

**Liability on Pre-incorporation Contracts:  
A Comparative Review**

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INTRODUCTION .....	513
SOUTH AFRICA .....	514
ISRAEL .....	516
THE AMERICAN APPROACH .....	518
a. Ratification and Adoption .....	518
b. Accepting a Continuing Offer .....	522
c. Novation .....	524
d. Pre-incorporation Services .....	525
e. Quasi-Contract .....	527
f. Statutory Liability .....	528
GERMANY .....	530
a. Strict Liability (Identity between Promoters and Company) .....	532
b. Assumption .....	533
CONCLUSION .....	535

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## Introduction

The rigid rule of *Kelner v. Baxter*<sup>1</sup> expressed more than one hundred years ago, still governs English Law. Most common law countries follow this rule to the effect that no pre-incorporation contract is binding upon a company, nor can the company adopt a pre-incorporation contract. For the company to be bound by such a contract, a new contract must be made between the newly-incorporated company and the contracting party.<sup>2</sup>

The present state of the law is considered in most common law countries as "unsatisfactory and replete with serious difficulties for promoters, companies and the public at large" and the rules on this subject are "highly technical and inconvenient and it is clearly desirable that they should be abrogated".<sup>3</sup>

We should bear in mind that most existing solutions are not satisfactory since they do not cover the various aspects of the subject. A comparative outlook might therefor be of some help to the legislators who intend to codify this complicated aspect of company law.<sup>4</sup>

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<sup>1</sup> (1866), L.R. 2 C.P. 174.

<sup>2</sup> Australia: *Black v. Smallwood*, (1966), 117 C.L.R. 52; *Summergreene v. Parker*, (1950), 80 C.L.R. 304; Davies, W.E.D., *Personal Liability of 'Directors' of Non-Existent Companies*, (1964), 6 U.W. Austl. L. Rev. 400; Nicholson, *Contract and Non-Existent Companies*, (1967), 7 Austl. Lawyer 3.

New Zealand: *Official Assignee of Motion v. N. Z. Sero-Vaccines Ltd.*, [1935] N.Z.L.R. 856; *Folly's Creek Extended Co. v. Cutten & Faithful*, (1903), 22 N.Z.L.R. 759; Dalglish, *Company Law in New-Zealand*, (1948), at p. 28.

India: *Barasal Baisirtat Rly. v. Dt. Board*, (1944), India L.R. 2 Cal. 101; *Ganesh Flour Mills v. Puran Mal*, (1905) P.R. 2. See also: *Abraham Philipose*, (1952) C.C. 99. Cf. Chattejee & Krishnamurthi, *Company Law*, (1957), at p. 82; Pandia, *The Companies Act, 1956* (2nd ed., 1962), at p. 133.

<sup>3</sup> Interim Report of the Select Committee on Company Law of Ontario (Lawrence Report), 1967 P. 10. See: Getz, Leon, *Pre-incorporation contracts: some proposals*, (1967), U.B.C.L. Rev. 383; Nugan, F.J. *Pre-incorporation Contracts* in *Studies in Canadian Company Law* (ed. by Ziegel, J.S., 1967), at p. 197; Report of the Israel Committee on Company Law (Zeltner Committee), 1965, para. 2; Gross, *The Problem of Pre-incorporation Contracts*, (1964), 21 Hapraklit, at p. 38.

Gower, *Report on Company Law in Ghana*, (1961), at p. 32. See also: Jenkins Committee 1962 (Cmnd. 1749), para. 44.

<sup>4</sup> EDITOR'S NOTE: The Canadian jurisdictions have almost invariably followed the *Kelner v. Baxter* line of jurisprudence, with the possible exception of some earlier Quebec cases. Note, however, the introduction of the "adoption" principle in s. 20 of the *Ontario Business Corporations Act* R.S.O. 1970, c. 53. The effects of this amendment are considered briefly by Waisberg in his "Analysis of Changes Made by the Business Corporations

## South Africa

Section 71 of the South African Companies Act,<sup>5</sup> gives a company the power to ratify preliminary contracts made by the promoter:

*Any contract made in writing by a person professing to act as agent or trustee for a company not yet formed, incorporated or registered shall be capable of being ratified or adopted by or otherwise made binding upon and enforceable by such company after it has been duly registered as if it had been duly formed, incorporated and registered, at the time when the contract was made, and such contract had been made without its authority. Provided that the memorandum contains as one of the objects of such company the adoption or ratification of or the acquisition of rights and obligations in respect of such contract and that ... [a copy of such] contract has been lodged with the Registrar together with the application for registration of the company.*

The section provides all the requirements for "adoption" of a

Act, 1970," in Law Society of Upper Canada, *Special One-Day Programme, The Business Corporations Act, 1970* (Toronto, 1970), p. A-7.

The one exceptional Canadian case which does not follow the prevailing common law principles seems to be *Brewster v. Chapman*, (1875), 19 L.C. Jur. 301. This decision of a four-judge Court of Queen's Bench found a "novation" to occur when the Montreal Railroad Car Company issued its promissory notes to the plaintiff upon the maturity of notes advanced by the promoters, notwithstanding the fact that the company was not incorporated until after it purported to issue the corporate obligation. This decision has not been followed in any subsequent case, in Quebec or elsewhere in Canada; moreover, later cases in that province adopt the traditional common law rule: *Duquenne v. Compagnie Général des Boissons Canadiennes*, (1907), 31 C.S. 409 (Cour de Révision), followed in *Gadbois v. Montreal Exhibition Co. Ltd.*, (1930), 36 R. de Jur. 478, 583-84; *King v. Modern System Sign Service Lt.*, (1922), 28 R.L. (n.s.) 324 n.

Canadian common law jurisdictions have invariably adopted the *Kelner v. Baxter* principle. The leading cases in each province are noted below: Alberta — *Re Red Deer Milling and Elevator Co. Limited, Ex parte the Liquidator*, (1907), 1 Alta. L.R. 237.

Manitoba — *Waddell v. Dominion City Brick Company*, (1888), 5 Man. R. 119 n (full court); *Cass v. McCutcheon*, (1905), 15 Man. R. 669 (full court); *Re Crown Mutual Hail Insurance Co.*, (1908), 18 Man. R. 51; *Re Veitch*, (1956), 19 W.W.R. 1, 5 D.L.R. (2d) 373.

North-West Territories — *Coit v. Dowling*, (1901), 4 Terr. L.R. 464.

Nova Scotia — *Guildford v. Anglo-French Steamship Co.*, (1881), 14 N.S.R. 54 (full court).

Ontario — *Thomson v. Feeley*, (1877), 41 U.C.Q.B. 229 (full court); *Repetti Ltd. v. Oliver Lee Ltd.*, [1923] 3 D.L.R. 1100, 52 O.L.R. 315 (App. Div.); *Hudson — Mattagami Exploration Mining Co. Ltd. v. Wettlanfer Bros. Ltd.*, (1928), 62 O.L.R. 387 (App. Div.); *Murray Elias Ltd. v. Walsam Investments Ltd.*, [1964] 2 O.R. 381, 45 D.L.R. (2d) 561.

