 10 at 471; G. Treitel, *supra*, note 81 at 555; L.H. Leigh et al., *supra*, note 123 at 35.

130 See L.C.B. Gower et al., *supra*, note 44 at 337.

131 L.C.B. Gower et al., *supra*, note 44 at 337.

132 See B.S. Markesinis, *supra*, note 41 at 125.

overemphasizes principles without taking into consideration that legal ideas are merely instruments to achieve a certain goal; they are not an end in themselves. In pre-incorporation transactions, the contract is made with a view to the company coming into existence - circumstances that differ considerably from the case that someone acts for a third party being an absolute outsider to the transaction. The measure of protection the English law provides for the company is excessive; it even turns out to be disadvantageous as it prevents the company from deriving the benefits from the contract made - to say it in untechnical terms - on its behalf. The English solution has therefore justifiably encountered a lot of criticism[133].

It has been suggested that the phrase "subject to any agreement to the contrary" be interpreted to mean that the parties agree the company may, once incorporated, step into the contract[134]. In the same breath, the proposition was abandoned, however, arguing - quite superficially - that the English courts would probably answer this question in the negative[135] Certainly, the phrase quoted does not offer a loophole for the assumption that the legislator did not object to the company's right to step into the contract of its own accord. But there seems to be no reason why the court should look unfavourably upon the parties agreeing to the company's right to

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133 L.C.B. Gower et al., *supra*, note 44 at 337; C.M. Schmitthoff, *supra*, note 113 et 20-03; D.D. Prentice, *supra*, note 114 at 533; N.N. Green, *supra*, note 14 at 687; B.S. Markesinis, *supra*, note 41 at 125; J.G. Collier & L.S. Sealy, *supra*, note 124 at 7.

134 C.M. Schmitthoff, *supra*, note 113 at 20-03.

135 *Ibid*

ratify the contract after incorporation. This would be nothing but an option - a device that has always been recognized in contract law[136].

Summing up the legal situation in the United Kingdom today, one has to acknowledge that essential deficiencies of the old law have been eliminated although the drafting is of doubtful quality. The most important weakness lies in the continuing reluctance to recognize the company's right to step into the contract. The statute's advantage to avoid the common law's problems as to the acting person's liability are frequently emphasized; upon examining the writers' statements, however, one fails to see any positive attempt to explain the bases on which the promoter's liability is founded after statutory enactment. This question will be dealt with more closely elsewhere.

2. United States

In the United States, as opposed to other common law jurisdictions, the problem of pre-incorporation transactions has not stimulated much academic debate over the past years. The last time the underlying principles were the subject of profound analysis was about thirty years ago when Robert A. Kessler criticized the prevailing law and laid down a liability scheme of his own[137].

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[136] See N.N. Green, *supra*, note 14 at 678; J.M. Gross, *supra*, note 61 at 391.

[137] R.A. Kessler, "Promoters' Contracts: A Statutory Solution" (1961) 15 Rutgers L. Rev. 566.

The legislators have not remained inactive - neither before Kesslers' article was published nor afterwards In several states, statutory provisions dealing with pre-incorporation transactions were enacted. Two of them, adopted in Michigan (1931) and in Kansas (1939), were later abrogated (1972/73), the remaining ones are of even more questionable value as we will see later. The revised *Model Business Corporation Act (1983)*, as well as its predecessor, includes a special provision. This provision, however, far from being comprehensive, is also of doubtful value since it cannot be determined with certainty to what extent the provision affects the problems discussed here. After a brief look at the legal situation in the United States, one is inclined to wonder why Kessler's criticisms and ideas have not engendered more response - in one sense or the other. Or do we have to assume that the American courts have found a solution that does not cause the problems English law is struggling with?

a. Turning Away From English Principles

In one respect, American law certainly did find a solution that avoids the problems which English law seems to be unable to deal with. By a vast majority, American courts have never followed the rule in *Kelner* v. *Baxter* as far it states that the company cannot step into the contract made by its promoters unless it makes a new conract with the third party[138]. However, they agree with the English view that as long as the corporation is not in existence, binding contracts cannot be made on its behalf because at that

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[138] J.H. Gross, "Liability on Pre-incorporation Contracts: A Comparative Review" (1972) 18 McGill L.J. 512 at 518.

time a corporation is - as nicely expressed by Ehrich and Bunzl - just "of such stuff as dreams are made of"[139]. Therefore it is incapable of being bound as a principal[140] American courts have followed English courts also insofar as the corporation does not step into pre-existing contracts automatically upon its birth[141]. To benefit from the pre-incorporation contract, however, they do not require the corporation to make a new contract with the third party, recognizing its right to declare itself party to the contract unilaterally by some affirmative act[142]. This is the crucial difference between English and American law.

One might be inclined to say that both approaches are closer to each other than appears at first glance. As was said above when discussing the English approach, to assume a new contract it is sufficient to infer an agreement from factual circumstances, generally from the fact that the company impliedly accepts the contractual benefits offered by the third party. The same is true with American law: accceptance need not be explicit the

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139 M.W. Ehrich & L.C. Bunzl, "Promoters' Contracts" (1929) 38 Yale L.J. 1011 at 1024.

140 H.W. Ballantine, *Ballentine on Corporations*, rev. ed. (Chicago: Callaghan, 1946) para. 36; *Fletcher Cyclopedia of the Law of Private Corporations*, vol. 1A (Wilmette, Ill.: Callaghan, 1983, suppl. 1988) para. 205; A.A. Miller, "Inadequacy of Traditional Concepts in the Treatment of the Promoter" (1932-33) 81 U.Pa. L. Rev. 746 at 747; R.W. Calloway, "Pre-incorporation Agreements" (1957) 11 Southwestern L.J. 509.

141 *Hamilton Anthony Wayne Hotel Corp.* v. *BecHotel Management, Inc.* (1965), 216 N.E. 2d 66 (Ohio, C.P.); *In re Dynamic Enterprises, Inc.* (1983), 32 B.R. 509 (Tenn., Bkrtcy).

142 H.S. Richards, "The Liability of Corporations on Contracts Made By Promoters" (1905) 19 Harv. L. Rev. 97 at 102 ff.; R.W. Calloway, *supra*, note 13 at 510; T.F. Baines, "Company Liability for Pre-incorporation Contracts" (1958) 16 U.T. Fac. L.Rev. 31 at 33 ff.; J.H. Gross, *supra*, note 138 at 518 ff.

courts being satisfied with some affirmative act, provided, however, that the corporation acts with full knowledge of the background[143].

Although both approaches seem to be identical in the result, in substance they are not. In England, the company does not have any right under the contract, vis-à-vis the company, the third party is not obliged to perform unless there is a separate agreement. In the United States, the outsider once bound by a pre-incorporation contract has no more right to choose; if the corporation wishes it he has to perform. The difference is not merely theoretical as the corporation might turn out to lack sufficient assets to satisfy its creditors. But there is still another important feature that differentiates English and American law with regard to the corporation's liability. Although English courts recognize that the making of the new contract may be inferred from the surrounding facts, they restrict this possibility considerably by requiring strong evidence that the parties really intended to make a new contract, not simply to act on the original one[144]. American law does not require such evidence for it is understood that the corporation becomes bound on the basis of the old contract.

To take into account business needs is one thing, legal justification another: theories have been advanced to offer a basis for a result deemed to be necessary - theories that apparently have not been able to convince courts and legislator in the United Kingdom.

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[143] (1985) 18 Am.Jur 2d at paras. 125, 126.

[144] H.S. Richards, *supra*, note 142 at 104.

In many cases, the courts acknowledged the corporation's right to *ratify* the promoter's contract[145] applying the agency rule that the principal may assent to the agent's acts after the contract was made. In agency law, ratification relates back to the time when the purported agent acted This result is accepted by those who favour the application of the ratification concept in pre-incorporation transactions[146] Strictly speaking, there is no room for the application of the ratification doctrine in the context of pre-incorporation transactions where at the time the contract is made the principal is not yet in existence. The doctrine does not address this issue because it only remedies lack of authority, not the lack of the principal's existence. For this reason, the ratification theory has been rejected by many courts[147] and writers[148].

To avoid these conceptual difficulties without losing the practical advantages, i.e. to give the corporation the right to step into the contract unilaterally, it has been suggested that the corporation's right to "adopt" the

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145 *Maryland Apartment House Co.* v. *Glenn* (1908), 108 Md. 377, 70 A. 216 (Md., C.A.); *Boatnight* v. *Steinite Radio Corp.* (1931), 46 F. 2d 385 (Circuit C.A., Tenth Circuit); *Frazier* v. *Ash* (1956), 234 F. 2d 320 (U.S.C.A., Fifth Circuit); *Speedway Realty Co.* v. *Grasshoff Realty Corp.* (1966), 248 Ind. 6, 216 N.E. 2d 845 (Ind., S.C.); *Jacobson* v. *Stern* (1980), 96 Nev. 56, 605 P. 2d 198 (Nev., S.C.).

146 *Frazier* v. *Ash* (1956), 234 F. 2d 820 (U.S.C.A., Fifth Circuit) at 327; *Rees* v. *Masonic Technologies, Inc.* (1984), 742 F. 2d 765 (U.S.C.A., Third Circuit); see also E.G. Rice, *Case Comment* (1985) 24 Duquesne L. Rev. 333 at 344 n. 66.

147 *Gardiner* v. *Equitable Office Bldg. Corp.* (1921), 273 F. 441 (Circuit C.A., Second Circuit); *Re Super Trading Co.* (1927), 22 F. 2d 480 (Circuit C.A., Second Circuit); *McCrillis* v. *A. & W. Enterprises Inc.* (1967), 270 N.C. 637, 155 S.E. 2d 281 (N.C., S.C.); *Smith* v. *Ford Motor Co.* (1976), 289 N.C. 71, 221 S.E. 2d 282 (N.C., S.C.); *Stone* v. *First Wyoming Bank N.A., Lusk* (1980), 625 F. 2d 332 (U.S.C.A., Tenth Circuit).

148 H.G. Henn & J.R. Alexander, *Laws of Corporations and Other Business Enterprises*, 3rd ed. (St. Paul, Minn.: West Publishing, 1983) at 253; M.W. Ehrich & L.C. Bunzl, *supra*, note 139 at 1031; A.A. Miller, *supra*, note 140 at 748; R.W. Calloway, *supra*, note 140 at 511.

contract be recognized[149]. In contrast to ratification, adoption does not have the "relate-back-effect": the corporation becomes a party to the contract as of the time the contract is adopted. New consideration is not required[150]. Although sometimes described as pure word-magic[151], the difference between the ratification and the adoption concept is more than semantic. Practically, it might be of some importance with respect to the application of the Statute of Frauds[152]. Legally, both concepts have to be distinguished because of their differing theoretical basis. Whereas the ratification concept is based on the extension of agency rules, the idea of adoption purports to be an immediate contractual approach. In *Wall* v. *Niagara*[153], the leading case applying the adoption theory, it was pointed out expressly that the corporation does not become bound by virtue of agency principles. Its liability is founded on its "own inherent powers as a body corporate to make contracts". The corporation becomes bound on the ground of the traditional contract rule of offer and acceptance the pre-incorporation contract constituting a so-called continuing offer[154]. The adoption theory and the idea of the corporation accepting a continuing offer

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149 *Wall* v. *Niagara Mining & Smelting Co. of Idaho* (1899), 20 Utah 474, 59 P. 399 (Utah, S.C.); *McCrillis* v. *A. & W. Enterprises, Inc.* (1967), 270 N.C. 637, 155 S.E. 2d 281 (N.C., S.C.); *Smith* v. *Ford Motor Co.* (1976), 289 N.C. 71, 221 S.E. 2d 282 (N.C., S.C.).

150 R.W. Calloway, *supra*, note 140 at 511.

151 F.S. Glover, "Pre-incorporation Contracts of Michigan Corporations" (1953) 16 U. Det. L.J. 113 at 114.

152 See H.G. Henn & J.R. Alexander, *supra*, note 148 at 254 n. 10; Fletcher, *supra*, note 140 at para. 207.

153 (1899) 20 Utah 474, 59 P. 399 (Utah, S.C.).

154 *Kirkup* v. *Anaconda Amusement Co.* (1921), 59 Mont. 469, 197 P. 1005 (Mont., S.C.).

have frequently been treated as separate theories[155]. In truth, the latter is nothing but the theoretical basis of the former[156].

Although seemingly in accordance with general principles of contract law[157] and therefore called "nice and ingenious"[158], the adoption theory leaves questions unanswered. It presupposes without further inquiry that an offer can be made to an entity not yet in existence[159] Furthermore, it has been submitted that the theory is based on hardly realistic grounds, at least as far as executed contracts are concerned[160]. It is true that there is no room for adoption when dealing with executed contracts. This does not result from deficiencies of the approach, but from the mere fact that there is no more offer to adopt, the parties having fulfilled their contractual obligations and thereby brought to an end their contractual obligation before the corporation was born. The courts usually do not distinguish between ratification and adoption using the terms interchangeably[161]. From a

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155 J.A.F. Wendt, "Corporate Liability on Pre-incorporation Contracts in Colorado" (1949-50) 23 Rocky Mountain L. Rev. 465 at 467; F.S. Glover, *supra*, note 151 at 114; R.W. Calloway, *supra*, note 140 at 513; J.H. Gross, *supra*, note 138 at 522; (1985) 18 Am. Jur. 2d at para. 124.

156 H.G. Henn & J.R. Alexander, *supra*, note 148 at 256.

157 *Hackberth* v. *Wilson Lumber Co.* (1923), 36 Idaho 628; 212 P. 969.

158 M.W. Ehrich & L.C. Bunzl, *supra*, note 139 at 1032; see also (1985) 18 Am. Jur. at para. 124.

159 T.F. Baines, *supra*, note 142 at 34.

160 *Ibid.*

161 *Petroff* v. *Asbone* (1976), 336 So. 2d 178 (Ala., S.C.); *Bankers Trust Co. of Western New York* v. *Zecher* (1984), 426 N.Y.S. 2d 960 (S.C., Monroe County); see also J.H. Gross, *supra*, note 138 at 522.

practical point of view, the result is the same; the corporation is entitled to step into the contract by unilateral act. From an academic standpoint, however, this approach is hardly satisfactory in particular when one bears in mind that the English legal system still considers its logical difficulties unsurmountable.

The courts have not taken much notice of a third approach originally suggested by Williston[162]. Instead of speaking of adoption, he prefers to use the term "novation". Like the concept of adoption, the idea of novation is based on the assumption that the third party initially makes an offer to the corporation to be accepted by the latter when it comes into existence. However, it differs substantially from the adoption concept inasmuch as Williston assumes that the offer is not made in order to enter into an additional contract alongside the promoter's contract; according to him, it may usually be inferred from the facts that the parties want to maintain the original contract, merely replacing the contracting parties. The modes of interpreting the parties' intentions as advanced by the adoption and the novation concept tend towards completely differing effects. When the corporation agrees to enter into an existing contract, the promoters "drop out of the picture" serving merely as a "stop gap"[163]. He is no longer liable on the contract he originally made. The situation is not so clear in the case of adoption as will be seen later. Most courts consider the promoter liable even if the corporation adopts the contract. Whether the novation concept is

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162 W.H.E. Jaeger, *Williston on Contracts*, vol. 2, 3rd ed. (Mount Kisco, N.Y.: Baker, Voorhis, 1959, supp. 1989) at 430-431.

163 E.H Warren, "The Progress of the Law: Corporations" (1920) 34 Harv. L. Rev. 282 at 288.

to be followed or not is closely related to the problem of the promoter's liability and will therefore be dealt with more specifically elsewhere. As far as the corporation's liability is concerned, it is sufficient to note that, in the United States, the courts as well as the legal writers agree in allowing the corporation to become a party to the contract by unilateral act, disagreeing only on the underlying principle.

Before discussing the more complex and often neglected problem of the promoter's liability it should be mentioned that even in the result the American approach as to the corporation's rights on pre-incorporation contracts is not as uniform as it might appear from the foregoing. In 1931 Michigan enacted a statutory provision[164] which gave rise to many questions[165]. As interpreted by the courts the section meant the corporations could become liable on all pre-incorporation contracts immediately upon their birth[166]. No ratification or adoption was required. On the other hand there was no way to avoid liability. Notwithstanding the question whether the attained result was desirable, the provision was criticized on the ground that it did not state clearly which acting persons were meant, promoters in general or incorporators in the technical sense of the word, such as employees in the lawyer's office who are in charge of the

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164 "No contract made by the incorporators for or on behalf of any corporation to be formed preliminary to the filing of the articles shall be deemed to be invalid or ineffectual because made prior to such filing, and all property held by such incorporation for the benefit of the proposed corporation shall be deemed to be the property of such corporation". (Mich. Pub. Acts, 1931, No. 327, § 8).

165 See R.L. Rogers, *Case Comment* (1940) 38 Mich. L. Rev. 1266; R.A. Kessler, *supra*, note 137 at 576 ff.

166 In *re Montreuil's Estate* (1939), 291 Mich. 582, 289 N.W. 262 (Mich., S.C.); *Bil-Gel Co. v. Thomas* (1956) 345 Mich. 698; 77 N.W. 2d 89 (Mich., S.C.).

incorporation procedure[167]. Furthermore it was argued that the interpretation given by the courts was difficult to justify in light of the manner in which the provision was drafted[168]. Nonetheless, Michigan courts recognized for a long time the promoter's right to bind the corporation in advance without the latter's consent. Today, however, this is no longer possible because the statutory provision, then s. 21.8 of the *Michigan General Corporation Act (1948)*, was abrogated in 1973[169].

Another statutory attempt to clear up the legal situation was made in Kansas in 1939[170]. Although preponderantly concerned with the promoter's liability, the provision indirectly reveals a new way to bind the corporation: the corporation is presumed to have agreed to step into the contract. No longer has the third party to prove adoption; it is up to the corporation to establish that it did not want to incur liability. The statute shows a clear defect in providing for liability notwithstanding the possibility that the

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167 F.S. Glover, *supra*, note 151 at 119 ff.; R.A. Kessler, *supra*, note 137 at 578.

168 R.L. Rogers, *supra*, note 165 at 1267.

169 In the New Jersey Case *K. & J. Clayton Holding Corp.* v. *Kauffel & Esser Co.*, as it appears from the headnote, it was decided that upon the corporation's coming into existence, it is entitled to all rights under promoter contracts as well as assuming full liability therefor (1971, 272 A. 2d 565 [N.J., Superior Ct., Ch.D.]). As the reasoning reveals, this statement is misleading. The Superior Court of New Jersey does not support the idea that the corporation becomes bound automatically upon its birth. Still in accordance with the general American approach, some affirmative act on the part of the corporation is required once it comes into existence.

170 The provision (later Kansas Gen. Corp. Code § 17-2807, 1949) reads as follows: When the existence of a corporation has begun under the provisions of section 14 (17-2805) and the condition precedent to the beginning of business under the provisions of section 15 (17-2806) have been performed, the promoters, subscribers and incorporators shall thereafter be relieved and released from all personal liability for the obligations of such corporation contracted in its name, either before or after the organization thereof, unless said corporation within thirty days from the date of filing the affidavit provided for in section 15 .... shall have disaffirmed or repudiated said obligation made on its behalf".

corporation might not have been informed about the contract[171]. In 1972, Kansas abolished the statute returning to the general principles described above.

Whereas Michigan and Kansas, at least in the past, went quite far in holding the corporation liable on pre-incorporation contracts, Massachusetts courts seemingly tend to the other extreme. Relying on the rule in *Kelner* v. *Baxter*, it was held in *Abbott* v. *Hapgood*[172] that a corporation, after its birth, could not become a party to the contract even if it ratified or adopted it. Whether the strict English rule is still prevailing law in Massachusetts has to be doubted. In *Pennell* v. *Lothrop*[173] it was stated that a corporation can benefit from a pre-incorporation contract only by making a new contract. Recent cases and even a case decided before *Pennell* v. *Lothrop* indicate that the rule in *Kelner* v. *Baxter* was not followed strictly. In the early case *Holyoke Envelope Co.* v. *United States Envelope Co.*[174], Holmes J suggested two ways the corporation could be bound on a pre-incorporation contract. by making a new contract or by accepting an offer made by the third party in advance. The latter possibility reflects the idea of a continuing offer and is well opposed to the rule in *Kelner* v. *Baxter* as it is understood in England. Referring to Holmes' statements, recent decisions recognize the corporation's right to step into the contract upon acceptance of an implied

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171 Note (1940) 54 Harv L. Rev. 140 at 141; R.A. Kessler, *supra*, note 137 at 550.

172 (1889) 150 Mass. 248, 22 N.E. 907 (Mass., S.J.C.).

173 (1906) 191 Mass. 357, 77 N.E. 842 (Mass., S.J.C.).

174 (1902) 182 Mass. 171, 65 N.E. 54 (Mass., S.J.C.).

continuing offer made by the third party in advance[175]. Bearing in mind that the idea of a continuing offer made by the third party is often seen as the legal basis of the adoption concept, it is hard to see in what respect the actual legal situation in Massachusetts differs from the remaining states which in some way or the other recognize the corporation's right to step into the contract by unilateral act. At least, one wonders why, in *Framingham Savings Bank* v *Szabo*, the United States Court of Appeals did not consider it necessary to reconcile the application of the continuing offer theory with the rule in *Abbott* v. *Hapgood*, said to be identical with the rule in *Kelner* v. *Baxter*[176] The two approaches, seen through the comparison of English and American law, are not the same.

b. The Acting Person's Liability: Preservation of Common Law Rules?

Whereas American courts refused to follow the common law rules as far as the corporation's rights and liabilities are concerned, their position is far less clear with respect to the acting person's role. Many states, among them Washington, Florida, Alaska and Oregon, enacted statutory provisions stating generally that all persons who presume to act as a corporation without having the authority to do so shall be jointly and severally liable for all debts. According to s. 2.04 of the *Revised Model Business Corporation Act*, all persons who purport to act as or on behalf of a corporation are liable provided they know that there was no incorporation. At first glance it

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[175] *Framingham Savings Bank* v. *Szabo* (1980), 617 F. 2d 897 (U.S.C.A., First Circuit); In *re Maxcy* (1985), 45 B.R. 268 (Mass., Bkrtcy); In *re David's & Unique Eatery* (1987) 82 B.R. 652 (Mass., Bkrtcy).

[176] *Ibid.* at 899 n. 2.

seems that American law tends to hold the promoters liable regardless of the factual circumstances under which the contract was made. However, such a conclusion would be premature In general, even in states where statutory provisions as described above exist, the courts rely on non-statutory principles when dealing with the acting person's liability. Only the Washington Court of Appeals considers the statutory provisions to have codified the promoter's liability[177], but does not give any further explanation. The Washington Supreme Court is much more reserved as appears from its appeal decision in the *Goodman* case[178] Other courts are similarly reluctant to rely on the statute. Whereas in a Florida case the question was simply left open[179], the Supreme Court of Oregon clearly stated that the statute did not intend to establish a codified rule as to the promoter's liability on pre-incorporation contracts in general[180]. With reference to the official comment on the parallel provision in the former *Model Business Corporation Act*, it argued that the provision's scope is much narrower than one is inclined to believe at first sight.

According to the official comment, the provision's purpose was confined to abrogating the de facto corporation doctrine by providing for an unlimited

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177 *Heintze Corporation, Inc.* v. *Northwest Tech-Manuals, Inc.* (1972), 502 P 2d 486 (Wash., C.A.) at 487; *Goodman* v. *Darden, Darden & Stafford Associates* (1982), 653 P. 2d 1371 (Wash., C.A.) at 1372.

178 *Goodman* v. *Darden, Darden & Stafford Associates* (1983) 670 P. 2d 648 (Wash., S.C.) at 651 n. 3.

179 *Ratner* v. *Central National Bank of Miami* (1982), 414 So. 2d 210 (Fla., District C.A., Third District) at 212.

180 *Timberline Equipment Company, Inc.* v. *Davenport* (1973), 514 P. 2d 1109 (Or., S.C.); *Sherwood & Roberts-Oregon, Inc.* v. *Alexander* (1974), 525 P. 2d 135 (Or., S.C.) at 138-139.

liability until the corporation is born; no longer should it be possible to claim for protection under the limited liability concept before all incorporation requirements were fulfilled. Under the de facto corporation doctrine, persons acting for the corporation were sometimes entitled to benefit from the corporate veil although the corporation was not yet in existence[181] As the doctrine applies only where the corporation is as good as formed, i.e where a "good faith" attempt to comply with the statutory requirements has been made[182], the scope of a statutory provision that abrogates this rule must be limited to this period and cannot be interpreted as a comprehensive rule governing the whole area of pre-incorporation activities. The *Revised Model Business Corporation Act* does not give rise to a different, i e. to a wider interpretation. Although the relevant section is still drafted in broad terms, a look at the official comment confirms that the provision is still meant to make sure that the privilege of limited liability is not conceded before the incoporation is accomplished in every respect, there being no room for the de facto corporation doctrine[183]. Consequentially, the section applies only when the incorporation procedure has been set in motion in some way. The actual problem dealt with here is not settled. American law, after all, does not provide for a comprehensive statutory solution of the promoter's liability issue, either at federal or at state level. The courts therefore have to refer to principles developed at common Law.

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[181] See generally H.G. Henn & J.R. Alexander, *supra*, note 148 at 329 ff.

[182] R.W. Hamilton, *The Law of Corporations*, 2d ed. (St. Paul, Minn.: West Publishing, 1987) at 74-75.

[183] See M.A. Eisenberg, ed., *Corporations and Business Associations* (Westburg, N.Y.: The Foundation Press, 1988) at 161.

There being no clear principles as we have seen above, it is understandable that the American courts have found it difficult to arrive at a consistent formula. In principle, they agree in holding the promoter liable on pre-incorporation contracts[184] following the rule in *Kelner* v. *Baxter* The promoter's liability is justified by analogy to agency principles[185] the promoter being seen as some kind of agent "by anticipation"[186] American courts follow their English counterparts in interpreting the rule as a rule of construction; the promoter's liability thus finally depends on an intention test[187]. Like the application of the rule in *Kelner* v. *Baxter* in English law, the American approach as formulated by the courts and in § 326 of the Restatement of Agency, Second (1958) has been marked by lack of consistency in its application.

However, the American approach differs in applying a more generous and less hair-splitting intention test. Subtle distinctions such as those made in the *Newborne* decision are not to be encountered in American judgments. Interestingly enough, an almost identical case decided by an American court

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184 *O'Rorke* v. *Geary* (1903), 207 Pa. 240, 56 A. 541 (Pa., S.C.); *King Features Syndicate* v. *Courrier* (1950), 241 Iowa 870, 43 N.W. 2d 718 (Iowa, S.C.); *Frazier* v. *Ash* (1956), 234 F. 2d 320 (U.S.C.A., Fifth Circuit), *Refrigeration Engineering Co.* v. *McKay* (1971), 486 P. 2d 718 (Wash., C.A.); *Scandinavia, Inc.* v. *Cormier* (1986), 514 A. 2d 1250 (N.H., S.C.); A.A. Miller, *supra*, note 140 at 747; R.L. Rogers, *supra*, note 165 at 1269; R.A. Kessler, *supra*, note 137 at 593.

185 M.W. Ehrich & L.C. Bunzl, *supra*, note 139 at 1012; A.A. Miller, *supra*, note 140 at 747; R.W. Calloway, *supra*, note 139 at 509.

186 *Arnold* v. *Searing* (1910), 78 A. 762 (N.J., Ct. of Ch.) at 766.

187 *Company Stores Development Corp.* v. *Pottery Warehouse, Inc.* (1987), 733 S.W 2d. 886 (Tenn., C.A.); L.D. Salomon & R.B. Stevenson & D.E. Schwartz, *Corporations - Law and Policies* (St. Paul, Minn.: West Publishing, 1982) at 142; M.W. Ehrich & L.C. Bunzl, *supra*, note 139 at 1020; R.L. Rogers, *supra*, note 165 at 1270.

showed the opposite result[188] The corporation's president who, in this capacity, had signed a pre-incorporation contract on behalf of the corporation was held liable personally although the third party could not have meant to contract with him since it did not know about the non-existence of the corporation. The result would not be noteworthy if the plaintiff had sued in an action for deceit or breach of warranty of authority, but this was not the case: the plaintiff sued on the ground of an immediate personal obligation. The court argued that, as there was no principal in existence, the defendant must have meant to bind himself because otherwise the contract would have been inoperative. The reasoning nicely illustrates the double face of the intention test.

The fact that American law has never turned on the subtle distinction between acting as or on behalf of a corporation has not facilitated its application. Other cases illustrate just as well how ambiguous and misleading the test can be. The *Hagan* case can be contrasted with the view expressed in *Weiss* v. *Baum*[189] where the promoter fraudulently represented that he was setting up a corporation and induced the third party to enter into a contract with the corporation that was signed "Ruth Realty Corp. by Charles Baum". The court stated that someone who acts as an agent cannot be assumed to have intended to bind himself. It thus accepted a result that appeared to have been unacceptable to the court in *Hagan* v. *Asa G. Candler*: the contract which the parties had made turned out to be nugatory[190]. Other

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188 *Hagan* v. *Asa G. Candler Inc.* (1939), 189 Ga. 250, 5 S.E. 2d 739 (Ga., S.C.).

189 (1926) 219 App. Div. 83, 217 N.Y.S. 820 (S.C., App. Div.).

190 *Durgin* v. *Smith* (1903), 133 Mich. 331, 94 N.W. 1044 (Mich., S.C.); *Strause* v. *Richmond Woodworking Co.* (1909), 109 Va. 729, 65 S.E. 659 (Va., S.C.A.); *Quaker Hill,*

courts occupy a middle ground by holding the promoter basically liable unless the contract shows a contrary intention. However, there are differing statements as to the requirements that have to be fulfilled before the court recognizes exemption from liability. Some state jurisdictions require that the contract clearly shows on its face that there is no intent to hold the promoter liable[191]. Others do not go as far as to require an express agreement, being satisfied with an implied agreement which may be shown by circumstantial evidence[192]

The promoter's liability having been once established, American law has to deal with a further problem not encountered in English law because it does not recognize the corporation's right to step into the contract unilaterally. What happens to the promoter's liability if the corporation decides to become a party to the contract? From an objective standpoint, one might assume that the promoter is released from liability as soon as the corporation steps into the contract. This result would reflect most accurately the intention of the parties involved for the contract was made with the corporation, not the promoter in view[193]. However, the large majority of the courts do not share this standpoint. The fact that the

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Inc. v. *Parr* (1961), 148 Colo. 45, 364 P. 2d 1056 (Colo., S.C.); *H.F. Philipsborn & Co.* v. *Swan* (1974), 59 Ill. 2d 465, 322 N.E. 2d 45 (Ill., S.C.); *Stap* v. *Chicago Aces Tennis Team, Inc.* (1978), 63 Ill. App. 3d 23, 379 N.E. 2d 1298 (Ill., App. Ct., First District.).