Saskatchewan — *Dairy Supplies Ltd. v. Fuchs*, (1959), 18 D.L.R. (2d) 408, 28 W.W.R. 1 (C.A. of S.). J.D.F.

<sup>5</sup>No. 46 of 1926.

preliminary contract, and nothing more is required than the strict compliance with its terms.<sup>6</sup>

The South African section has radically altered the doctrine of *Kelner v. Baxter* in its bearing upon pre-incorporation contracts, by exonerating the promoter irrespective of whether the company was or was not in existence at the time of the contract, excluding warranty of authority if the other party knew at the time of the contract that he had no authority.<sup>7</sup>

Although section 71 refers both to "agents" and "trustees", South African law recognises a distinction between an "agent" and "trustee" regarding pre-incorporation contracts.<sup>8</sup> It was on this very ground that the Privy Council decision in *Natal Land Company v. Pauline Colliery Syndicate*<sup>9</sup> was distinguished in *McCulloch v. Fernwood Estate Ltd.*<sup>10</sup> In the latter case, the contract at issue was between McCulloch and one Apsey "acting as trustee for and on behalf of a limited liability company in the course of formation" and in that capacity styled the purchaser. Innes, C.J., said:

The term 'trustee' comes from English law; I do not propose to attempt a definition; but clearly it is not identical with 'agent'. Speaking generally it implies that the person described is the dominus of the relative subject matter which the term 'agent' does not imply. It is therefore appropriate to a case where the person described acts in his own name and on his own responsibility though for the benefit of another.

As a result of this distinction we may say that where it is found that the party so contracting in fact contracted in his individual capacity (and not merely as agent)<sup>11</sup> the section does not apply.<sup>12</sup> The rules which apply in this instance are those of Roman-Dutch Law.

The law in South Africa seems, therefore, to be as follows:

(1) If the promoter acts only as an agent, he is not personally

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<sup>6</sup> *Ex parte Universal Property (Pty.) Ltd.*, 1947 (4) S.A. 12 (D); *Ex parte Central Properties (Pty.) Ltd.*, (1930) C.P.D. 360. See generally: E. Henochsberg, *Companies Act*, (1963), at pp. 184-185.

<sup>7</sup> *Peak Lode Gold Mining Co. Ltd. v. Union Government* 1932 T.P.D. 48, at p. 51 (*per* Greenberg J.). *Cf. Semer v. Retief & Berman*, 1948 (1) S.A. 182. See: *Ex parte Vickerman*, 1935 C.P.D. 429; *Alberts v. Fick* (1935) S. Afr. L.J. 219.

<sup>8</sup> *Semer v. Retief & Berman, id.*

<sup>9</sup> [1904] A.C. 120.

<sup>10</sup> 1920 A.D. 204, at p. 209.

<sup>11</sup> Even where *ex facie* a written contract a party has contracted only as agent the whole contract must be examined to determine whether or not he was in fact acting as principal. *Martian Entertainments (Pty.) Ltd. v. Berger*, 1949 (4) S.A. 583.

<sup>12</sup> See: De Villiers and Mackintosh, *The Law of Agency* (2nd ed., Cape Town 1956), at p. 286.

liable on the contract. (2) Where it seems from the facts of the case that the promoter did not act merely as agent, but contracted personally, albeit as a trustee, or ostensibly for the benefit of the company, he is himself liable on the contract and can sue on it in his own name.<sup>13</sup> The promoter is released from his personal liability after the company has confirmed the preliminary contract. (3) If the conditions of section 71 are complied with, the company may ratify pre-incorporation contracts. (4) Even where the requirements of section 71 have not been complied with, it seems that the rules of Roman-Dutch law might still apply (despite the section), so that the company can adopt the preliminary contracts where the promoter contracted on its behalf.<sup>14</sup>

### Israel

The Palestinian courts during the Mandate period followed the English rules to an extreme degree. In *Gutter v. Heilfren*,<sup>15</sup> the promoters promised the plaintiff that they would employ him in the company not yet formed. In consideration for this promise, the plaintiff lent the promoters a sum of money which was supposed to be returned to him in case of his leaving the company. The parties further agreed that upon the Registrar duly issuing the certificate of registration, any debts, obligations and rights arising from the contract would automatically be transferred to the company and the borrowers would in no respect be responsible further towards the lender. The company ratified the contract but after a short time refused to employ the plaintiff. The High Court of Palestine held that the company was not liable on the contract. The promoters argued that the condition in the contract with the plaintiff was a condition subsequent and since the company had ratified the contract they were not liable on it. The court held that the promoters could be released from liability only when the company took over their liability and since the ratification had no effect, the promoters remained liable.

In a similar case, the plaintiff invested money in the proposed company, through its promoters. After registration the plaintiff

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<sup>13</sup> If the promoter wishes to bring an action on the contract, or set it aside before the company is formed, he must sue in his personal capacity, and not in his capacity as trustee. See: *Ackerman v. Burland and Milunsky*, (1944), W.L.D. 172.

<sup>14</sup> *Ex parte Vickerman & Oth.*, 1935 C.P.D. 429; *Ex parte Eland Properties (Pty.) Ltd.* 1945 T.P.D. 37.

<sup>15</sup> C.A. 208/1941, 8 P.L.R. 539.

sued the company for his share of the company's profits as promised him by the promoter. The promoter left the country and the plaintiff could not sue him nor could he get his money back from the company, because it was not a party to the preliminary contract.<sup>16</sup>

In still another case<sup>17</sup> a local government authority decided to permit a promoter to erect a petrol station on part of its land in consideration of a lump sum payment and a payment out of the annual profits of the station. When the station was built, the lease of the land was vested and a company set up for the purpose. The authority contended that by the transfer of the promoter's rights to the Company, the latter was expressly or by implication bound to adopt also his obligations towards the authority, especially as at various meetings between it and the promoter ("representing the Company"), held before incorporation, proposals had been made to vary the consideration payable. At first instance the court adopted the submissions of the local authority and refused in equity to follow the established English rule that in such a case the company is not bound by the contract entered into by its "agent", even if ratified by it after incorporation. The Court of Appeal did not question this rule in general, but went on to add that a new contract could be inferred from acts done by the company, which would have the same effect as the original contract.

More recently, in Israel, the legislature has attempted to solve the problems in this area, or some of them, by incorporating in a new *Agency Law, 1965*, a provision to the effect that, "a body corporate may ratify an act done on its behalf prior to its establishment, and the provisions of this section shall apply in such a case".<sup>18</sup> The other provisions of the law allow *ex post facto* ratification of unauthorised acts and preserve the right of the other party — so long as the ratification has not come to his knowledge — either to regard the "agent" as a party to the act or to withdraw therefrom and claim damages from him.