191 *Podpichv. Collier Country Developers, Inc.* (1975), 319 So. 2d 43 (Fla., District C.A., Second District); *RKO - Stanley Warner Theatres, Inc.* v. *Graziano* (1976), 355 A. 2d 830 (Pa., S.C.); *Maliszewskiv. Singer* (1979), 123 Ariz. 195, 598 P. 2d 1014 (Ariz., C.A.).

192 *Kelloggv. Gleeson* (1947), 27 Wash. 2d 501, 178 P. 2d 969 (Wash., S.C.); *Johnson* v. *Nagi* (1957), 50 Wash. 2d 87, 309 P. 2d 380 (Wash., S.C.); *Goodman* v. *Darden, Darden & Stafford Associates* (1982), 653 P. 2d 1371 (Wash., C.A.).

193 R.A. Kessler, *supra*, note 137 at 585.

corporation becomes liable under the contract does not necessarily mean that the promoter is released[194]. Only in the case of novation do the courts accept the promoter's release from liability[195]. If they followed the suggestion that the third party impliedly assents to the novation at the time when the contract is made, the promoter would normally be released from liability. But as stated above, this is not the case: most courts assume novation only when the agreement clearly shows the intent to replace the contracting party[196]. Otherwise the promoter remains liable. Only under the former Kansas statute was the promoter released from liability when the corporation stepped into his shoes[197]. That statute having been abolished, Kansas courts today follow the remaining state jurisdictions in holding the promoter liable although the corporation adopted the contract[198].

c. The American Approach: Balancing Legal Principles and Business Needs

As to the corporation's rights on pre-incorporation transactions the American courts clearly take account of the interests of the parties involved. Since the contract was made with the corporation in view, it

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194 *Bibbee* v. *Root Glass Co.* (1934), 67 S.W. 2d 407 (Texas, Ct. of Civil Apeals); *Wolfe* v. *Warfield* (1972), 266 Md. 621, 296 A. 2d 158 (Md., C.A.); *Pierson* v. *Coffers* (1985), 706 S.W. 2d 409 (Kicky., C.A.); *Clinton Investors Co.* v. *Watkins* (1989), 536 N.Y.S. 2d 270 (S.C.); H.G. Henn & J.R. Alexander, *supra*, note 148 at 252.

195 *Mt. Pleasant Coal Co.* v. *Watts* (1926), 91 Ind. App. 501, 151 N.E. 7 (Ind., App. Ct.); *Jacobsen* v. *Stem* (1980), 96 Nev. 56, 605 P. 2d 198 (Nev., S.C.).

196 *Jacobsen* v. *Stem* (1980), 96 Nev. 56, 605 P. 2d 198 (Nev., S.C.); J.H. Gross, *supra*, note 61 at 393-394.

197 See *Meehan* v. *Alarm Enterprises, Inc.* (1973), 507 P. 2d 849 (Kan., S.C.).

198 *Iola State Bank* v. *Biggs* (1983), 233 Kan. 450, 662 P. 2d 563 (Kan., S.C.).

appears to follow that the corporation be accorded the right to step into the contract. To ask for a new agreement is artificial, especially in view of the requirements that have to be fulfilled at common law. However, American courts and legal writers have some difficulties in justifying the solution on the ground of recognized principles of law. Sometimes, the common law approach is praised as the actually accurate one without putting in question the results achieved at American law, however[199] One author's statement that the same result could have been possible without doing violence to traditional principles of contract and agency law[200] is yet to be confirmed. As long as only the corporation's liability is in issue, the legal basis for a generally accepted solution is of secondary importance. The underlying principles become more significant when we turn to the question whether the corporation's stepping into the contract leads to the acting person's release from liability. The American view that the promoters remain liable is no longer in accordance with the agency principles[201] which are said to be the basis of the promoter's liability. Generally the agent is not liable when the principal declares that he wishes to be bound. Nor can the American *double security rule* be based on the parties' intent. Admittedly, the third party does not mind having as many debtors as possible; but, since the contract is made with one party only, double security provides over-protection, a result that does not conform to the parties' intent as

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199 H.S. Richards, *supra*, note 142 at 105; M.W. Ehrich & L.C. Bunzl, *supra*, note 139 at 1025.

200 H.S. Richards, *ibid* at 105.

201 A.A. Miller, *supra*, note 140 at 748; R.A. Kessler, *supra*, note 137 at 582.

reasonably understood[202]. Finally, the *double security rule* has to be criticized on the ground that it puts the third party in an even better position than when dealing with an existing corporation[203] Certainly, the third party takes the risk that the corporation it dealt with turns out not to have enough assets to satisfy its creditors. But this risk always exists there being no requirement that the corporation has to be endowed permanently with sufficient assets. Fraudulent misrepresentations made by the promoter in advance can still be sanctioned by tort liability. Beyond that, there is no justified need to protect the third party by allowing for cumulative recourse.

American law deserves criticism also with regard to the promoter's liability in general. The basis of the liability is obscure and inconsistent results are the predictable consequence. The often cited intention test is misleading as has been seen already when discussing English law. As was emphasized by some legal writers the parties in truth do not intend to create an immediate contractual relationship[204]. All that can be said is that in normal situations the parties expect the corporation to be formed and - in some way or another - to become a contracting party with all contractual rights and liabilities. The only thing that might be expected from the promoter is that he will secure the corporation's formation. There being no

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202 R.A. Kessler, *supra*, note 137 at 585; J.F. Zimmermann, *Case Comment* (1948) 32 Marquette L. Rev. 170.

203 R.A. Kessler, *supra*, note 137 at 584.

204 M.W. Ehrich & L.C. Bunzl, *supra*, note 139 at 1020-1021; R.L. Rogers, *supra*, note 165 at 1271; D.J. Conroy, "Liability of Promoters of Corporations in Louisiana" (1952) 26 Tulane L. Rev. 227; F.S. Glover, *supra*, note 151 at 113; J.H. Gross, *supra*, note 51 at 386-387.

foothold for an immediate contractual liability based on intent the promoter's liability can so far only be founded on tort concepts such as negligent misrepresentation or an implied guarantee in the sense of warranty of authority. A comprehensive liability concept has to seek other grounds - a question we will come back to later. The American approach, like English law, demonstrates that, inspite of some improvements, traditional contract and agency principles provide little guidance in solving the pre-incorporation contract problem which is turning out more and more to be sui generis[205].

3. Canada

a. The Common Law

Unlike American law, the Canadian approach was marked for a long time by loyalty to the original English common law rules. Basically, Canadian courts followed the rule in *Kelner* v. *Baxter* by holding the promoter liable according to the parties' intent[206] and by requiring a new contract if the company wanted to take advantage of the contract[207]. It is not clear if the rule in *Kelner* v. *Baxter* was followed in Québec. Some decisions indicate that it was[208], but such statements have been strongly criticized[209]. It has

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205 L.D. Salomon & R.B. Stevenson & D.E. Schwartz, *supra*, note 187 at 141

206 *Dairy Supplies Ltd.* v. *Fuchs* (1959), 18 D.L.R. (2d) 408 (Sask., C.A.) at 414.

207 *Clergreen* v. *Humphrey* (1900), 31 S.C.R. 66; *Crane* v. *Lewis* (1912), 4 D.L.R. 175 (Man. C.A.); *Repetti Ltd.* v. *Oliver-Lee Ltd.* (1922), 52 D.L.R. 315 (Ont. C.A.); *Re J.R. Morgan Ltd.* (1926), 31 O.W.N. 343 (Ont. S.C.).

208 *Duquesne* v. *La Compagnie Générale des Boissons Canadiennes* (1907), 31 C.S. 409; *Komery* v. *Restaurant Komery Inc.* (1965), B.R. 853; *Clément Monterosso* v. *Diamantis Andreopoulos*

been argued that civil law devices were available at Québec law which avoid the common law's main deficiency, the refusal to acknowledge legal relations between the third party and the company, contractual or quasi-contractual. The rules relating to delegation (Art. 1169 C.C.L.C), "stipulation pour autrui" (Art. 1029 C.C.L.C.) and conditional contracts (Art. 1079 C.C.L.C.) were seen as appropriate instruments to make the company contractually bound without requiring a new contract. Civil law concepts like "negotiorum gestio" and unjust enrichment were quoted as a panacea for the unsatisfactory situation often encountered in some common law jurisdictions[210] where the third party frequently fails in the attempt to get back the benefits conferred upon the company when the latter refuses to become a party to the contract. In some decisions, the courts even resorted to the theory of adoption of the contract[211].

But in the other provinces as well the courts have not always followed the English rule with "slavish consistency"[212]. In *Gardiner* v. *Martin & Bluewater Conference Inc.*[213], a company was held liable by means of a tort argument, the doctrine of conversion. It is true that the rule in *Kelner* v. *Baxter* does

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(1987) R.I. 373 (Montréal, C.A.); see also C. Fortin, "The Pre-incorporation Trust: A Victim of Misconstruction?" (1970) 30 R. du B. 78 at 82.

209 J. Smith, "Duties and Powers of Promoters in the Company Law of the Province of Quebec" (1973) R. du N. 207 at 212; R. Demers, "From the Bubble Act to the Pre-incorporation Trust: Investor Protection in Quebec Law" (1977) 18 Cah. de Dr. 335 at 367.

210 See J.H. Gross, *supra*, note 61 at 396; R.A. Kessler, *supra*, note 137 at 597.

211 *T.W. Hand Fireworks* v. *Baikie* (1911), 39 C.S. 227; *Integrated Consultants Ltd.* v. *B.D. Bohne and Co. Ltd.* (1967), B.R. 338.

212 T.F. Baines, *supra*, note 192 et 33.

213 (1954) 1 D.L.R. 587 at 590 (Ont. H.C.).

not preclude a claim based on tort, but nevertheless the reasoning is surprising in view of the usual reluctance of the courts to circumvent the results emerging from the application of the rule in *Kelner* v *Baxter*. The validity of the traditional approach was again put in question in *Hudson-Mattagami Exploration Mining Co.* v. *Wettlaufer Bros. Ltd*[214] where the Ontario Court of Appeal hold that the company was bound on paying the price, arguing that it thereby assented to a "tentative contract" kept open for acceptance by the company after it came into existence. The most remarkable solution was advanced in *Associated Growers of B.C. Ltd.* v *B.C. Fruit Land Ltd.*[215]. There the third party was held contractually bound because, prior to incorporation, it had handed a document to the promoters which was deemed to be an offer the promoters were to transmit to the company after incorporation. The promoters were looked upon as agents of the third party (!). Strangely enough, the idea of a continuing offer made by the third party was vehemently rejected[216].

In British Columbia where, as in Nova Scotia, Prince Edward Island[217] and the Northwest Territories, the common law rules still prevail today the reluctance to apply the continuing offer theory seems less strong now. In a recent case[218], it was said obiter that the company's liability could also

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214 (1928) 3 D.L.R. 661 (Ont. C.A.).

215 (1925) 1 D.L.R. 871 (B.C. S.C.).

216 *Ibid* at 874.

217 In Prince Edward Island, propositions for statutory provisions were made (see F. Iacobucci & M.L. Pilkington & J.R.S. Prichard, *Canadian Business Corporations* [Toronto: Canada Law Book, 1977] at 55, 57-58), but not enacted when the Prince Edward Island *Companies Act* (R.S. P.E.I. 1974, c. 15) was revised in 1984 (R.S. P.E.I. 1984, c. 15).

218 *Heinhuisv. Blacksheep Charter Ltd.* (1987), 46 D.L.R. (4th) 67 (B.C.C.A.).

have been based upon the acceptance of a continuing offer made before the company was incorporated[219]. It might be too premature to state that in British Columbian law the strict application of the common law rules has become a thing of the past; but, as in Massachusetts, a first step might have been made.

Another common law device to resolve the problems caused by the rule in *Kelner* v. *Baxter* has provoked a lot of confusion. This is the trust. Former federal and provincial statutes (Ontario, Manitoba, New Brunswick, Prince Edward Island and - still today - Québec) contained provisions dealing with pre-incorporation trusts. Briefly summarized, they stated that on incorporation the company was vested with the property and rights held for it under a trust created with a view to its incorporation. At first glance this appears to be a perfect statutory solution; the provisions nonetheless never played a major role because of doubt as to their particular target. According to some statements, the pre-incorporation trust as understood by the legislation was only meant to facilitate the transition from joint stock companies to letters patent companies[220]. Joint stock companies preceded the modern corporate entities. Since they themselves could not benefit from limited liability, they sought to achieve the same result by making an arrangement with the other party to the effect that only the property held by trustees should attract liability under the contract. Others considered

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219 *Ibid* at 71-72.

220 F.J. Nugan, *supra*, note 6 at 204-205; Interim Report of the Select Committee on Company Law of the Ontario Legislative Assembly, 5th Session, 27.Legis., 15-16 Eliz. II (Toronto: Legis. Ass., 1967) at 11 (hereafter: Lawrence Report).

the pre-incorporation trust as a generally applicable device[221] Legal writers in Québec particularly pointed out that the historical argument was not persuasive[222] Nonetheless, the pre-incorporation trust never made an impact as a way of circumventing difficulties caused by the rule in *Kelner* v *Baxter*. As to Québec law, there has been uncertainty about whether the trust should follow common law or civil law rules[223]. Furthermore, courts and legal writers disagreed as to the impact of the rule in *Kelner* v. *Baxter* on pre-incorporation trusts: in order to become vested with all contractual rights, did the company have to make a new contract[224] or at least to adopt it[225], or was it automatically bound[226]? The latter problem would have arisen in the common law jurisdictions in Canada as well.

Taking all these difficulties into account, federal and provincial legislation followed the recommendations in the Lawrence Report[227] and abolished the relevant provisions. In Québec, art. 31 of the *Loi sur les Compagnies*[228] is still in force, but no longer of practical importance since this section

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221 F.W. Wegenast, *The Law of Canadian Companies* (Toronto and Calgary: Burroughs, 1931) at 262; T.F. Baines, *supra*, note 142 at 37.

222 C. Fortin, *supra*, note 208 at 83 ff.; J. Smith, *supra*, note 209 at 271-272; P. Martel, "Un sujet à la mode: le fidéicommis préconstitutif" (1979) 39 R. du B. at 317 ff.

223 J. Smith, *supra*, note 209 at 274-275 ; R. Demers, *supra*, note 209 at 361-362.

224 *Guillemet* v. *Braczek* (1973), C.S. 953; *Hewlings* v. *Mirotchick* (1972) R.P. 22 (Montréal, C.P.); *Marie Klein-Schwartz* v. *Powell* (1976) R.P. 24 (Montréal, C.A.).

225 J. Smith, *supra*, note 209 at 277 ff.

226 R. Demers, *supra*, note 209 at 370; P. Martel, *supra*, note 222 at 319.

227 Lawrence Report, *supra*, note 220 at 11.

228 L.R.Q. 1977, c. C-38.

applies only to letters patent companies which have now been superseded in practice by companies incorporated upon filing articles[229]. In the course of the reform of the Civil Code, art. 31 of the *Loi sur les compagnies* and the provisions referring to companies incorporated upon filing articles (art. 123.7 and 128.8 of the *Loi sur les compagnies*) will be replaced by new provisions[230] which will be discussed later

b Statutory Solutions

In Canada as elsewhere, the common law rules were considered to be unsatisfactory and unconvenient[231] although their conformity with legal principles of contract and agency law was expressly recognized[232]. Statutory reform started in Ontario where the Lawrence Committee recommended that the rule in *Kelner v. Baxter* be repealed[233] Following the American approach, it suggested that the company should have the right to adopt the contract by unilateral act. The Committee's proposals, enacted in Ontario in 1970, differed from the American model inasmuch as the promoter would generally be held liable until the company adopted the contract. He would not be allowed to exempt himself from liability[234]. This

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229 M. Martel & P. Martel, *supra*, note 6 at 98.

230 See proposed art. 353 and 354 of the *Draft Civil Code*, G.O.Q. 1987 I 4175.

231 F.J. Nugan, *supra*, note 6 at 206; F. Iacobucci & M.L. Pilkington & J.R.S. Prichard, *supra*, note 217 at 50; T. Hadden & R.E. Forbes & R.L. Simmonds, *Canadian Business Organizations Law* (Toronto: Butterworths, 1984) at 133; M.A. Maloney, "Pre-incorporation Transactions: A Statutory Solution?" (1986) 10 C.B.L.J. 409.

232 F.J. Nugan, *supra*, note 6 at 201.

233 Lawrence Report, *supra*, note 220 at 12.

234 *Ibid*; see also F.J. Nugan, *supra*, note 6 at 206.

elaborate liability scheme was made more flexible by a provision to the effect that a contracting party was entitled to make an application to the court in order to declare company and promoter jointly and severally liable when this appeared to be just and equitable. This device, quite a novelty in the debate on pre-incorporation transactions, was meant to take account of particular situations where it did not appear to be justifiable to free the promoter from liability upon the company's adoption of the contract or to leave the company unaffected merely because it did not adopt the contract[235]. Finally, the Committee recommended a provision dealing with the promoters' claims against the company thus putting an end to much uncertainty about the common law position.

The federal provision, enacted in 1975 as s.14 of the *Canada Business Corporations Act* [236], followed in principle the suggestions made by the Lawrence Committee; however, it is marked by some significant differences. First, whilst the Lawrence Committee proposals apply to all pre-incorporation contracts, the federal provision covers only written contracts in order to avoid problems of proof which arise in the case of oral contracts[237]. The common law rules are therefore still in force where the contract is merely an oral one. Secondly, the federal act differs from the Lawrence Committee proposals insofar as it does not provide for the company's liability towards the promoter, the legislator apparently being

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[235] Lawrence Report, *ibid*

[236] S.C. 1974-75-76, c.33.

[237] R.W.Y. Dickenson & J.L. Howard & L. Getz, "Proposals for a New Corporations Law in Canada", vol 1, 1971, para. 70 (hereafter: Federal Proposals).

satisfied with (deficient) common law rules A third quite important difference relates to the promoter's right to exempt himself from liability. *CBCA*, s 14 allows for exemption clauses provided they are express (*CBCA*, s 14[4]) If held valid disclaimer clauses may even counter court orders made upon application by the other party declaring the promoter liable In this context, another difference between the Lawrence Committee recommendations and the federal act is noteworthy. The former restricts the court's discretion to a declaration that promoter and company are jointly and severally liable; the federal provision goes further by allowing for any order the courts think to be fit.

The federal provisions were adopted in Manitoba[238], Saskatchewan[239], Newfoundland[240] and - with slight nuances - in New Brunswick[241] and in Ontario[242] where the former provision based on the Lawrence Committee's proposals was revised in 1982. The New Brunswick and Ontario provisions apply also to oral contracts.

Interestingly enough, the federal provision was not the model for all provincial legislators. Whereas British Columbia, Nova Scotia, Prince Edward Island and the Northwest Territories prefer to preserve the common

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238 Manitoba *Corporations Act*, S.M. 1976, c. 40, s. 14.

239 Saskatchewan *Business Corporations Act*, R.S.S. 1978, c. B-10, s. 14.

240 Newfoundland *Corporations Act*, S.N. 1986, c. 12, s. 29.

241 New Brunswick *Business Corporations Act*, S.N.B. 1981, c. B-9.1, s. 12.

242 Ontario *Business Corporations Act*, S.O. 1980, c. 4, s. 21.

law rules, Alberta, followed in 1986 by the Yukon Territory, and Québec chose a different route.

S. 14 of the *Alberta Business Corporation Act* [243] and s. 17 of the *Yukon Business Corporation Act* [244] follow the federal approach regarding the corporation's right to adopt the contract and the possibility to apply for a court order Beyond that they provide for restitution claims the promoter or the third party might assert against the corporation if the latter received benefits under the contract, but did not adopt it. The most striking difference concerns the promoter's liability. As in the federal model, the Alberta and the Yukon provisions hold the promoter generally liable, but they go one step further by indicating what such liability should be based upon. According to s. 14(2) of the Alberta Act and s. 17(2) of the Yukon Act, the acting person is presumed to have warranted that the corporation will be incorporated "within a reasonable time" and that - also within a reasonable time - the contract will be adopted. If these events do not occur, the promoter will be held liable for breach of warranty. The common law problem of measuring the damages[245] arises again: According to s. 14(2) (c) of the Alberta Act and s. 17(2) (c) of the Yukon Act, damages are measured as if the corporation was already in existence when the contract was made They may be nominal where the corporation does not have sufficient assets.

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[243] Alberta *Business Corporations Act*, S.A. 1981, c. B-15.

[244] Yukon *Business Corporations Act*, R.S.Y. 1986, c. 15.

[245] *Wickberg* v. *Shatsky* (1969), 4 D.L.R. (3d) 540 (B.C.S.C.); *Delta Construction Co. Ltd.* v. *Lidstone* (1979), 96 D.L.R. (3d) 457 (Nfld. S.C.); T. Hadden & R.E. Forbes & R.L. Simmonds, *supra*, note 231 at 133-134.

As to companies incorporated by the filing of articles, in 1979 Québec enacted provisions dealing with pre-incorporation activities Art 123 7 and 123 8 the of *Loi sur les compagnies*[246] departed from art 31 and its trust model which had caused so much trouble in the context of letters patent companies The new provisions recognize the company's right to "ratify" the contract, but limit this right to 90 days after incorporation. Differing sharply from the remaining statutory solutions to be encountered in Canada, the Québec provisions do not free the promoter from liability upon the company's adoption of the contract, following in that respect legal writers in Québec who recommended the adoption of the American *double security rule*[247].

In Québec, there is no express provision entitling any contracting party to apply for a court order. The promoter is generally liable under the contract unless the contract provides otherwise. The exemption clause - a further particularity of Québec law - is only valid if it informs the third party about the possibility that it might have no recourse at all in the event that the corporation never comes into existence or refuses to adopt the contract.

In the future, all provisions in the *Loi sur les compagnies* dealing with pre-incorporation activities will be replaced by arts. 353 and 354 of the new *Civil Code*[248]. Those apply to all "personnes morales" and - apart from the

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[246] L.R.Q. 1979, c. C-31.

[247] J. Smith, *supra*, note 209 at 297-298; see also R. Demers, "La responsabilité contractuelle du promoteur" (1978) 19 Cah. de Dr. 811 at 818.

[248] G.O.Q. 1987 I 4175.

some less important items - are almost identical to art 123.7 and 123.8 of the *Loi sur les compagnies*.

c Canada: A Variety of Solutions

Canada's legal landscape offers an extensive variety of solutions ranging from the old common law rules to elaborate, but not identical statutory solutions. Taking leave of old principles seems to cause hardship: even under some statutory régimes the common law position has not been abandoned completely. Looking at the statutory liability schemes more closely one has to establish uniformity as to the corporation's right to adopt the contract. While it might be deplorable that there is no better definition of what is meant by adoption[249], one has to take into consideration that the multitude of cases cannot be foreseen. Traditional rules of contract law must be seen to offer sufficient guidance on the question of whether a corporation has adopted a contract or not. Canadian legislation thus follows the American model - seemingly unconcerned in providing justification. Strikingly enough, neither the Lawrence Report nor the Federal Proposals nor any legal writer deal with the underlying principles on which the statutory solution can be based.

This finding is in stark contrast to the situation prevailing as to the promoter's liability. As reflected by a variety of statutory solutions, there is still a considerable disaccord on almost all of the questions raised in relation to the promoter's liability. The scope of the provision holding the

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249 M.A. Maloney, *supra*, note 231 at 416.

promoter liable is still in dispute Disharmony prevails also with respect to disclaimer clauses and the impact of the adoption of the contract by the corporation on the promoter's liability. As to the scope of the provisions declaring the promoter liable on pre-incorporation contracts, considerable doubt has been expressed as to whether the statute really results in abrogating the frequently criticized common law rule[250] There is some nicety in the argument advanced in support of this point of view, i e that if the statutory provisions declare that the corporation is entitled to adopt "a contract", an effective contract must have been in existence before; otherwise it can hardly be imagined that the corporation could step into the contract and that the promoter could be potentially liable thereunder. It is submitted, therefore, that *C.B.C.A.*, s. 14 and the related provisions cannot operate without a precise analysis of the parties' intent.

Although based on sound reasoning, this position misses the point. The provisions aim at avoiding the unsatisfactory legal position which the application of common law principles had led to. Canadien cases also illustrate how misleading the intention test at common law can be. While in *Brennan v. Brenwick Fruit Co Ltd.*[251], the promoter was held liable on the ground that this must have been intended, otherwise the contract would have been inoperative, two recent Québec cases[252], also referring to the intention test, reach the opposite conclusion. If the third party knew about the non-

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250 B. Welling, *supra*, note 27 at 288-289; E.E. Palmer & B. Welling, *Canadian Company Law*; 3d ed. (Toronto and Vancouver: Butterworths, 1986) at 5-25.

251 (1928) 1 D.L.R. 548 (N.S. S.C.).

252 *Monterossov. Andreopoulos* (1987), R.D.I. 373 (Montréal, C.A.) at 376; *Major and Martin Inc.v. Landsman* (1978), 19 Cah. de Dr. 821 (Montréal, C.S.) at 824.

existence of the company on whose behalf the promoter acted it could not have intended to make a binding contract with the promoter because the latter manifestly did not act for himself[253] How hair-splitting the intention test can be emerges from *General Motor Acceptance Corporation of Canada Ltd.* v *Weisman* [254] where the court walked the same "legal tightrope" as the court in the English *Newborne* case With the common law difficulties in mind, the Lawrence Report[255] and the Federal Proposals[256] both recommended that the promoter be declared generally liable[257] In the light of these statements and the foregoing criticisms of the common law position, it is hardly conceivable that the legislator intended to preserve the common law position[258]. Even on the basis of the statutory provisions themselves, it can be argued that the legislator cannot have meant to use the term "contract" in its technical sense when providing for the corporation's right to adopt "the contract" and for the promoter's potential liability thereunder Provisions which allow for the promoter's exemption from liability in a situation where no contractual link exists[259], but nevertheless accord the corporation the right to adopt "the contract", cannot

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[253] See also F. Iacobucci & M.L. Pilkington & J.R.S. Prichard, *supra*, note 217 at 50; R.L. Simmonds & P.P. Mercer, *supra*, note 6 at 449.

[254] (1979) 96 D.L.R. (3d) 159 (Middlesex County Ct., Ont.).

[255] Lawrence Report, *supra*, note 220 at 12.

[256] Federal Proposals, *supra*, note 237 at para. 70.

[257] See also L. Getz, *supra*, note 1 at 402; F.J. Nugan, *supra*, note 6 at 206.

[258] F.H. Buckley & M.Q. Connelly, *supra*, note 3 at 143; M.A. Maloney, *supra*, note 231 at 411.

[259] M.A. Maloney, *supra*, note 231 at 427; L. Getz, *supra*, note 1 at 407.

be seen as being restricted to "real" contracts. *Landmark Inns of Canada Ltd. v Horeak*[260] was therefore correctly decided[261], the court having applied the relevant Saskatchewan provision without entering into a detailed intention analysis

The question remains whether, and how, the statutory provisions can be traced back to recognized principles of contract law. In essence, they cannot There might be situations where the corporation adopts "a contract" which in legal terms does not deserve this classification. For those who believe that by no means can the promoter be considered to bind himself, the situation envisaged by the statute does not arise since there would never be a pre-existing contract the company could adopt. The statute's deficient language can only be cured by assuming a "legal"[262] or - particularly in the case of disclaimer clauses - a "tentative" contract or by exchanging the term "contract" by the notion "agreement"[263] Those who furthermore plead for intention as a basis for promoter liability[264] have to realize that the law in Canada as far as governed by statute has generally ceased to see a link between the parties' intention and the promoter's liability. The parties' intention only plays a part when it comes to excluding the promoter's liability. Disclaimer clauses are recognized nowadays; earlier attempts to

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260 (1982) 2 W.W.R. 377 (Sask. Q.B.).

261 *Contra*: B. Welling, *supra*, note 27 at 291.

262 *Gargetziadis v. South Town Developments Ltd.* (1980), 6 Sask. R. 151 (Sask. Q.B.) at 155; M.A. Maloney, *supra*, note 231 at 414.

263 M.A. Maloney, *supra*, note 231 at 414.

264 B. Welling, *supra*, note 27 at 288-289; M.H. Ogilvie, *supra*, note 13 at 343; C. Fortin, *supra*, note 208 at 97.

reform the common law rules preferred to deny the acting person's right to exempt himself from liability[265] The legislator's distrust of such clauses, which entail considerable risks for the unsuspecting third party, is still reflected in the Québec provision (art 123 8 of the *Loi sur les compagnies*, henceforth art 354 of the *Draft Civil Code*) In order to be effective the clause must disclose the possibility that the company may not come into existence or may not adopt the contract[266]. Some further significance is accorded to the parties' intentions when dealing with the question whether the promoter is continuously liable after the corporation adopted the contract. In contrast to the American approach, Canadian statutes take into consideration that the contract was essentially made with the corporation in view; double security, under these circumstances, is considered a pure artificialty[267]. Only the Québec legislation, given its general reservations about promoters, maintains the view that the promoter's liability should not cease when the corporation adopts the contract. This rule can only be justified on policy grounds[268]. When judging Québec law, one has to bear in mind that there is no provision allowing for a corrective court order. In some exceptional cases where it appears to be just and equitable to hold the promoter liable despite the contract's adoption by the company Québec law is without any sanctions. Whether it would have been preferable to include a provision similar to the federal and other provincial acts, is another question. In Québec, such provisions have been criticized on the ground that

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265 Lawrence Report, *supra*, note 220 at 12; F.J. Nugan, *supra*, note 6 at 206.

266 See also L. Getz, *supra*, note 1 at 408; M.A. Maloney, *supra*, note 231 at 429.

267 Lawrence Report, *supra*, note 220 at 12.

268 See J. Smith, *supra*, note 209 at 297; R. Demers, *supra*, note 247 at 818.

the legislator should regulate the matter comprehensively instead of leaving the difficult cases to the courts to decide[269]

In view of the variety of cases where the need for correction is obvious a comprehensive statutory solution is hardly possible. Leaving room for court decisions that differ from the basic liability scheme is a new approach and a commendable one[270] It is true that the court's discretion is wide[271] but this does not mean that the court can use it at will. The legislators' fundamental decision that the third party can have only one debtor - the corporation in the case of adoption - must be observed. To allow for a choice between two debtors requires a specific justification. It seems too narrow, though, to assume that the courts in exercising their discretionary power will mainly have recourse to the traditional contractual analysis when deciding whether a second debtor should be established[272].

It is admitted that in *Bank of Nova Scotia* v *Williams*[273] contractual arguments were advanced to reject the third party's claim for recourse against the promoter in addition to claims against the corporation that had become insolvent. But this can hardly be said to have been the crucial argument because under the same factual circumstances the opposite outcome would still have been covered by the court's discretionary power.