Apart from the peculiarity of attempting a solution indirectly through agency law, this statutory provision begs the question whether there can be ratification by a principal who was non-existent at the date of the act. It leaves open the position of the "agent" where the other party knew that he was acting for a non-

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<sup>16</sup> C.A. 107/1942, 9 P.L.R. 519. Cf. Civil Case, Tel-Aviv, 28/1943, 1943 *Selected District Judgments* 175. This view was followed by an Israeli District Court, Civil Case, Haifa, 280/1949. 4 *Psakim Mehozim* 261.

<sup>17</sup> C.A. 312/65, 20 P.D. (1) 573. For a further discussion of this point see Gross, (1969), 23 *Hapraklit*, at p. 444.

<sup>18</sup> Section 6(c).

existent company. The same is true of the case where the "agent" acts for a company which he expressly purported to be already in existence. If, for example, the company ratifies, is the other party automatically bound thereby, losing such rights as he may have against the "agent", when for one good reason or another he is adverse to entering into any contractual ties with the Company? More particularly, the whole question of the "agent's" duties and obligations to the company is not met by any provision of the statute.

### The American Approach

The mere fact of incorporation does not of itself affect the promoter's contract, and the newly formed corporation does not thereby become a party to the contract made before incorporation in its name and for its benefit.<sup>19</sup> However, in almost all states the English doctrine has been repudiated, and it has been held that a contract made by the promoters of a corporation on its behalf may be adopted by the corporation, and thereupon the corporation is liable on the contract itself, not merely for the benefits received.<sup>20</sup>

The courts have professed difficulty in finding a scientific or rational basis to explain how the corporation may make itself a party to a pre-incorporation contract of the promoter.<sup>21</sup> Four theories have been advanced as to how the liability of the corporation may arise: ratification, adoption, continuing offer accepted; novation, or some other new contract by the corporation based upon a mutual agreement of all the parties.

#### a. Ratification and Adoption

In many cases a corporation has been held capable of ratifying a contract made by its promoter before it was formed.<sup>22</sup> The doctrine

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<sup>19</sup> *Kirkup v. Anaconda Amusement Co.*, 59 Mont. 469, 197 P. 1005 (Sup. Ct. Mont., 1921).

<sup>20</sup> *Gardiner v. Equitable Office Bldg. Corp.*, 273 F. 441, 17 A.L.R. 431 (C.C.-2, 1921); *New England Oil Co. v. Wiltsee*, 3 F. 2d 424 (C.C.-1, 1925). A corporation may be found liable on a promoters' contract where it affirms or ratifies by receipt of benefits with knowledge. *Indianapolis Blue Print & Mfg. Co. v. Kennedy*, 19 N.E. 2d 109 (Ind., 1939).

<sup>21</sup> See: *Clifton v. Tomb*, 21 F. 2d 893 (C.A.-4, 1927); note in (1932-33), 81 U. of Pa. L. Rev. 746; *Ballantine on Corporations* (Rev. ed., 1946) para. 38.

<sup>22</sup> *Rosenberg v. Rolling Inn Inc.*, 212 Md. 552, 129 A. 2d 924 (C.A. Md., 1957); *Maryland Apartment House Co. v. Glenn*, 108 Md. 377, 70, A. 216 (1908); *Frazier & Wertheimer v. Ash*, 234 F. 2d 320 (C.A.-5, 1956); *Bortright v. Steinitz Radio Corp.*, 46 F. 2d 385 (C.A.-10, 1931).

of ratification has been criticised on the ground that it pre-supposes an existing person on whose behalf the contract might have been made at the time.<sup>23</sup> As a matter of fact, a majority of the cases do not formulate a precise theory nor distinguish between adoption and ratification. The phrases: "the corporation accepted and adopted", "ratified and adopted", or "recognized and adopted" the contract, are used indiscriminately.<sup>24</sup> Usually it does not seem important to distinguish between adoption and ratification;<sup>25</sup> the trend is to eliminate the differences between them. Except as to relation back they are identical in effect, although possibly susceptible of technical differentiation. The term "ratification" is employed in a non-technical sense.<sup>26</sup> The important result is that it is possible for the corporation to become bound by the promoter's contract without formally making a new contract on the same terms.

Though strictly speaking the corporation cannot ratify the action of the promoter, it may, with or without formal action, become bound by adoption.<sup>27</sup> The contract is regarded as made by the corporation on the date of its adoption, not on the date of the

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<sup>23</sup> See annotation to *Kirkup v. Anaconda Amusement Co.*, (1921), 17 A.L.R. 441, at p. 458; note in (1939), 23 Minn. L. Rev. 224; Colloway, *Pre-incorporation Agreements*, (1957), 11 Southwestern L.J. 509; *MacArthur v. Times Printing Co.*, 48 Minn. 319, 51 N.W. 216 (1892); *Stone v. Walker*, 201 Ala. 130, 134, 77 So. 554, 558 (1917).

Ballantine; *op. cit.*, n. 21 para. 38 says that the doctrine of "relation back" to the date of the contract with the promoter does not seem an essential feature of the idea of ratification, which is the subsequent affirmance of an act of another, done while purporting to act as an agent.

Even though the promoters cannot be regarded as agents of the future company, yet when they have assumed to contract on its behalf the approval and confirmation of such acts will have substantially the same effect as the ratification of the acts of an unauthorized agent, except for the purpose of relating back and except possibly for that of releasing the promoters from liability.

<sup>24</sup> See: *Schreyer v. Turner Flouring Mills Co.*, 29 Ore 1, 43 P. 719 (1896); *Horowitz v. Weehawken Co.* 10 N.J. 417, 159 A. 384 (Sup. Ct. N.J., 1932); *Harris & Tourist Bed Co. v. Whitbeck*, 147 Okla. 109, 294 P. 800 (Sup. Ct. Okl., 1930).

<sup>25</sup> *Arapahoe Inv. Co. v. Platt*, 5 Col. App. 515, 39 P. 584 (1895).

<sup>26</sup> *Jones v. Smith*, 87 S.W. 210 (1905); *Stanton v. New York R.R.*, 59 Conn., 285, 22 A. 300 (1890).

<sup>27</sup> See: *Gardiner v. Equitable Office Bldg. Corp.*, 273 F. 441, 17 A.L.R. 431 (C.A.-2, 1921); *Re Super Trading Co.*, 22 F. 2d 480 (C.A.-2, 1927). Williston on *Contracts*, (3rd ed., 1959) vol. 2, para. 306.



promoter's contract.<sup>28</sup> Adoption seems to have evolved from an equitable doctrine, grafting an exception to the general rule that a corporation is not bound by the promoter's contract.<sup>29</sup> If a contract was made for the benefit of the contemplated corporation and was reasonable and proper for its operation, the contract would, upon acceptance by the corporation of the benefits, become binding without any formal contract.<sup>30</sup>

The leading case applying the adoption theory is *Wall v. Niagara Mining & Smelting Co. of Idaho*,<sup>31</sup> where the court analysed the problem as follows. After a corporation comes into being, the directors are free to make any contract provided it is within the corporate purpose and is not *ultra vires*. No doubt the directors can agree to enter into a new contract which is exactly the same as the promoter's contract. If so, there is no reason for restraining the company from adopting that contract. The company may adopt it not because of an agency on the part of the incorporator before its existence, but because of its own inherent powers as a body corporate to make contracts. The "equitable reason" for this theory was that otherwise a corporation might accept and adopt such a contract, receive and retain the benefits thereof, and yet at the same time be absolved from its burdens. This would lead to fraud and injustice.