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269 R. Demers, *supra*, note 247 at 818.

270 M.H. Ogilvie, *supra*, note 13 at 344; L. Getz, *supra*, note 1 at 406-407.

271 Federal Proposals, *supra*, note 237 at para. 72.

272 See T. Hadden & R.E. Forbes & R.L. Simmonds, *supra*, note 231 at 135.

273 (1976) 70 D.L.R. (3d) 108 (Ont. H.C.).

Confronted with the question whether to declare the promoter liable despite the contract's adoption by the corporation, the court must not ask itself if the third party harbours expectations that might be based on contractual grounds. The main question is rather one of expectation in a more general sense: the third party believes that a corporation, working normally, might become his contracting party. As to his expectation that the corporation will be endowed with sufficient assets to meet its obligations, it has to be observed that this expectation is not worthy of protection. To this extent, the third party assumes a normal risk of business life that cannot be taken away from him because this would be tantamount to introducing clandestinely a minimum capital requirement where no such thing exists. Therefore, the provision for application to the court cannot be understood as a mere device to increase the quantity of assets available to satisfy the claim.

But inasmuch as the third party expects to deal with an honest promoter who sets up a business according to the ethics of business life, it can claim for protection under the statutory provision if it turns out that the promoter incorporated the business merely to escape personal obligations In fact, this has been considered the main case in which a court order declaring the promoter liable would be appropriate[274]. In case of fraudulent behaviour, the promoter certainly does not deserve protection in the form of discharge from liability which is usually granted when the corporation adopts the contract[275]. This can mainly be assumed where promoter and corporation

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[274] Federal Proposals, *supra*, note 237 at para. 72.

[275] *Daoust* v. *Lee* (September 16, 1982), Montréal 500-05-014382-822, cited by M. Martel & P. Martel, *supra*, note 6 at 92 n. 31.

are almost identical, i e. where the promoter becomes the sole or dominant shareholder[276] In essence, declaring the promoter liable by virtue of court order is similar to the tortious act shareholders or managers commit when they deprive the corporation of its assets thus inducing it to breach a contract[277]

The court's power to hold the promoter liable despite the fact that his liability ceased after the contract's adoption by the corporation has its limits. Disclaimer clauses bar the apportioning of liability It is argued that such provisos if in accordance with the strict statutory requirements make the third party fully aware of the risks he is running; therefore, the non-liability of the promoter could by no means be considered to be unequitable[278] This view has attracted strong criticism on the ground that frequently third parties not familiar with the subtle rules on pre-incorporation activities do not realize the possibility that they might have no recourse against anybody[279]. For this reason, earlier statements generally rejected disclaimer clauses[280] or - at least - wanted to make sure that the third party was fully aware of the risks[281]. The last proposal, presently law in Québec, is certainly the preferable one, for it preserves

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276 Lawrence Report, *supra*, note 220 at 12; Federal Proposals, *supra*, note 237 at para. 72; L. Getz, *supra*, note 1 at 405-406.

277 F H. Buckley & M.Q. Connelly, *supra*, note 3 at 147.

278 Federal Proposals, *supra*, note 237 at para. 73.

279 M.A. Maloney, *supra*, note 231 at 429.

280 Lawrence Report, *supra*, note 220 at 12; F.J. Nugan, *supra*, note 6 at 206.

281 L. Getz, *supra*, note 1 at 408.

freedom of contract without exposing the third party to the risk of experiencing an unpleasant surprise later.

By application to the court, it is also possible to have recourse against the corporation although the contract was not adopted This disregard of corporate self-determination needs special justification which has not been forthcoming in cases where the third party has discovered that the primarily liable promoter is not a man of substance[282]. As was seen above, the right to apply for a court order is not considered a device to increase the assets disposable to satisfy the claims. However, the corporation's right to take its own decisions seems to be of less importance when the promoter who arranged the agreement maintains a crucial position in the new corporation[283] In this case, the corporation's disapproval is less an expression of a separate corporate will than a matter of "venire contra factum proprium" given the fact that the factually dominant person asserted to the deal beforehand. Thus, the promoter's position towards the corporation - so far without any impact on the liability scheme - becomes a decisive factor in apportioning liability between acting person and corporation[284].

It is questionable whether both the third party and the promoter are entitled to apply for a court order stating that benefits conferred upon the corporation are to be restored. This issue has been one of the weak points

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[282] Federal Proposals, *supra*, note 237 at para. 72.

[283] Federal Proposals, *supra*, note 237 at para. 72.

[284] M.A. Maloney, *supra*, note 231 at 412-413.

at common law for there has been much doubt as to what extent restitutionary claims were to be recognizable Following the Lawrence Committee recommendations[285], the earlier Ontario provision provided for such relief Alberta and the Yukon inserted similar provisions. Québec law declares "mandat" rules applicable to the promoter's rights and otherwise makes use of general restitutionary rules that provide for satisfactory results Incomprehensibly, the federal provisions and those which are based upon it do not include restitutionary remedies The Federal Proposals do not even address this problem. Whether this was a deliberate policy or simply an oversight, it would have been desirable to enact a clear rule[286].

Summing up, it has to be conceded that Canadian legislation on pre-incorporation transactions represents - in all its facets - a clear improvement of the common law position. Even in the light of the critical remarks that have to be made[287], the statutory provisions do not merit the hard judgment[288] that they created as many problems as they solved.

4. Australia and New Zealand

In 1981 and 1983, Australia and New Zealand where previously the old common law rules had prevailed made the latest attempt to overcome the

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285 Lawrence Report, *supra*, note 220 at 12.

286 M.A. Maloney, *supra*, note 231 at 430 ff.

287 Doubts as to the federal provision's constitutionality have been left aside here. See M.A. Maloney, *supra*, note 231 at 432 ff.; R. Demers, *supra*, note 247 at 817; P. Martel & M. Martel, *supra*, note 6 at 92; B. Welling, *supra*, note 27 at 295.

288 M.A. Maloney, *supra*, note 225 at 410; B. Welling, *supra*, note 27 at 288.

rules' deficiencies by statutory provisions. In both countries, very complex provisions were enacted, even more complex than the Canadian provisions. It appears that as legislators deal with the matter they tend to enact more elaborate and subtle rules Law reformers in Australia and New Zealand examined the Canadian approach, but did not adopt it entirely S 81 of the Australian *Companies Code* and s. 42 A of the New Zealand *Companies Act* are distinct from the Canadian model in many respects The two provisions are even dissimilar from one another, New Zealand did not follow the Australian approach in every respect although the statutory reform was based on Australian considerations[289]. Both statutes are identical in abrogating the common law rule that a company may not step into a contract by a unilateral act, recognizing the company's right to "ratify" the contract As far as the common law problem of determining the promoter's liability is concerned, harmony between both statutes is not so obvious. Whereas New Zealand follows the English and Canadian approach in equalizing all factual patterns encountered in the field of pre-incorporation transactions[290], Australian law does not express this concern clearly[291]. Declaring the provisions applicable to cases where a person "executes" a contract *in the name of a non-existent company* or purports "to enter into a contract as agent or trustee for a *proposed* company" (see s. 81[1] [a]) the statute does not seem to cover the case that the acting person is not aware of the non-existence of the company for then he would act as an agent of an existing

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289 M.R. Bucknill, *supra*, note 2 at 28 n. 11.

290 C.L. Watson, "Pre-incorporation Contracts in New Zealand Law" (1985) J.B.L. 83 at 85.

291 J.P. Hambrook, "Pre-incorporation Contracts and the National Companies Code: What Does Section 81 Really Mean?" (1982) 8 Adel. L. Rev. 119 at 128 ff.

company, not of a non-existent or a proposed one as the statute requires[292]. Not only with respect to its scope, but also with respect to its substance, the promoter's liability as regulated by the statute gives rise to many questions. This is also true in the case of New Zealand law Unlike the English and most Canadian counterparts, the Australian and the New Zealand provisions do not declare the promoter a party to the contract[293] Whilst s 81(4) of the Australian *Companies Code* merely states that the promoter is liable in damages, s. 42 A(4) of the New Zealand *Companies Act* goes one step further by indicating what the promoter's liability should be based upon: following the Alberta and the Yukon approach, the provision sets up a presumption to the effect that the promoter is deemed to warrant that the company will come into existence within a certain period and thereafter ratify the contract. The reason why both legislators did not follow the English and the Canadian model is the assumption that the promoter can hardly be declared a party to the contract given the fact that the contract was made with a view to the company[294]. This divergence from other statutory models entails several problems.

First, the question of how to measure the damage arises. If liability is based on the breach of a warranty as suggest the New Zealand and - less expressly - the Australian act, the third party has to be compensated to the amount he would have recovered against the company had the company come

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292 J.P. Hambrook, *ibid.* at 129.

293 J.P. Hambrook, *ibid* at 128, 143; M.R. Bucknill, *supra*, note 2 at 37.

294 Law Reform Commissioner of Victoria, Report N° 8: *Pre-incorporation Contracts* (Melbourne, 1979) at 14 (para. 35).

into existence, ratified the agreement and subsequently refused to act upon it The company possibly being insolvent, there is a risk that the damages will be nominal. The Australian act avoids this results by assessing damages as the amount the third party would have been *awarded* against the company. Amazingly enough, the New Zealand act did not follow the Australian model by providing - as in the Alberta and Yukon statute - that damages should be measured according to the amount the third party would in fact have recovered against the company. This solution appears to be more logical, but produces considerable uncertainty for the third party who asserts claims against the promoter.

Secondly, the approach taken in the Australian and New Zealand statutes creates problems as to the parties' position until ratification occurs. With respect to English and Canadian law (except for Alberta and the Yukon), the position is clear Since the contract, by virtue of statute, is considered to be binding from the outset as the promoter is *deemed* to be a party, the parties are not free to repudiate the contract by a unilateral act. Only by agreement is it possible to bring the contract to an end thus preventing the company from ratifying it[295]. The result could be different under Australian and New Zealand law. Since, from the outset, there is no binding agreement, the third party should be free in repudiating the "contract" before ratification. This finding seems to contradict the rule in *Bolton Partners* v. *Lambert* [296] which states that ratification "relates back" rendering effective the contract notwithstanding that the third party withdrew from

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[295] *Landmark Inns of Canada Ltd.* v. *Horeak* (1982), 2 W.W.R. 377 (Sask. Q.B.).

[296] (1889) 41 Ch. D. 295 (C.A.).

the agreement prior to ratification. However, the rule does not apply where the contract is made subject to ratification[297] because in these circumstances the offer is just conditional, the agent's acceptance merely contemplated: there is nothing that could be ratified Applying this exception to the rule to pre-incorporation transactions, it could be argued that where the third party knows that the company is not yet in existence, the agreement is - impliedly - subject to ratification. However, this could not be said when the third party is unaware of that fact. Thus, knowledge becomes a crucial point in deciding whether the third party can get out of the agreement or not[298] This finding appears to be objectionable , not in legal, but in policy terms[299] To allow for unilateral repudiation before ratification runs counter to the underlying purpose of pre-incorporation agreements. These are made to bind the third party as early as possible. Against this background, to prevent the company from ratifying seems quite incomprehensible especially when the third party knows about the non-existence of the company. Finally, it cannot be said that it is unfair to hold the third party bound whilst the promoter is not: he is bound in the sense that he faces liability in case of non-ratification. Thus, the Australian and New Zealand approach leads to an unsatisfactory result.

Another - third - problem that is caused when founding liability on breach of warranty relates to the mutual obligations the parties have to fulfill. Since

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297 *Watson v. Davies* (1930), [1931] 1 Ch. 455.

298 J.P. Hambrook, *supra*, note 291 at 139; M. Hurley, "Pre-incorporation Contracts: Section 42(A) of the Companies Amendment Act (No. 2) 1983" (1985) 5 Auckland U.L. Rev. 224 at 229.

299 M.R. Bucknill, *supra*, note 2 at 35-36.

the promoter is not considered to be a party to the contract, he cannot enforce contractual rights nor can these rights be enforced against him[300]. Under Australian law, mutual enforcement would only be possible if one follows the interpretation that s 81 of the *Companies Code* does not cover all factual patterns that arise in the context of pre-incorporation agreements[301] Otherwise, recourse to common law rules is expressly excluded (see s 81[11] of the *Companies Code*). In New Zealand where such a provision does not exist a contract would be enforceable by or against the promoter if on the basis of the *Kelner* and *Newborne* distinction he has to be considered a contracting party[302]. Thus, to a certain extent the old common law rules still apply.

Apart from these features of Australian and New Zealand law it is also noteworthy that both acts follow the Canadian approach in providing for an application to the court in order to avoid results that appear to be unjust. (See s 81(5) and (7) of the Australian *Companies Code*, s. 42 A (6) and (7) of the New Zealand *Companies Act*) As to the company's liability despite non-ratification, both statutes contain restitutionary remedies thus avoiding a grievious defect of the Canadian model. With respect to the promoter's liability which usually expires after the company ratified the contract, court orders like in Canadian law are mainly supposed to prevent promoters from setting up undercapitalized companies in order to make them ratify the

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300 J.P. Hambrook, *supra*, note 291 at 143-144.

301 J.P. Hambrook, *ibid* at 129-130.

302 M. Hurley, *supra*, note 298 at 232.

contract thus creating a loophole to escape personal liability[303] For good reasons, it is submitted that courts have to be reserved when making orders in this area[304]; before piercing the corporate veil, aggravating circumstances have to be given even in the case of one-man companies because basically the limitation of liability is also available for this type of entity[305]

The Australian and the New Zealand approach reviewed shortly, it has to be conceded that the main defects of the common law rules were eliminated. In particular with respect to the promoter's liability, the statutory solutions illustrate that some doubts are still justified. It appears that after statutory reforms in different common law jurisdictions the debate on pre-incorporation transactions has to focus increasingly on the promoter's liability,the problem of the company's rights - with the exception of the United Kingdom - nowadays being largely resolved.

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303 J.P. Hambrook, *supra*, note 291 at 142-143; M.R. Bucknill, *supra*, note 2 at 38-39; H.A.J. Ford, *supra*, note 96 at 545.

304 M.R. Bucknill, *supra*, note 2 at 38.

305 *Salomon v. Salomon & Co.* (1897) A.C. 22.

IV. Pre-incorporation Transactions Under German Civil Law

In Germany, pre-incorporation transactions have always been and still are the subject of intense legal debate Over the past decades, the law has developed considerably, the outcome being quite different than all approaches to be encountered in common law jurisdictions, although the starting points were quite similar the German statutory provisions dealing with pre-incorporation activities reflect the same ideas that prevail at common law Both s 11 of the *Gesetz betreffend die Gesellschaften mit beschränkter Haftung* (Private Limited Companies Act, *GmbHG*) and s 41 of the *Aktiengesetz* (Public Companies Act, *AktG*) are based on the principle that the body corporate only comes into existence upon registration. Liability therefore lies only with the "Handelnder" (acting person) The provisions originate from art. 211 of the *Allgemeines Deutsches Handelsgesetzbuch* (General Commercial Code of Germany, *ADHGB*), enacted in 1861, when incorporation could only be achieved by grant of a charter Personal liability was meant to sanction the acting person's disregard of the fact that the status of legal autonomy had not yet been accorded. Although the concession system was abandoned in 1870, the provisions dealing with pre-incorporation activities did not undergo any change.