No new consideration is required to support the adoption; the benefits to the corporation resulting from the services rendered to it or the goods received by it is sufficient consideration.<sup>32</sup> After acquiescence in this adoption by the other party, he is estopped from denying that he is bound by all the terms of the contract.<sup>33</sup>

The adoption need not necessarily be by a formal or express act but may be inferred or implied by conduct or acquiescence on

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<sup>28</sup> *Pittsburg & Tennessee Copper Co. v. Quintrell*, 91 Tenn. 693, 20 S.W. 248 (1892); *Badger Paper Co. v. Rose*, 95 Wis. 145, 70 N.W. 302 (Sup. Ct. Wisc., 1897).

<sup>29</sup> See: Glover, *Pre-incorporation Contracts of Michigan Corporations*, (1953), 16 U. Det. L.J. 113, at p. 114.

<sup>30</sup> See: *Brace v. Oil Fields Corp.*, 173 Ark. 1128, 293 S.W. 1041 (Sup. Ct. Ark., 1927); note in (1927-28), 26 Mich. L. Rev. 329.

<sup>31</sup> 20 Utah 474, 59 P. 399 (1899).

<sup>32</sup> *Hart-Toole Furniture Co. v. Shahan*, 220 S.W. 181 (Tex. Civ. App., 1920); *Seifert v. Gildersleeve*, 84 Colo. 31, 268 P. 589 (1928). See: Colloway, *op. cit.*, n. 23.

<sup>33</sup> *Bondham Cotton Compress Co. v. McKellar*, 86 Tex. 694, 26 S.W. 1056 (1894).

the part of the corporation or its authorised agents,<sup>34</sup> such as payments made under the terms of the contract,<sup>35</sup> modification of the terms of the contract sought,<sup>36</sup> rights claimed under the pre-incorporation contract,<sup>37</sup> or reliance thereon in court proceedings.<sup>38</sup>

The clearest evidence of adoption is when the corporation accepts the benefits of the contract or carries it out in detail.<sup>39</sup> If the corporation accepts a conveyance of property, or the benefit of services known by it to be made or performed in pursuance of a contract with the promoters, it impliedly agrees that in consideration of the performance by the other party it will on its part perform the covenants which the promoters agreed should be performed on its part, and the court will not permit it to deny the assumption of the corresponding burdens.<sup>40</sup> The question is not whether the plaintiff benefit the corporation, but whether the corporation accepted the benefits under the contract. A corporation may be benefited by the unsolicited act of a third party without being liable to pay therefor. To establish its liability it is necessary to point to some affirmative act on its part which constitutes an acceptance.<sup>41</sup> The adoption must be of a contract

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<sup>34</sup> *McArthur v. Times Printing Co.*, 48 Minn. 319, 51 N.W. 216 (1892); *Webber v. Lance Lumber Co.*, 237 F. 357 (C.A.-3, 1916); *Beefast v. Beefast Water Co.*, 115 Me 234, 98 Atl. 738 (1916); *Streator & Independent Tel. Co. v. Continental Construction Co.*, 217 Ill. 577, 75 N.E. 546 (1905); *In Re Quality Shoe Shop*, 212 F. 321 (D. Pa. 1914).

<sup>35</sup> *Bankers Const. Co. v. American National Bank of Cheyenne*, 30 Wyo. 449, 223 P. 33 (1924); *Freeman v. Osborn*, 14 Colo. App. 448, 60 P. 730 (C.A., 1900).

<sup>36</sup> *Mayers v. Wells*, 252 Wisc. 352, 31 N.W. 2d 512 (1948).

<sup>37</sup> *Moore v. Dallas Post Card Co.*, 215 S.W. 2d (1948).

<sup>38</sup> *Banker's Construction Co. v. American National Bank of Cheyenne*, 30 Wyo. 449, 223 P. 33 (1924). See also: *Brownholtz v. The Providers of Life Assurance Co.*, 236 Ill. App. 494 (1925).

<sup>39</sup> *In re Ballou*, 215 F. 810 (1914); *Morgen v. Bon Bon Co.*, 227 N.Y. 22, 118 N.E. 205 (1917); *Dealers Granite Corp. v. Faubion*, 18 S.W. 2d 737 (1929). Yet where benefits are conditions precedent to the existence of the corporation, something more is required than a mere acceptance of the benefits which the corporation has no power to reject without abolishing itself: *United German Silver Co. v. Branon*, 92 Conn. 268, 102 Atl. 647 (1917); *Indiana polis Blue-Print Co. v. Kennedy*, 215 Ind. 409, 19 N.E. 2d 554 (1939).

<sup>40</sup> *White v. Stevens*, 326 Ill. 528, 158 N.E. 101 (Sup. Ct. Ill., 1927); *In Re Ballou*, 215 F. 810 (1914).

<sup>41</sup> *Zalewski v. Pennsylvania Rabbit Breeders Coop. Assn.*, 76 Penn. District and County Rep. 225 (1950).

made on behalf of the proposed corporation.<sup>42</sup> The acceptance must be with knowledge of the facts concerning the contract,<sup>43</sup> and the knowledge of the promoter will not be imputed to the corporation.<sup>44</sup> This approach may be compared with the English view regarding the inference of a "new contract" from the acts of the company after incorporation.<sup>45</sup> The English courts require some formal action by both parties to the contract (inferrable from the parties' conduct), while the American courts say that from a practical and justifiable point of view the corporation might be liable without a new contract, which in fact would only repeat the original conditions. What underlies the American rule of implied adoption, and in a restricted manner the English rule of an implied new contract, is that, "to permit the corporation to retain possession of the property and its proceeds, without paying the agreed price therefor would be subversive of every principle of justice".<sup>46</sup> Although theoretically the English rule seems to be correct, the result reached in the American cases is the desirable one.<sup>47</sup>

#### b. *Accepting a Continuing Offer*

Just as "ratification" and "adoption" are often used together or interchangeably, so also the phrase "accepting of a continuing offer" is often used together with "adoption". Developed by some

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<sup>42</sup> *Gardiner v. Equitable Office Bldg. Corp.*, 273 F. 441 (C.A.-2 1921); *Gardiner v. DuPont*, 250 F. 227 (C.A.-2d 1918). Cf. *Maryland Apartment House Co. v. Glenn*, 108 M. 337, 70 A. 216 (1908); *In re Super Trading Co.*, 22 F. 2d 480 (C.A.-2d, 1927); note in (1919), 33 Harv. L. Rev. 110.

<sup>43</sup> *Little Rock Ry. v. Perry*, 31 Ark. 164 (1881). Some courts have allowed recovery where the services performed prior to organization were necessary to the formation of the corporation: *Ramsey v. Brook*, 102 W. Va. 119, 135 S.E. 249 (1926). At least one court has predicated a finding of liability upon the theory that an estoppel is created by receipt of the benefits of the contract made in its behalf: *Grape Sugar & V. Mfg. Co. v. Small*, 40 Md. 395 (1874).

<sup>44</sup> *Clifton v. Tomb*, 21 F. 2d 893 (4th cir. 1927). Cf. *Gardiner v. Du Pont*, *op. cit.*, n. 42; *Gardiner v. Equitable Office*, *op. cit.*, n. 42.

<sup>45</sup> *Melhado v. Porto Alegre Ry. Co.*, (1874), L.R. 9 C.P. 503.

<sup>46</sup> *Wall v. Niagara etc.*, 20 Utah 474, 59 P. 399, (1899); *Bathelle v. Northwestern Cement & Concrete Pavement Co.*, 37 Minn. 89, 33 N.W. 327 (1887): "the highest degree of fairness is required in cases of this character; the property had been used and every stockholder and officer know that it was conveyed to the corporation with the understanding that the corporation was to assume and pay the debt to which the property was subjected." See also: *Air Traffic & Service Corp. v. Fay*, 90 U.S. App. D.C. 319, 196 F. 2d 40 (1952).

<sup>47</sup> (1919), 33 Harv. L. Rev. 110.

American courts to avoid the analogy of agency, this theory takes the view that when the promoters have made a contract on behalf of a corporation, the contract be deemed a continuing offer on the part of the other party, unless withdrawn by him.<sup>48</sup> Originally accepted in Wisconsin,<sup>49</sup> only a few States have followed it.

Although praised by the courts and writers it has not received the same recognition as the theories of adoption and ratification.<sup>50</sup>

A clear example of how this theory is applied together with the adoption theory, is found in the law of Utah, where a contract made by and with promoters and which is intended to enure to the benefit of a projected corporation is to be regarded as an open offer which the corporation may accept or adopt as it chooses, and if it does so accept or adopt it and retain the benefit, it cannot deny liability thereunder. In the absence of acceptance or adoption, the corporation is not liable even though the contract may have been entered into upon the understanding that the corporation would be bound.<sup>51</sup>

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<sup>48</sup> *Wheatherford v. Granger*, 86 Tex. 350, 24 S.W. 795 (1894).

<sup>49</sup> *Meyers v. Wells*, 252 Wis. 352, 31 N.W. 2d 512 (Sup. Ct. 1948), discussed by Zimmerman, *Corporations — Promoter's Contract Binding upon a Corporation*, (1948), 32 Marq. L. Rev. 170.

See: *Hinkley v. Sagenmiller*, 191 Wis. 512, 210 N.W. 839 (Sup. Ct. 1926). In "subscription contracts" where the promoter binds a third party to subscribe for a certain amount of shares, the subscription becomes an offer to the company which accepts it. See: Louisiana General Corp. Laws, s. 6.

*Cf. Bridgetown Co-Operative Society v. Whelan*, [1917] 2 I.R. 39: an application for shares made to the promoters of an unregistered co-operative society is a continuing offer, which may, if not revoked be accepted by the society when registered, and the promoters are the agents of the applicant to communicate the offer to the society when so registered; but this rule does not apply to a company (*ibid.*, Ross., J., at p. 42).

<sup>50</sup> *Hackbarth v. Wilson Lumber Co.*, 36 Idaho 628, 212 P. 969 (1923); Ehrich and Bunzel, *Promoters Contracts*, (1929), 38 Yale L.J. 1011; Bains, *Company Liability for Pre-incorporation Contracts*, (1958), 16 U. of Toronto L.J. 31, at p. 34, attacks it saying that it seems rather over-stretched in the case of an executed contract where all that required to be done by both parties, i.e. promoter and outsider, is in fact done prior to incorporation. See also: Wandt, *Corporate Liability on Pre-incorporation Contracts in Colorado*, (1949-1950), 23 Rocky Mountain L. Rev. 465.

<sup>51</sup> *Knox v. First Security Bank of Utah*, 196 F. 2d 112 (C.A.-10, 1952); *Wall v. Niagara Mining & Smelting Co.*, 20 Utah 474, 59 P. 399 (1899). See also: *Pratt v. Oshkosh Match Co.*, 89 Wisc. 406, 410, 62 N.W. 84, 85 (1895); *Deschamps v. Loiselle*, 50 Mont. 565, 148 P. 335 (1915); In *Hackbarth v. Wilson Lumber Co.*, 36 Idaho 628, 631, 212 P. 969 (1923).

It is rare that the corporation's assent to the agreement is definite or express. In most cases where a promoter's contract has been held binding on the corporation, it is because the latter has, with the knowledge of its terms, derived some benefit from the contract.<sup>52</sup>

Strictly speaking this theory would seem to be applicable only when the third party knows that a corporation is to be formed and it is intended that the offer be to the corporation. It would be difficult to presume that the third party could intend to make a continuing offer to a company of whose contemplated existence he was unaware.<sup>53</sup>

### c. *Novation*

Although the cases generally speak of the obligation as created by "adoption", "novation" seems to Williston the more accurate term.<sup>54</sup> If the assent of the corporation to the bargain is merely an adoption of it, the promoter must still remain liable. It seems, therefore, more nearly to correspond with the intentions of the parties to say that when the corporation assents to the contract, it agrees to take the place of the promoter — a change to which the other party to the contract assents in advance. There would then be a novation which would discharge the promoter at the same time as the corporation assumes the obligations.<sup>55</sup>

*Chicago Bldg. & Mfg. Co. v. Talbotton Creamery & Mfg. Co.*<sup>56</sup> appears to be one of the few cases to which the theory of novation might readily be applied. Here the plaintiff contracted with the promoters to build a factory. The latter were to obtain a charter for a corporation, in which each of them was to be interested to the extent of his liability on the contract. The corporation was founded and took over the property. Holding that there was a cause of action against the corporation and not against the pro-

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<sup>52</sup> *Rogers v. The N.Y. and Texas Land Co.*, 134 N.Y. 197, 32 N.E. 27 (1892).

<sup>53</sup> Calloway, *op. cit.*, n. 23.

<sup>54</sup> *Williston on Contracts* (3rd ed., 1959), vol. 2, para. 306.

<sup>55</sup> A novation may be accomplished by the substitution of a new obligation between the same parties with intent to extinguish the old obligation (*Lincoln v. King*, 193 S.W. 2d 437 (1946)), the substitution of a new obligor in place of the old one with intent to release the latter (*Wright Titus Inc. v. Swafford*, 133 S.W. 2d 287 (1939)), or the substitution of a new obligee in place of the old one with intent to transfer the rights of the latter to the former (*Kirkup v. Anaconda Amusement Co.*, 19 Mont. 469, 197 P. 1005 (1921)).

<sup>56</sup> 106 Ga. 84, 31 S.E. 809 (1898).

motors, counsel said that it was clearly the intention of both parties that the plaintiff, when he complied with the contract, should have a right to proceed against the corporation:

In being alleged that the corporation has been formed in conformity to the contract, it would seem that the right of action of the plaintiff against the individuals does not exist, and that the only right which it has is to sue the artificial person, which the contract provided for, and which when brought into being was to take the place of the natural person who had agreed to form it.