Even with similar starting points, however, the law developed fairly differently in Germany and in common law jurisdictions. Whereas, in most common law jurisdictions, the legislator intervened in order to free judge-made rules from deficiencies, the German legislator remained largely inactive leaving it to the courts and legal writers to redefine statutory rules generally considered to be unsatisfactory. Thus, the field of pre-

incorporation transactions illustrates quite nicely the attempts of different legal systems to improve their rules by having recourse to the other system's methods of law making.

1 German Law's Main Feature Die "Vorgesellschaft"

Corresponding with well-established common law rules, German law does not recognize the possibility of making immediately binding contracts with non-existent principals. However, in the field of pre-incorporation transactions, German law does not have to deal with this problem to the same extent as the common law. It is true that the company - Aktiengesellschaft or Gesellschaft mit beschränkter Haftung - only comes into existence upon incorporation. Nevertheless, German law assumes a principal in existence even before the company itself is incorporated. This was already suggested by the Reichsgericht in 1905[306] which argued that to fix the company's birth at the date of its registration did not necessarily exclude the existence of any other kind of association before that date. According to the Reichsgericht, the founders, after agreeing upon the formation of a company, enter into a "civil partnership" ("Gesellschaft des Bürgerlichen Rechts")[307]. According to some courts, the "civil partnership" becomes a "commercial partnership" ("Offene Handelsgesellschaft") where the founders start or continue to run a business[308]. This classification was

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306 RGZ 58, 55-56.

307 See also: RGZ 83, 370 at 373; RGZ 105, 228 at 229; RGZ 151, 86 at 91.

308 OLG Frankfurt NJW 1947/48, 479; OLG Hamburg JZ 1952, 436; OLG Oldenburg BB 1955, 713.

criticized on the ground that with respect to its corporate structure the pre-incorporation entity more resembled an association without legal capacity ("Nichtrechtsfahiger Verein") than a partnership[309]

The attempts to classify the pre-incorporation association as one of the established entities became obsolete in 1956 when the Bundesgerichtshof (Federal Supreme Court) declared the pre-incorporation association to be an entity *sui generis* governed by the law of the proposed company as far as the rule at stake does not specifically require the company's previous registration[310]. This view was approved by the large majority of legal writers[311] Not surprisingly, the dispute shifted to the question, to what extent should the provisions included in the *Aktiengesetz* and the *GmbH-Gesetz* apply to the so-called Vorgesellschaft[312] It is obvious that the more the "Vorgesellschaft" is looked upon as the company's "foetus", the more identity has to be assumed meaning that contracts made on the company's behalf before incorporation will bind the company upon its birth. This outcome, however, runs counter to one of German company law's main concerns: the minimum capital requirement. Shareholders have to contribute 50,000 DM (GmbH) or 100,000 DM (AG) in cash or kind, as the

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309 W. Flume, "Die werdende juristische Person" in Festschrift für Ernst Gessler (München: Vahlen, 1970) 3 at 27.

310 BGHZ 21, 242 at 246; see also BGHZ 45, 338 at 347; BGHZ 51, 30 at 32.

311 See only H. Wiedemann, *Gesellschaftsrecht*, vol. I (München: C.H. Beck, 1980) at 146.

312 The following statements are restricted to private limited companies (GmbH's) where pre-incorporation problems have been discussed to a greater extent than in the context of public companies (AG's). It should be noted, however, that the principles developed for the unborn GmbH also apply to the unborn AG (see K. Schmidt, Gesellschaftsrecht [Köln, Berlin, Bonn, München: Heymann, 1986] at 601).

agreement may be. For a long time, the courts and legal writers concluded that the assets required to be available upon the company's registration must not be diminished[313] The way which was opened by the recognition of some kind of pre-incorporation entity seemed to be barred by this prohibition called "Vorbelastungsverbot" for binding agreements would affect the value of the assets the shareholders brought in However, the "Vorbelastungsverbot" has not been strictly observed The statutes themselves allow for charging the company with obligations emerging from contracts that are necessary in view of the formation of the company and those that are provided for in the articles. With respect to companies formed by non-cash capital contributions, the courts extended considerably the scope of "necessary" contracts, even to all kinds of business related transactions when an existing business was brought in[314] Thus, an attempt was made to reconcile the rules with commercial reality, but not much was left from the original view[315] that the pre-incorporation association's purpose was first and foremost to achieve incorporation. This view was upheld only with regard to companies formed by cash contributions

The law as it stood was quite unsatisfactory and inconsistent: on the one hand, the principle of capital maintenance was virtually abandoned where - as happens frequently - a business was brought in, whereas on the other hand, the same principle was defended at all costs where its abandonment would have made commercial sense, too, for thus the company could not

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313 See only BGHZ 17, 385 at 391; BGHZ 53, 210 at 212.

314 BGHZ 45, 338 at 343; BGH LM Nr. 12 zu § 11 GmbHG.

315 RGZ 83, 370 at 373; RGZ 105, 228 at 229.

benefit from profitable deal opportunities. The obvious disharmony within the rule gave rise to substantial legal debate. Following suggestions made by Ulmer[316] the Bundesgerichtshof decided in 1981[317] that the "Vorbelastungsverbot" should no longer prevail However, the principle of capital maintenance was not abandoned, but replaced by the so-called "Differenzhaftung", i.e. the founders' pro rata liability for potential deficits. The effect of this decision, largely welcomed as a landmark judgment[318], was the automatic transfer of all rights acquired and liabilities incurred by the pre-incorporation association.

The mere fact that the pre-incorporation assocation is capable of being subject to all rights and liabilities[319] does not answer the question, which requirements have to be fulfilled in order to bind the "Vorgesellschaft" and consequentially the company. Like the company itself, the "Vorgesellschaft" acts through the directors[320] who attain their position not only upon the company's registration, but already at the time when the "Vorgesellschaft" comes into existence, i.e. at the time when the shareholders/founders agree

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316 P Ulmer, "Das Vorbelastungsverbot im Recht der GmbH - Vorgesellschaft" in Festschrift für Kurt Ballerstedt (Berlin: Duncker & Humblot, 1976) 279 at 290 ff.

317 BGHZ 80, 129 ff.

318 K. Schmidt, "Die Vor-GmbH als Unternehmerin und als Komplementärin" NJW 1981, 1345 ff.; W. Flume, "Zur Enträtselung der Vorgesellschaft" NJW 1981, 1753 ff.; P. Ulmer, "Abschied vom Vorbelastungsverbot im Gründungsstadium der GmbH" ZGR 1981, 593 ff.; U. John, "Zur Problematik der Vor-GmbH, insbesondere bei der Einmann-Gründung" BB 1982, 505 at 510 ff

319 K. Schmidt, in Scholz, *Kommentar zum GmbH-Gesetz*, 7th ed. (Köln: Otto Schmidt, 1986), s. 11 at para. 27.

320 P. Ulmer, in M. Hachenburg, *Grosskommentar zum GmbHG*, 7th ed., 2nd rev. (Berlin, New York: de Gruyter, 1985) s. 11 at para. 33.

- recorded by a notary - upon the formation of the GmbH or - in the case of the Aktiengesellschaft - adopt the by-laws. Very much concerned with the founders' interest not to be overburdened by the "Differenzhaftung", the Bundesgerichtshof refuses to recognize the directors' unlimited authority during the pre-incorporation phase stating that the relevant provisions in the *GmbH-Gesetz* (s 37[2]) and the *Aktiengesetz* (ss 78, 82) which give the directors unlimited authority did not apply to the "Vorgesellschaft"[321]. According to the Bundesgerichtshof, during the pre-incorporation phase the directors' authority will always depend on the shareholders' will, expressed or implied, if the shareholders/founders run a business before incorporation is accomplished, it has to be assumed that their general approval to run the business embraces their consent to all business related activities by the directors[322].

The courts' restrictive view as to the directors' authority has been much criticized[323] on the ground that with the abolition of the "Vorbelastungsverbot" the "Vorgesellschaft" has been accepted as an entity fully capable of maintaining legal relations. Participating as such in commercial life, the "Vorgesellschaft" should not be privileged against

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321 BGHZ 53, 210 at 212; BGHZ 80, 129 at 139; see also U. John, *supra*, note 304 at 512; H.J. Fleck, "Entwicklungen in der Rechtsprechung zur Vor-GmbH" GmbH-Rdsch 1983, 5 at 8-9; G. Hueck, in A. Baumbach & G. Hueck, *GmbHG*, 15th ed. (München: C.H. Beck, 1988) s. 11 at para. 18.

322 P. Ulmer, *supra*, note 320 at para. 52.

323 K. Schmidt, "Theorie und Praxis der Vorgesellschaft nach heutigem Stand" GmbH-Rdsch. 1987, 77 at 84; T. Raiser, *Das Recht der Kapitalgesellschaften* (München: Vahlen, 1983) at 183; W. Theobald, *Vor-GmbH und Gründerhaftung* (Köln, Berlin, Bonn, München: Heymann, 1984) at 23 ff., G. Dilcher, "Rechtsfragen der sogenannten Vorgesellschaft" JuS 1966, 89 at 92; W. Krause, "Die Haftungsbeschränkung auf das Gesellschaftsvermögen bei der GmbH und deren Vorgesellschaft und ihre Konsequenzen für die Gläubiger" DB 1988, 96 at 99.

incorporated businesses which - in the interest of efficient commerce - are contractually bound regardless of internal restrictions on authority. Shareholders' protection should not be a concern because giving life to an organization governed in essence by the law on GmbH's necessarily entails the assumption of risks that emerge from the directors' activities[324] Even though these arguments sound convincing, in practice commercial life follows the rules set up by the Bundesgerichtshof To bind the company, it does not matter if the director acts on behalf of the "Vorgesellschaft", of the future company or on behalf of both[325] Unless the directors specify clearly that the contract should be effective only upon the company's coming into existence, the contract is already binding on the "Vorgesellschaft". Upon registration, the contractual rights and liabilities turn over to or simply become the company's depending on whether one follows the doctrine of universal succession[326] or the theory of identity between "Vorgesellschaft" and incorporated company[327]. Thus, even in the light of the restrictions on authority, German law recognizes to a large extent the possibility to bind a company before it comes into existence.

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324 K. Schmidt, *ibid.*

325 P. Ulmer, *supra*, note 320 at para. 56.

326 H. Wiedemann, "Das Rätsel Vorgesellschaft" JurA 1975, 439 at 440 ff.; P. Ulmer, *supra*, note 320 at para. 73; G. Hueck, *Gesellschaftsrecht*, 18th ed. (München: C.H. Beck, 1983) at 321; see also BGHZ 80, 129 at 138, 145

327 K. Schmidt, *supra*, note 319 at para. 133; G. Dilcher, *supra*, note 323 at 92; M. Lieb, "Abschied von der Handlungshaftung" DB 1970, 961 at 968.

2. The Third Party's Right to Additional Protection

a The Acting Person's Liability

GmbHG, s 11(2) and AktG, s 41(1) provide for the acting person's liability ("Handelndenhaftung") The "Vorgesellschaft" being liable as a principal for obligations incurred on its behalf, such liability does not seem to be consistent with the liability scheme as it stands now - at least not where the acting person acted within his authority In fact, the "Handelndenhaftung" has given rise to many questions Originally justified as an instrument to prevent people from doing business on the future company's behalf although its legal status had not yet been officially granted[328], the underlying principle has to be found elsewhere today The "Vorgesellschaft" being recognized as subject to rights and liabilities itself, pre-incorporation activities are expressly accepted so that there is no room left for preventive considerations[329] The purpose of the liability was later explained by the third parties' need for security considering the fact that the envisaged contracting party, i e. the company, is not yet in existence when the contract is made. A recourse is now available against the "Vorgesellschaft" and - after incorporation - the company, a debtor is given from the outset. In those cases, where the courts would not accept a binding agreement because the director acted without authority, the third party's interest in security is sufficiently protected by general agency

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328 RGZ 47, 1 at 2-3; RGZ 55, 302 at 304.

329 RGZ 159, 33 at 43; BGHZ 47, 25 at 29.

law[330]. s. 179 of the German Civil Code (*Bürgerliches Gesetzbch*, BGB) declares agents without authority liable on contracts they made. Finally, the acting person's liability was interpreted as a manner to put pressure on the "Handelnden" to push the incorporation procedure[331]. Even this explanation seems to be objectionable given the fact that the "Handelnden" are not in a position to influence the duration and progress of the incorporation procedure. With respect to these difficulties of justifying the provisions' purpose, many writers declare today that the acting person's liability is obsolete[332].

However, the provisions' abolition is neither possible nor even advisable. It is not possible because art. 7 of E.E.C. Directive of March 9th, 1968 - predecessor of what is now s. 36(4) of the *Companies Act (U.K.)* - obliged all E.E.C. member states to enact provisions to the effect that the acting person is liable on pre-incorporation contracts. It is not advisable since even under the present liability scheme the acting person's liability does not appear to be purposeless. It is true that the fundamental interests of the third party are not at stake inasmuch as the third party can be sure to have a debtor. Nevertheless, there are other interests that are worthy of protection. Assuming that the company - for whatever reason - cannot be registered,

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330 H.J. Fleck, *supra*, note 321 at 14.

331 BGHZ 47, 25 at 29; H. Wiedemann, *supra*, note 326 at 465; K. Schmidt, "Der Funktionswandel der Handelndenhaftung im Recht der Vorgesellschaft" GmbH-Rdsch. 1973, 146 at 152.

332 B.-H. Hennerkes & K. Binz, "Zur Handelndenhaftung im Gründungsstadium der GmbH & Co." DB 1982, 1971 at 1972; H.J. Priester, "Die Unversehrtheit des Stammkapitals bei Eintragung der GmbH - ein notwendiger Grundsatz?" ZIP 1982, 1141 at 1152; U. Hüffer, "Das Gründungsrecht der GmbH - Grundzüge, Fortschritte und Neuerungen" JuS 1983, 161 at 168.

the third party when executing is restricted to the "Vorgesellschaft's" assets; those, however, have never been officially confirmed to be in accordance with the statutory requirements. To adjust this deficit, imposing liability on the acting person makes good sense[333]

A restricted purpose stands for a restrictive interpretation. Accordingly, as opposed to former interpretations, only the company's directors are considered to be "Handelnde". The company's founders are no longer held liable under the provisions[334] unless they purport to act as directors[335]. Originally, corresponding to the liability's wide purpose, not only the company's directors, but also those who assented to running the business, i.e. the founders, were considered to be "Handelnde"[336]. Thus, the "Handelndenhaftung" changed to a mere officer's liability[337].

To declare the director liable requires only that he acted on the company's behalf; acting within authority is not necessary. Since, by its very nature, the "Handelndenhaftung" amounts to declaring agents liable, subtle distinctions such as those prevailing at common law are not at the bottom of the acting persons' liability in German law. Whether the director acted as agent or - like in *Newborne's* case - "as the company", in German law the

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333 P. Ulmer, *supra*, note 320 at para. 94; K. Schmidt, *Case Comment* NJW 1978, 1979 at 1980; W. Theobald, *supra*, note 323 at 41.