Williston's theory has been followed by other scholars,<sup>57</sup> but the courts have been unwilling to accept automatic novation and have insisted on the normal contract rule of express assent of the other party to the substitution.<sup>58</sup> The theory would, however, appear reasonable where it is contemplated in advance by the third party that the corporation should succeed to the rights and liabilities arising under the contract and the promoter be discharged. On the other hand, where the third party does not know that a corporation is to be formed to succeed to the rights and liabilities arising under the contract, it is difficult to find any assent by the third party, even implied, since he cannot assent to something of which he had no knowledge.

#### d. *Pre-incorporation Services*

A contract for services may, like any other contract, be entered into by the promoters prior to formation. The corporation has the

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<sup>57</sup> *Stevens on Corporations*, (2nd ed., 1949), at pp. 223, 227:

'This peculiar nature of the preincorporation contract not only justifies the inference of an advance assent to a novation, but is sufficient to indicate that the promoter's liability is conditional;' rather than do violence to the law of contract, the plaintiff's recovery might be supported on the theory of novation.

Warren, E.H., *The Progress of the Law: Corporations*, (1920), 34 Harv. L. Rev. 282, at p. 288, explaining *Carle v. Corham*, 103 S.E. 699 (Va. C.A. 1920) that where a contract is made by promoters avowedly on behalf of a corporation to be formed, the parties intend that the promoters shall serve only as a stop-gap, and it is proper to imply consent in advance by the outsider to a novation.

<sup>58</sup> *Chestain v. Copper & Reed*, 152 Tex. 322, 257 S.W. 2d 422 (1953); ann. (1939), 123 A.L.R. See: Lattin, *Corporations*, (1959), at p. 102; Oleck, 1 *Modern Corporation Law*, (1958), at pp. 208-9 and p. 219, Ehrlich & Bunzel, *op. cit.*, n. 50, say that the novation theory is never used by the courts because it is too artificial and it is doubted whether the third party will agree to release the promoter from any liability. See: Kessler, *'Promoters' Contracts: A Statutory Solution*, (1961), 15 Rutgers L. Rev. 566, at p. 573.

same right of repudiating obligations under it as with any other contract. The problem arises where all or part of the services are performed prior to repudiation. The corporation has no choice of rejecting or adopting the contract nor can it return the services, as would be the case where goods are supplied under a repudiated contract. By its mere formation the corporation accepts the benefits.<sup>59</sup>

The weight of authority is in favour of denying liability of the corporation for pre-incorporation services. In many of the cases the statement of the rule is dictum and most cases do not even bother to give reasons. A rather simple approach was taken in an old Louisiana case: "How the defendant a juridical person, incurred a debt before its existence we cannot imagine".<sup>60</sup> A misplaced fear of scheming promoters and a policy of protecting investors is one reason submitted for denying liability.<sup>61</sup>

To attenuate the rigour of this absolute principle, several principles of law are called in aid. The corporation may be rendered liable by virtue of a promise made subsequent to incorporation.<sup>62</sup> If the promoter can persuade the corporation to give him a promissory note for his services, the court will hold that the note is founded on a sufficient consideration,<sup>63</sup> and if payment for his services is voluntarily made, such payment cannot be recovered by the corporation.<sup>64</sup>

Then too the doctrine may be applied that, if the services were requested by a majority of the incorporators on the understanding that they would be paid for, the corporation is liable therefor.<sup>65</sup>

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<sup>59</sup> *Kridelbough v. Aldrehn Theatre Co.*, 195 Iowa 147, 191 N.W. 803 (1923); note in (1926), 11 Minn. L.R. 465; note in (1939), 23 Minn. L.R. 224.

<sup>60</sup> *Marchand v. Loan & Pledge Ass.*, 26 La. Ann. 389, 390 (1874); dist. in *David v. Southern Import Wine Co.*, 171 So. 180, 183 (La., 1936).

<sup>61</sup> *N.Y. & N.H.R.R. v. Ketchum*, 27 Conn. 169 (1858). Cf. *Weatherford v. Granger*, 86 Tex. 350 (1894); *Rockford R.I. & S.L.R.R. v. Sage*, 65 Ill. 328, 332 (1872).

<sup>62</sup> *Cushion Heel Shoe Co. v. Hart*, 181 Ind. 167, 103 N.E. 1063 (1914).

<sup>63</sup> *Smith v. New Hartford Water Co.*, 73 Conn. 626, 48 A. 754 (1900); *N.Y. N.H. etc. v. Ketchum*, 27 Conn. 170 (1858).

<sup>64</sup> *Southern Hardwood Lumber Co. v. Scott*, 46 Ill. App. 285 (1892).

<sup>65</sup> *Ash Law v. Conn. etc. Ry.*, 45 N.R. 370 (1864); *Hall v. Vt. & Mass. Rly. Co.*, 28 Utah 401 (1856); *Bell's Gap. R.R. Co. v. Christy*, 79 Pa. St. 54, 21 Am. Rep. 39 (1875).

### e. *Quasi-Contract*

Finally, as the most usual ground, liability may be based on *quasi-contract*.<sup>66</sup>

The Louisiana Court of Appeal<sup>67</sup> recognized that one who renders services prior to incorporation may recover on a *quasi-contractual* basis from a corporation which by its very existence accepts the benefits of the services which brought it into being.

The corporation may not be heard to say that the service was unauthorized because rendered prior to incorporation, or to question the authority on which the service was employed. The corporation, "may not be held to the contract itself, but it may not repudiate the service entirely and yet reap the benefits therefrom. It may repudiate the contract price if a price has been agreed upon, but it may not refuse to pay for the service on the basis of the value of the benefits received; in other words on a *quantum meruit*".

But the cases taking a *quasi-contractual* view of the liability of the corporation are the minority.<sup>68</sup> The refusal of any remedy in *quasi-contract* is based on practical grounds of policy against imposition upon innocent investors.<sup>69</sup> Although, in practice, the corporation, after organisation, pays or makes a promise to pay,

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<sup>66</sup> A study of the cases indicates diminishing emphasis by the courts on the requisite that there be knowledge of the facts by those in a position to bind the corporation in order to find an implied promise. See: *Ash Law v. Conn. etc.*, 45 N.B. 370 (1864); *Bell's Gap. R.R. Co. v. Christy*, 79 Pa. St. 54 (1875); *Taussing v. St Louis & K. Rly. Co.*, 166 Mo. 281, 65 S.W. 969 (1901); *Ramsey v. Brook County Building & Loan Ass.*, 102 W. Va. 119, 135 S.E. 249 (1926).

<sup>67</sup> *David v. Southern Import Wine Co. Inc.*, 171 So. 180, 182 (1936). See also: *Ramsey v. Brook*, 102 W. Va. 119, 135 S.E. 249 (1926). See: note in (1955), 57 W. Virginia L.R. 82.

<sup>68</sup> Ballantine, *op. cit.* n. 21, at p. 112: 'The better opinion and the weight of authority is that there is no such liability on the part of the corporation to its promoters or to those employed by them, in the absence of an express promise by it after its organization, unless as is sometimes the case, such a liability is imposed by its charter.' See also: 13 Am. Jur. Corp. para. 101, 124 (1938); Stevens, *op. cit.*, n. 57, at p. 219.

<sup>69</sup> *Gardiner v. Equitable Office Bldg. Co.*, 273 F. 441 (C.A.-2, 1921); *Hackney v. York*, 18 S.W. 2d 923 (C. App. Tex. 1929); *Abbot v. Mut. Co. Ltd.*, 85 P. 2d 961 (1939). *Rockford R.I. & S.L.R.R. v. Sage*, 43 Ill. 328 (1872): 'It appears more reasonable to hold any services performed or expenses incurred prior to the organization of a corporation, to have been gratuitous, in view of the general good or private benefit expected to result from the object of the corporation.'



and in most states such past services are regarded as valid consideration for voluntary payment<sup>70</sup> or an enforceable promise to pay,<sup>71</sup> the law is unsatisfactory.

#### f. Statutory liability

Only two states have made any statutory attempt to solve the problem of preliminary contracts. They are Michigan and Kansas. The Michigan statute<sup>72</sup> provides that:

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 incorporators for the benefit of the proposed corporation shall be deemed to be the property of such corporation.

The first question that the section raises is who are the "incorporators"? Is the term a synonym for "promoters"? Since the actual "incorporators" are usually dummies, employees in the lawyer's office, and thus not the real promoters of the corporation, they will not enter into any contract in any event. Nevertheless the purpose of the section is thought merely to permit the making of contracts by the incorporators in the brief interim period between the signing of the articles of incorporation and the completion of the formation of the corporation by filing the articles, a view that would lead to unrealistic results and exclude all contracts

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<sup>70</sup> It seems that the gratuitous nature of the payment does not prevent it from being taxable income, *La Motte v. Cohn*, 8 T.C. (U.S.A.) 796 (1947). The courts have given consideration to the real intent of the parties: *Thomas v. Commissioner*, 135 F. 2d 378, 379 (C.A.-5, 1943) and to the tax treatment which the corporation accords the payment: *Willkie v. Commissioners*, 127 F. 2d 958 (C.A.-6, 1942). According to the English law even extra remuneration, paid without obligation but in recognition of services rendered, is taxable as remuneration from employment (*Weston v. Hearn*, 27 T.C. 425), but a pure gratuity given by an employer to an employee is not taxable (*Seymour v. Reed*, (1927), 11 T.C. 625 (H.L.)).

An Israeli District Court held (Appeal No. 848/57) that a promoter who received shares for his services must pay income tax according to the real value of the shares. See: Brudno & Bower, *Taxation in the U.K.*, (Harvard Law School, 1957), at p. 236.

<sup>71</sup> *United German Silver Co. v. Bronson*, 92 Conn. 266, 102 A. 647 (1917); The rule in N.Y. is still uncertain, see: *Kimmel Sales Corp. v. Lauster*, 167 Misc. 514, 4 N.Y. S. 2d 88 (Sup. Ct. 1938); *Brown v. Watson*, 285 App. Div. 587, 139 N.Y. S. 2d 628 (1st Dept. 1955). Cf. Horenstein, *Corporation Law and Practice*, (N.Y., 1959), at p. 99.

<sup>72</sup> Mich. Stat. Am. Cl. 195, para. 21.8 (1931) (*Michigan Corporation Act*, Act No. 327, para. 8).

made by promoters who have not signed the articles.<sup>73</sup> Moreover, in *In re Montreuil's Estate*,<sup>74</sup> the court equated the term "incorporator" with the broader "promoter", holding that the statute, "abrogates the common law rule . . . that promoters may make no contract in behalf of a proposed corporation". This holding has, however, been attacked. The intent of the statute is not to abrogate the common law rule at all, "but rather exempting preincorporation contracts from the voiding effect of the franchise tax law".<sup>75</sup> On the other hand, the Michigan Supreme Court in *Bil Gel Co. v. Thomas*,<sup>76</sup> affirmed the opinion that the statute abrogated the common law rules. As appears from the facts of this case, promoters' contracts in general are covered by this statute. In the *Montreuil* case it was held that,

Under this statute the order in behalf of the contemplated corporation, upon organisation of such corporation, by adoption and the acts of the parties, became a contract exclusively between such corporation and the plaintiff.

In effect, the promoter-incorporator, as agent of the corporation even before its incorporation and in the absence of a personal undertaking, is not liable personally on the contract.<sup>77</sup> The decision seems to alter the common law rule that there can be no agency for a non-existent principal and destroys the presumption, first definitely formulated in *Kelner v. Baxter*, that the personal liability of the promoter is intended in the absence of a clear showing to the contrary. The statute says *nothing* about the promoter's liability. The safest statement of the rule to be drawn from the case is that the promoter will be released from liability where the corporation assumes it.<sup>78</sup> The problem of who shall be liable where the corporation is never formed, or, once formed, repudiates the promoter's contract is left open by the decision, and is placed in even greater doubt by the statute. Nor is it clear whether the corporation is automatically shackled with any contract the promoter chooses to make for it without some right of rejection.<sup>79</sup>

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<sup>73</sup> *Ballantine, op. cit.*, n. 21, para. 37. See: *Glover, op. cit.*, n. 29, at p. 119.

<sup>74</sup> 291 Mich. 582, 289 N.W. 262, 264 (1939).

<sup>75</sup> *Glover, op. cit.*, n. 29, at p. 122.

<sup>76</sup> 345 Mich. 698, 77 N.W. 2d 89 (1954).

<sup>77</sup> See also: *In Hart Potato Growers' Ass. v. Grenier*, 236 Mich. 638, 211 N.W. 45 (1926), where it was intimated that the section made the corporation liable upon the contracts of the incorporators immediately upon incorporation.

<sup>78</sup> *Kessler, op. cit.*, n. 58; *Rogers, Preincorporation Contract*, (1940), 38 Mich. L. Rev. 1266.

<sup>79</sup> *Kessler, ibid.*, at p. 577. For a further discussion, see *Zenke, Preincorporation Subscription Contracts in Michigan*, (1957), 34 U. Det. L.J. 662.

Section 16 of the *General Corporation Statute of Kansas*,<sup>80</sup> reads as follows:

When the existence of a corporation has begun under the provisions of s. 14 and the conditions precedent to the beginning of business under the provisions of s. 15 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 organisation 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.