334 BGHZ 47, 25 at 29; BGHZ 65, 378 at 381.

335 BGHZ 51, 30 at 35; BGH NJW 1980, 287.

336 RGZ 55, 304 at 304-305; RGZ 70, 296, 301-302.

337 P. Ulmer, *supra*, note 316 at 301; K. Schmidt, *supra*, note 333 at 1980.

solution will be the same because in both cases the agency relationship - basis of the liability - existed. Unlike at common law, the acting person need not be declared a principal before being held liable. Liability occurs in any event. However, with regard to the contractual benefits the distinction between acting as a principal or as an agent becomes important. only in the former case would the law recognize the acting person's right to enforce the contract. If he acts as director/agent, the right to enforce the contract is not provided for[338] whether he acted with authority or not. The statutory provisions in the *GmbH-Gesetz* and the *Aktiengesetz* take precedence over the general agency principle that agents without authority may enforce the contract if the company does not ratify it (embodied in s. 179[2] of the *Bürgerliches Gesetzbuch*)[339]. In this context, when deciding whether the "Handelnde" is entitled to enforce the contract, German law does not recognize the technical distinctions made at Common law either. A director will be looked upon as a principal only if he acted clearly for himself - without any reference to the company. To become liable as a "Handelnder" it does not matter if the director acts on the "Vorgesellschaft's" or simply on the company's behalf[340]. In both cases, the intent of immediately binding the "Vorgesellschaft" will be presumed. The contract being made with the "Vorgesellschaft", the third party - according to the purpose of the "Handelndenhaftung" - becomes entitled to further protection. This is not the case if the contract expressly indicates that it should be effective only upon the company's registration. Under these circumstances, the third party

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338 P. Ulmer, *supra*, note 320 at para. 105.

339 P. Ulmer, *ibid.* at para. 96a.

340 P. Ulmer, *ibid.* at para. 101.

expects only the registered company to be its debtor; the capital contributions then being officially controlled, there is no need for adjusting the lack of asset control. From this it follows also that where liability has to be assumed it ceases as soon as the company is incorporated[341] Dissenters[342] do not understand the merely provisional purpose the "Handelndenhaftung" has to fulfill. Unlike at common law, the law as to the acting person's recourse against the company is clear: as long as he acts within his authority, recourse is based on contract. In the case where he exceeds his powers, he can still recover on the basis of negotiorum gestio (*Bürgerliches Gesetzbuch*, ss. 683, 684).

b. The Liability of the Founders

The founders are those who form the company. At the same time they are its original shareholders. Since the law largely aligns the "Vorgesellschaft" with the incorporated company, but still does not recognize its equal status, the question arises whether there is a "pre-corporate veil" exempting the founders from personal liability. Some writers tend to draw this conclusion[343]. For good reasons, the courts and the majority of legal writers do not follow this suggestion. Since the privilege of limited

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341 BGHZ 80, 182 at 183-184; W. Flume, *supra*, note 309 at 43 ff.; K. Schmidt, *supra*, note 320 at para. 118; U. Hüffer, *supra*, note 332 at 168; W. Theobald, *supra*, note 323 at 44.

342 U. Huber, "Die Vorgesellschaft mit beschränkter Haftung - de lege ferenda betrachtet" in Festschrift für Robert Fischer (Berlin, New York: de Gruyter, 1979) 263 at 280-281; D. Schultz, "Rechtsfragen der Vor-GmbH im Lichte der jüngsten höchstrichterlichen Rechtsprechung - BGHZ 80, 129" JuS 1982, 732 at 739.

343 U. Huber, *ibid* at 281 ff., 288; H.J. Priester, *supra*, note 332 at 1141, 1151-1152; see also D. Schultz, *ibid* at 728 (no liability after filing of the articles).

liability is available only when the minimum capital requirement is fulfilled, the corporate veil cannot be established in the pre-incorporation phase During this period the capital contributions have not yet been subject to official control. One could argue that the "Handelndenhaftung" is supposed to fill the gap. However, this view is exposed to objections First of all, the "Handelndenhaftung" would not cover all liabilities as it is confined to legal relations created by act of the party[344]. Besides, policy reasons tell against allocating the risk to the company's directors[345] who, as opposed to the founders, do not run the business in their own interest. It is true that they may have recourse against the "Vorgesellschaft", but this does not entirely shift the risk away from them: the reason why third parties assert their claims against the "Handelnden" will often be the "Vorgesellschaft's" lack of sufficient assets. Therefore, to allow the shareholders to hide behind the corporate veil before the incorporation procedure is accomplished would go too far. The founders' personal liability being after all indispensable, the real problem lies with its scope.

According to the Bundesgerichtshof, the founders are personally liable only to the extent of their contributions[346]. Many writers, however, do not agree[347] arguing that this view would lead to a paradoxical result inasmuch

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344 W. Theobald, *supra*, note 323 at 116.

345 W. Theobald, *ibid* at 117-118; U. John, *supra*, note 318 at 512.

346 BGHZ 65, 378 at 383; BGH WM 1985, 955 at 956; BGH WM 1983, 230 at 231; BGH NJW 1984, 2164; see also P. Ulmer, *supra*, note 320 at paras. 63-64; H.J. Fleck, "Die neuere Rechtsprechung des BGH zur Vorgesellschaft und zur Haftung des Handelnden" ZGR 1975, 212 at 228-229; U. Hüffer, *supra*, note 332 at 167-168; M. Lieb, "Meilenstein oder Sackgasse? Bemerkungen zum Stand von Rechtsprechung und Lehre zur Vorgesellschaft" in Festschrift für Walter Stimpel (Berlin, New York: de Gruyter, 1985) 399 at 414.

347 K. Schmidt, *supra*, note 312 at 770-771; W. Theobald, *supra*, note 323 at 75 ff.; G.

as the founders are granted a privilege they do not even attain when the company is incorporated: upon incorporation the founders may become fully liable on the ground of the "Differenzhaftung" Indeed limited liability during the pre-incorporation phase would appear to be inconsistent with the liability scheme arising upon incorporation. This argument has been criticized on the ground that unlimited liability before registration would not create harmony either[348] since the "Differenzhaftung" means only pro rata liability towards the company whereas unlimited liability during the pre-incorporation phase is tantamount to joint and several liability towards the creditors themselves. It is admitted that there are differences.

Nevertheless, those who favour unlimited liability deserve approval. Acting as or on behalf of a limited company as such does not suffice to create limited liability. The law grants this privilege only when the minimum capital requirement is fulfilled, i e. when the assets are disposable to the required extent. As long as this is not the case the principle of unlimited liability prevails. It is not those who favour unlimited liability, but those who - like the courts - want to protect the shareholders who have to worry about consistency within the liability system.

Derwisch-Ottenberg, *supra*, note 4 at 57; W. Flume, "Die Haftung der Vorgesellschaft bei der Gründung einer Kapitalgesellschaft" in Festschrift für Ernst von Caemmerer (Tübingen: Mohr, 1978)517 ff., U. John, *supra*, note 318 at 511-512; H. Wiedemann, *supra*, note 326 at 454 ff.

348 P. Ulmer, *supra*, note 320 at para. 63.

3. Pre-incorporation Contracts Entered Into Before the Company's Formation

German law recognizes the existence of an autonomous "Vorgesellschaft" only after the company has been formed. Therefore, the aforesaid rules apply only when the shareholders have agreed formally (recorded by a notary) upon the company's formation or - in the case of an Aktiengesellschaft - after the shareholders have subscribed the total amount of the nominal share capital However, pre-incorporation contracts are made even before this date given the fact that the company's formation does not immediately follow the future shareholders' first (informal) agreement to incorporate a business. The need for making contracts is paticularly obvious when the founders intend to bring in as a non-cash asset a going business. The rules governing this stage are quite different from those pointed out above. They deserve particular attention within this comparative analysis because for want of a "mediator" as embodied by the "Vorgesellschaft" the starting points are similar in German and in Anglo-Saxon law.

Under German law, as soon as the future shareholders agree in some way upon forming a company, the constitute a civil partnership ("Gesellschaft bürgerlichen Rechts", see *Bürgerliches Gesetzbuch*, ss. 705 ff.). If they run a business, the civil partnership automatically becomes a commercial partnership ("Offene Handelsgesellschaft", see *Handelsgesetzbuch*, ss. 105 ff.)[349]. Liability on pre-incorporation contracts is therefore governed by partnership rules, company law being of no impact. Thus, all partners are

[349] BGH NJW 1983, 2822; P. Ulmer, *supra*, note 320 at para. 21.

jointly and severally liable on all contracts effectively made on their behalf. Easy in principle, the application of this general rule may cause hardship Two questions arise: What is to be required in order to bind the partnership, and secondly, in the case of a binding contract, when and under which conditions does liability cease?

As to the first question, problems will frequently emerge from the fact that the contracting partner acts for the *proposed* company (company "in Gründung") In this case, it is doubtful whether the contract is made with the partners (or the partnership if a commercial partnership is involved) or the future (Vor-) Gesellschaft. If the business is in existence, the enterprise's actual holder, i.e. the partners or the partnership, will be considered contracting partners on the ground that those who make business related contracts are presumed to act for the actual holder[350]. If the business is not yet in existence, several factual patterns have to be distinguished: in case of disclosure of the facts to the third party, the contract might be effective immediately in terms of binding the partners or the partnership, or merely provisional in the sense that only the incorporated company or the "Vorgesellschaft" should be bound. In the latter case, the company/"Vorgesellschaft" has to assent (see BGB, s. 177). Which alternative prevails will depend on a subtle interpretation of the contract. Presumably, the parties intend an immediately binding effect as it cannot be assumed that the third party accepts to be bound without being certain that the contract will ever by effective[351]. If the third party is not aware of the

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[350] BGHZ 91, 148 at 152; K. Schmidt, *supra*, note 319 at para. 16.

[351] BGH NJW 1982, 932 at 933.

fact that the company has not yet been formed, the acting person is liable on the principle that acting for a nonexistent principal is tantamount to acting without authority (see *BGB*, s 179)[352]. Besides, there is no room for declaring the acting person liable. *GmbHG*, s. 11(2) and *AktG*, s. 41(1) apply only to the "Vorgesellschaft"[353]. Considering the limited purpose of the "Handelndenhaftung" the Bundesgerichtshof has given up its former view[354] that the aforementioned provisions applied also before the company's formation.

Turning to the question as to the time when the partners' or the partnership's liability ends, the principle is that liability remains unaffected by the formation and the registration of the company. If the parties intend to end the founders' liability upon one of these events, they have to so agree. Recourse to the parties' intent does not always provide for immediate results for frequently the parties will not make any arrangements It being left to the courts to interpret the parties' will, the Bundesgerichtshof has had some difficulty with this issue. Originally tending to consider the founders' liability as some kind of provisional liability just securing the creditors' interest until the incorporation is accomplished[355] the Bundesgerichtshof now opts for the opposite solution: unless the parties expressly agree otherwise, they are presumed to have

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352 K. Schmidt, *supra*, note 310 at para. 17.

353 BGHZ 91, 148; P. Ulmer, *supra*, note 320 at para. 24.

354 BGH NJW 1962, 1008.

355 BGH NJW 1982, 932 at 933.

envisaged that the founders' liability should outlast the company's birth[356]. Another question is whether liability ceases in the case that later the "Vorgesellschaft" or - if it does not want to - the company steps into the contract. Contracts made before the company is formed are not automatically binding on the "Vorgesellschaft" (or - if not adopted by the "Vorgesellschaft" - on the company)[357]. Generally - if the third party is aware of all facts - a new contract is required, the third party's assent to the debtor's exchange thus being indispensable[358] Mere ratification is sufficient if the contract was intended to be effective on the company's formation, in this case, however, the problem of the founders' release does not arise because no liability was created. Not more than ratification is required in the further case where the third party makes the contract believing that the company has already been formed. It is not necessary to make a new contract because the third party gets exactly what the contracting party is supposed to have contracted with. The acting person's liability, based on the general idea that agents without authority have to be held liable (see *BGB*, s. 179), ceases immediately upon ratification, the agent's statutory liability, considered to be a liability for breach of warranty[359], now being obsolete.

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356 BGH NJW 1983, 2822; OLG Düsseldorf BB 1987, 1624; see also P. Ulmer, *supra*, note 320 at para. 23; K. Schmidt, *supra*, note 319 at para. 17.

357 BGH WM 1985, 479; P. Ulmer, *supra*, note 320 at para. 23.

358 BGH NJW 1982, 932 at 933.

359 See BGHZ 39, 45 at 51; BGH NJW 1970, 241.

V. Policy Reasons in Conflict With Established Principles of Law: Pre-incorporation Transactions From a Comparative Point of View

In all jurisdictions examined here the law of pre-incorporation transactions has been in constant change over the past decades. Common law jurisdictions wholly or partly moved away from the original approach and German law as it stands now does not follow the original rules although the relevant statutory provisions have not been changed since the last century. Interestingly enough, even on the occasion of modern reforms (AktG: 1965; GmbHG: 1980), the legislator did not change the statutory rules, but rather left it expressly to the courts to develop a comprehensive liability scheme[360] - quite a remarkable finding for a legal system that is based on statutory provisions, not judge-made rules. In a way legislative attempts recently made in Canada, Australia and New Zealand where the courts are entitled to differ from the statutory liability scheme illustrate as well that inferring simple rules from a variety of factual patterns may cause considerable hardship. But as evidenced by the abrupt abolition of highly technical rules which prevailed for a long time at common law as to the promoter's liability, the difficulty lies less with the variety of circumstances under which the problem of pre-incorporation transactions arises. The German legislator's reserve and the diverging approaches to be encountered in common law jurisdictions are better explained by the fundamental conflict between business needs on the one hand and established legal principles on the other.

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[360] W. Theobald, *supra*, note 323 at 9-10.

The issue of pre-incorporation transactions constitutes a challenge for traditional concepts of law The businessman's undeniable need for making contracts before the company is incorporated puts to the test principles of contract, agency and corporate law The company being bound in advance might best reflect the parties' intentions, contract and agency law, however, do not directly allow for such a result offering at best cumbersome devices. Corporate law principles are affected inasmuch as the idea of a fictitious corporate entity is at stake The wish for immediately binding contracts conflicts with the concern to keep the company's endowment uncharged upon its coming into existence As illustrated by a minimum capital requirement and strict capital preservation rules this concern is mainly felt under German law which like other European legal systems assumes a necessary linkage between the raising of minimum capital and the privilege of limited liability by creating a body corporate[361] By contrast, in anglo-saxon jurisdictions the privilege of limited liability does not depend on the fulfillment of minimum capital requirements leaving aside some American states where starting business - not the incorporation itself - hinges on some initial capitalization usually not exceeding $1,000[362]. Among common law jurisdictions, an equivalent to German law is only to be found in Britain where public companies cannot commence business before £50,000 or such other sum as the Secretary of State may order are paid in[363]. The requirement goes back to the adjustment of the British Companies Act to the other E.E.C. members' company law. Although,

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[361] See H. Wiedemann, *supra*, note 311 at 557-558; K. Schmidt, *supra*, note 312 at 396 ff.

[362] See R.W. Hamilton, *supra*, note 182 at 43-44.

[363] *Companies Act* (U.K.), s. 117(1).

basically, Anglo-saxon corporate law is not concerned with the preservation of capital, apprehensions about the future company's assets are nonetheless the basis of the reluctance to make binding on the new company contracts made in advance on its behalf[364].

Corporate law principles are furthermore challenged where a business exists before incorporation is accomplished. The question arises whether and, if the answer be affirmative, to what extent, the formal non-existence can be disregarded on the ground that the substance of what is to receive a "corporate coat" is already in existence. In some way, the problem is opposite to the problems dealt with under the heading "piercing the corporate veil". German law has been focussing considerably on this point even where a business is not yet in existence.

In response to these challenges, diverging solutions have been developed, the most far-reaching being in Germany where the law has largely taken it nto consideration that registration does not necessarily reflect the company's "real" birth. Thus, as to the question, how the company can become a contracting party German law has found a specifically corporate solution by anticipating the company's existence in such a way that their parties can contract with a "quasi-corporate" entity even before the company is registered There is no need for a modification, contract and agency law principles remain unaffected. Common law jurisdictionsdo not go so far. To facilitate the company's stepping into the contract agency and contract rules are modified in order to give the companies the right to become a

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364 N. Isaacs, "The Promoter: A Legislative Problem" (1925) 38 Harv. L. Rev. 887 at 899.

party to the contract by a unilateral act English law, in this respect, did not undergo any development as it still preserves the traditional rules, i e requiring a new contract The finding that German law marks the clearest disengagement from basic principles of law is somewhat surprising given the fact that being obliged to the principle of capital maintenance it faces the greatest difficulties in developing a solution that permits binding the company in advance It is true that the fear that the company's assets could be diminished right at the outset also makes common law jurisdictions reluctant to accept prematurely binding contracts But, sine there is generally no requirement for minimum capital and therefore no justification to rely on some sort of capitalization, one wonders why common law jurisdictions have not developed a solution similar to German law Where, as in Britain and in some American states, minimum capital must be paid in so as to commence business some kind of "Differenzhaftung" could be established to ensure that the requirement is fulfilled[365]

Nevertheless, among recent legislative attempts to solve the pre-incorporation contract problem, none seriously considers allowing for prematurely binding contracts. Only in the course of the Ontario law reform was such a solution discussed[366] However, returning to a legal position that had already prevailed in England before the Court of Common Pleas decided *Kelner* v *Baxter* in 1866 was not recommended. Interestingly enough, reluctance was not founded on the concern that the company should

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365 As to English law see proposals made by T. Reith, "The Effect of Pre-incorporation Contracts in German and English Company Law" (1988) 37 I.C.L.Q. 109 at 129.

366 Lawrence Report, *supra*, note 220 at 10, 12.

not come into existence burdened with obligations. Rather the reason was that there is no defined class of persons who are authorized to bind the company before incorporation[367] Some writers, though, laid stress on the danger emerging from burdensome obligations imposed on the company upon its birth[368] Whereas the latter concern might be corrected by providing for some sort of "Differenzhaftung", the first point appears to be the decisive obstacle that prevents common law jurisdictions from recognizing the binding effects of contracts made on the company's behalf before incorporation. As was pointed out elsewhere, the term "promoter" is not a term of law. It does not indicate any kind of relationship to the future company. Promoters will often control the future company, but this is not necessarily so. To make pre-incorporation transactions automatically binding in response to business needs, it was suggested that the promoter be given a legal form by providing for a defined scope of authority and - in order to protect interests of third parties - for registration[369]. Compared with the approach taken in most common law jurisdictions at present, this solution is clearly more complicated. Instead of setting up a statutory limitation of authority and providing for a registration system, it is probably preferable to leave it to the company to decide if it accepts the contract made on its behalf before incorporation[370]. Nevertheless, the forementioned proposal deserves attention inasmuch as it points precisely at the weak point: the non-qualified relation between company and

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367 Lawrence Report, *ibid* at 12.

368 F.J. Nugan, *supra*, note 6 at 200-201; L. Getz, *supra*, note 1 at 402.

369 N. Isaacs, *supra*, note 364 at 900-901; J.P. Zimmermann, *supra*, note 202 at 171-172.

370 R.A. Kessler, *supra*, note 137 at 578-579 n. 45.

promoter. German law, of course, has to deal with the same question; the problem was solved by recognizing a pre-incorporation entity acting through the future company's director who - authorized by the founders - may bind the company effectively even before the incorporation procedure is accomplished One has to keep in mind, however, that the need for a legally fixed relationship between promoter and company marks also the limits of the device: a specific relation between both can only be recognized after the company's formation, i.e. upon the shareholders' formal agreement to incorporate Before the company's formation, a specific agent-principal-relationship is missing; therefore, the legal problems arising in German law before the company's formation are quite the same as those common law jurisdictions generaly have to deal with before incorporation.

Nevertheless, German law admittedly offers an appropriate solution for a considerable part of pre-incorporation activities. A model solution for common law jurisdictions? Despite all the advantages the answer must be in the negative. The underlying conditions that make the German solution possible are not to be encountered in common law jurisdictions. Due to the fact that after the company's formation it takes several months or even more than one year to achieve incorporation, it makes sense to develop the idea of the "Vorgesellschaft" as a separate entity which takes part in commercial life. In common law jurisdictions, since there is usually no minimum capital requirement and hence no time-consuming asset valuation, incorporation is not preceded by such a long phase where it can be said that the corporate entity has already partly crystallized. Where minimum capitalization is required, the situation is not different because the fulfillment of the requirements operates as a condition precedent, the

company not being allowed to start business before; incorporation as such is achieved regardless of whether the company complies with the requirement or not[371]

Although the German solution cannot be transferred directly to Anglo-Saxon law, there might still be a way to turn to account its underlying idea of continuing liability. A legal relation between the acting person and the future company being crucial, contracts made by "agents" can never be binding on the company. The outcome could be different if the contract was not made by a promoter who himself has no direct interest in the company but by such persons who incorporate a business as shareholders. The question arises whether pre-incorporation contracts made by these persons could be considered as being made with a partnership and - upon incorporation - virtually automatically binding the company. Such a solution could be justified on the ground of personal and substantial identity between the incorporated and the yet-to-be-incorporated business. English law, unfortunately, is cool to this idea. Although it might generally be doubtful[372] if co-promoters as such carry on "a business in common with a view to profit"[373], the requirement should be looked upon as fulfilled at least where the co-promoters are founders and make as such contracts for the business - already in existence or not[374]. English law does not draw this

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371 See *Companies Act* (U.K.), s. 117; as to American law see H.G.Henn & J.R. Alexander, *supra*, note 148 at 338 ff.

372 E.H. Scamell & R.C. l'Anson Banks, *Lindley on the Law of Partnership*, 15th ed. (London: Sweet & Maxwell, 1984) at 22-23.

373 See *Partnership Act* (U.K.), s. 1(1).

374 T. Reith, *supra*, note 365 at 117.

conclusion. As was stated in *Keith Spicer Ltd.* v. *Marsell*[375], to assume a partnership common activities undertaken to set up a business are not sufficient Accordingly, one has to conclude that the requirement would be considered as fulfilled where the promoters incorporate a current businss. American law does not seem to follow this arbitrary distinction[376] thus leaving much room for a liability transfer on the corporation. Since the legal distinction between partnership and corporation as two separate entities cannot be neglected, such a transfer can only be quasi-automatic in the sense that there is a presumption that liability was assumed by the corporation[377].

However, it must be emphasized that such a presumption is only justified in cases where the partners simply "put on a new coat"[378]. For instance, in cases where the assets are only partially transferred to the corporation[379] or where partners withdraw entirely while other persons become shareholders[380] the presumption does not apply. Also in Canadian law, as well as in Australian and New Zealand laws, the relationship between

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375 (1970) 1 All E.R. 462 (C.A.).

376 *Holzer Street Metal Work, Inc.* v. *Reynolds & Marshall* (1949), 43 So. 2d 169 at 171 (La., C.A.); *Maliszewski* v. *Singer* (1979), 598 P. 2d 1014 (Ariz. C.A.) at 1015.

377 *Moore & Handley Hardware Co.* v. *Towers Hardware Co.* (1889), 6 So. 41 (Ala., S.C.); *Reif* v. *Williams Sportswear, Inc.* (1961), 174 N.E. 2d 492 (N.Y., C.A.); *Scatler* v. *Rice* (1957), 135 A. 2d 775 (Pa., Superior Court); *Arthur Elevator Co.* v. *Grove* (1975), 236 N.W. 2d 383 (Iowa, S.C.); see also *Blumenthal* v. *Schneider* (1925), 203 N.W. 393 (Wisc., S.C.).

378 *Fletcher Cyclopedia of the Law of Private Corporations*, vol. 8 A (Wilmore, Ill.: Callaghan, 1982, suppl. 1988) at para. 1014.

379 *Pittsfield General Hospital* v. *Markers* (1969), 246 N.E. 2d 444 (Mass., S.J.C.).

380 *Universal Pictures Corp.* v. *Roy Davidge Film Laboratory* (1935), 45 P. 2d 1028 (Distr. C.A., Third District, Ca.).

promoter and corporation has impact. The promoter's position towards the corporation is called a decisive factor the court has to take into account when exercising its discretion[381] Thus, all legal systems discussed here leave a loop-hole permitting, to some extent, a legal fiction to be disregarded where to take consideration of it would appear artificial in the light of the surrounding facts. Those are mainly personal and substantial identity between the incorporated and the yet-to-be-incorporated business, an aspect which in American legal literature was emphasized early on as an important one in the context of pre-incorporation transactions[382]. In a more comprehensive way, the aforementioned idea is at the bottom of Adolf Berle's theory of enterprise entity, which according to this author allows also for an appropriate solution to problems emerging from pre-incorporation transactions[383]. But despite these discrete tendencies towards recognition of continuing liability Anglo-Saxon law in principle remains loyal to the idea of the body corporate as a separate and autonomous legal person. English law does not even show any readiness to reach a compromise between legal principles and commercial reality - hard to understand not only from the German point of view, but also from that of other common law jurisdictions.

Traditional concepts of law are at stake also with respect to the promoter's liability. Applying contract and agency rules to agreements made by

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381 M.A. Maloney, supra, note 231 at 412-413.

382 H.S. Richards, *supra*, note 192 at 100; M.W. Ehrich & L.C. Bunzl, *supra*, note 139 at 1042.

383 A.A. Berle, "The Theory of Enterprise Entity" (1947) 47 Col. L. Rev. 343 at 358; see also N.L. Zemke, "Pre-incorporation Subscription Contracts in Michigan" (1957) 34 U. Det. L.J. 662 at 668-669.

promoters has turned out to be an inappropriate way to handle the problem: promoters - at least usually - act like agents, but cannot be considered as such because the principal is not yet in existence. To say that the promoter acts like someone who makes a contract for "Dobbin, a horse"[384] might be legally correct but does not lead to an adequate result: the purchase of food for a horse is not tantamount to an agreement made on behalf of a yet-to-be-incorporated company. Consequently, all attempts to base the promoter's liablity on an intention test are misleading: generally promoters do not intend to become contracting parties nor does the third party expect them to have such an intention[385]

Since the contractual analysis does not offer any guidance unless there is a clear and unequivocal agreement, the grounds for liability must be found elsewhere. Thus, whether the promoter should be held liable or not, is first of all a matter of policy. Under this footing one might be inclined to protect the mostly "innocent" promoter[386] and plead for non-liability as a general rule[387]; on the other hand, it cannot be neglected that promoters often turn out to be dubious entrepreneurs, third party protection thus becoming a prior-ranking concern[388]. To decide the question according to the type of

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384 Expression used by D.F. Yagts, *Basic Corporation Law*, 3d ed. (Westbury: The Foundation Press, 1989) at 98.

385 M.W. Ehrich & L.C. Bunzl, *supra*, note 139 at 1020, 1023, 1037, R.L. Rogers, *supra*, note 165 at 1270; J.A.F. Wendt, *supra*, note 155 at 465; R.A. Kessler, *supra*, note 137 at 584; G. Shapira, *supra*, note 56 at 313; F. Iacobucci et al., *supra*, note 215 at 50; J.F. Hambrook, *supra*, note 291 at 143; G.R. Sullivan, *supra*, note 54 at 123.

386 R.A. Kessler, *supra*, note 137 at 569; see also M.H. Ogilvie, *supra*, note 13 at 343.

387 R.A. Kessler, *ibid* at 588 n. 68.

388 J. Smith, *supra*, note 207 at 297.

promoter does not seem to be the right approach since at private law liability is considered to be a way to allocate risks, not a sanctioning instrument. Starting from this principle, holding the promoter liable regardless of whether he acted innocently or in bad faith appears to be the right solution. This is also true from the third party's perspective: the risk allocation has to be the same notwithstanding the third party's knowledge about the non-incorporation[389].

Pre-incorporation contracts are made with a view to the company. In Anglo-Saxon law, to achieve the intended result the company has to come into existence and to accept what was agreed upon before. The risk that these events will occur lies manifestly with the promoter for as a matter of business reality he is in control of the situation thus being able to take the necessary steps[390]. It does not matter if in fact he is not, because acting on the company's behalf it can at least be said that he purports to have influence on the further proceedings. There is much truth in the statutory approaches taken in Australia, New Zealand, Alberta, and the Yukon Territory indicating as a basis for liability a presumed warranty to the extent that the company will come into existence within a reasonable time and then adopt the contract[391].

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389 M.W. Ehrich & L.C. Bunzl, *supra*, note 137 at 1018; M.H. Ogilvie, *supra*, note 13 at 327 ff.

390 L. Getz, *supra*, note 1 at 405; J. Smith, *supra*, note 209 at 290; M.H. Ogilvie, *supra*, note 13 at 329; see also Lawrence Report, *supra*, note 220 at 12.

391 See also R.L. Rogers, *supra*, note 165 at 1271.

Hence it seems to be justified to assume an interrelation between the parties' intention and the promoter's liability, but this is meant in an entirely different sense: the parties impliedly create some kind of "alternate" liability[392] This view of the principles underlying the promoter's liability is reflected also in German law where promoters act without being authorized by the founders or - after formation - by the directors. They are liable by virtue of *BGB*, s 179, a provision that is considered to establish some sort of secondary liability without making the "agent" a contracting party[393] although - as opposed to the "Handelndenhaftung" according to *GmbHG*, s 11(2) and *AktG*, s 41(1) - he is entitled to enforce the contract. Insofar as the promoter are founders (then liable as partners and after the formation of the company as guarantors) or directors (then liable by virtue of *GmbHG*, s 11[2]) or *AktG*, s 41[1]) different principles apply which are explained elsewhere and are not of interest here.

The reasons underlying the risk allocation with the promoter also allow definition of where liability has to end. Since the third party is only justified in relying on the company's incorporation and its subsequent acceptation of the contract, the promoter must be relieved from personal liability when these expectations come true. Continuous liability would operate as a security against deficient capital endowment - a concern that is not protected in common law jurisdictions there mostly being no

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392 R.A. Kessler, *supra*, note 137 at 593; see also G.H.L. Fridman, *supra*, note 59 at 1606 ("alternative parties").

393 H. Dilcher, in *J. v. Staudingers Kommentar zum Bürgerlichen Gesetzbuch*, Erstes Buch, Allgemeiner Teil, ss. 90-240, 12th ed. (Berlin: Schweitzer, 1980) s. 179, para. 2,12.

minimum capital requirement. Furthermore to hold the promoter liable even after incorporation would put the third party in an even better position than it had if it had made a contract with the company after incorporation. Therefore, the so-called *double security rule* prevailing in the United States and in the Province of Québec has to be rejected.

This comparative survey has revealed that the issue of pre-incorporation transactions constitutes a challenge to established principles of law in all legal systems dealt with here. In response to this challenge traditional concepts have been modified recognizing in principle that pre-incorporation contracts are of a particular nature and can hardly be strait-jacketed by established rules of law. Starting from this perception common law jurisdictions and German civil law have developed concepts that differ in extent and approach. German law probably took the most imaginative approach in developing a specifically corporate solution. On the other hand, English law preserving - at least in part - the original rules marks the other extreme. Other common law jurisdictions took into account business needs by extending contract and agency rules by means of analogy. However "modern" the German solution might appear, its adoption in common law jurisdictions does not seem to be possible since the crucial prerequisites simply do not exist. But notwithstanding this fact the law as it stands now - less in Britain, more so in the other countries - constitutes clear progress from the original position since it provides more "security of transaction"[394]. This is a major concern commercial law has to ensure in this area.

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[394] N.N. Green, *supra*, note 14 at 677.

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