The Kansas statute corrects two defects revealed in the Michigan act. In the first place, it expressly applies not only to "incorporators", but also to "promoters", defined as those "who undertake to form a corporation and procure for it the rights... and to establish it as able to do business". Secondly, it expressly provides for cases in which the corporation does not wish to assume the contract, by allowing it to repudiate the obligation. Yet this statute does not fix liability where the corporation receives a benefit but repudiates the contract. Perhaps the liability is only on the promoter, as it appears to be until the corporation makes its election.<sup>81</sup> Another serious defect is that the statute seems to make the corporation liable on *any* promoter's contract, whether or not it has notice thereof and whether or not it is unfair. Not surprisingly, therefore, the statute has been much criticised.<sup>82</sup>

Both these statutes indicate that if the promoter's problems are to be solved by legislation much more skill and thought must be expended to deal satisfactorily with the various problems involved.

## Germany

Article 211 of the first German commercial code, the *Allgemeines Deutsches Handelsgesetzbuch, 1861* (AHGB), stated that before the company is registered in the commercial register it does not exist as such. Until then if any action was taken in its name, the actors themselves were liable. The codes of 1870, 1884 and 1894 followed on the same lines.<sup>83</sup>

A new approach was adopted by the new Corporation Law of 1937, the *Gesetz Über Aktiengesellschaften und Kommanditgesells-*

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<sup>80</sup> Kansas Gen. Stat. Ann., para. 17-2807 (1939).

<sup>81</sup> (1940), 54 Harv. L. Rev. 154.

<sup>82</sup> *Id.*, Glover, *op. cit.*, n. 29, at p. 115; Ballantine, *op. cit.*, n. 21, para. 38.

<sup>83</sup> Lehmann, *Allgemeiner Teil des Bürgerlichen Rechts* (1952), 7 Auflage 6.

*chaften auf Aktien (Aktiengesetz)*, s. 34<sup>84</sup> and was followed by *Aktiengesetz, 1965 (AKtG)*.

Section 41 of the AKtG provides that:

(1) Prior to registration in the commercial register the corporation does not exist as such. Any person acting in the name of the corporation prior to registration is personally liable; several persons so acting are jointly and severally liable.

(2) If the corporation assumes an obligation entered into in its name prior to its registration, by means of a contract with the debtor in such a way that it takes the place of the previous debtor, the consent of the creditor is not essential for the effectiveness of the assumption of the obligation provided the assumption of the obligator is agreed and communicated to the creditor either by the corporation or the debtor within three months after the registration of the corporation.

Para. 1 repeats the existing law and makes it clear that the promoter, or whoever acts in the corporation's name and on its behalf, is personally liable. Para. 2, however, is new.<sup>85</sup> The provision applies only to contracts made in the name of the company. If the contract was made otherwise, e.g., in the name of the *Gruender*, "novation" is possible only with the consent of the other party. The same applies if the company did not avail itself of the three months' term. Though it could be interpreted as an expression of the novation theory, the provision does not harmonize with the definition of novation in the German Civil Code. It seems that the legal source for the concept embodied in section 41 is found in the guarantee theory.<sup>86</sup>

Many pre-incorporation contracts are made for the purpose of forming a company to take over a going concern. The promoters may also have to enter into contracts with third parties to obtain franchises, patents, etc. According to English law such contracts do not bind the company; according to the American view they do not bind the corporation unless they are adopted by the company. Section 27 of the AKtG 1965 takes a different view:

(1) Where shareholders make contributions... in cash or in kind (*sacheinlagen*), or in a case where the corporation takes over plant or installations either existing or to be erected or any other assets (*sachuebernahmen*), the corporate charter shall determine the subject matter of the *Sacheinlagen* or *Sachuebernahmen*, the person from whom the corporation takes over the same and the nominal amount

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<sup>84</sup> Reichsgesetzblatt 1.107 as amended RGL 1.588, 1140.

<sup>85</sup> Para. 398 BGB (the law of assignment) also does not require the consent of the debtor for the assignment of a right.

<sup>86</sup> See para. 416 I BGB.

of shares to be given in consideration for the *Sacheinlagen* or the compensation to be paid for the *Sachuebernahmen*.

(2) Without such determination, agreements concerning *Sacheinlagen* and *Sachuebernahmen* and the legal acts implementing the same shall be ineffective vis-à-vis the corporation. After the corporation is registered the validity of the charter shall not be impaired by this ineffectiveness; if an agreement concerning a *Sacheinlagen* is ineffective the shareholder is obliged to pay the par or above par value of the shares.

(3) After registration of the corporation in the commercial register the ineffectiveness cannot be legalized by amendment of the corporate charter.

Section 19 applies the same rules to pre-incorporation expenses. If, and insofar as all the matters enumerated are included in the articles, they become operative automatically on the company's registration. The company is entitled to all rights and benefits and incurs all duties and obligations. In contrast to the American "adoption" system, the company is bound without any action on its part.

The question of overvaluation at the expense of future shareholders and creditors is solved by the liability of the promoters to disclose these contracts in the corporate charter.<sup>87</sup>

There is no limit to the amount to be paid by the corporation for pre-incorporation expenses and services but it must be reasonable.<sup>88</sup>

If the amount of the expenses is fixed in the corporate charter, the individual to whom it is due has the right of a creditor against the company. The company is thus liable for pre-incorporation services without any action of its directors or officers.

#### a. *Strict Liability (Identity between Promoters and Company)*

A theory of identity between promoter and company has been developed.<sup>89</sup> The theory is limited to contracts and acts which are necessary for bringing the company into being. In advancing this theory the writers rely on para. 20 of the BGB which states that "an association whose object is not the carrying of an economic enterprise, acquires juristic personality by registration in the register of the competent district court". They say that while the legal form of the corporation changes upon incorporation, the entity

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<sup>87</sup> Mueller and Galbraith, *Aktiengesetz 1965* (Frankfurt: 1966) 9.

<sup>88</sup> See: Baumbach and Rueck, *Aktiengesetz* (1949), at p. 38; Fischer *Aktiengesetz, Grosskommentar*, (2d ed., 1957) vol. 1, para. 19.

<sup>89</sup> Schreiber, *Kommanditgesellschaft auf Aktien*, 134: Feine, in Ehronberg's *Handbuch des Gesamten Handelsrechts*, vol. 3, p. 201.

remains the same, in the economic and personal sense. From this they conclude that the company *eo ipso* steps into all contracts, rights as well as liabilities. Faced with the special provisions in articles 26, 27 and 41 of the AKtG, they contend that the reason for these sections is the inherent possibility of corporate losses in regard to pre-incorporation expenses and contract, but that does not mean that the statute has changed the strict identity between the promoter and the company.

The *Reichsgericht* (the German Federal Supreme Court) has also developed a theory of identity between the promoters and the company,<sup>90</sup> basing itself on the law of associations. When the corporation becomes a legal entity it is still identical with its promoter. Here again, the courts have limited the power of the promoter to bind the company only to those contracts and acts which are necessary to bring it into being. The court has also applied the law of agency. The problem in English and American law of an agent acting for a non-existent principal has not troubled the German court because of the theory of identity. The agent represents a being which, although changing its legal personality, remains the same entity.

The theory of identity has been criticized on the grounds that s. 41(2) AKtG does not fit in with it.<sup>91</sup> The AKtG has been very strictly construed and only if the contracts concern objects mentioned in articles 26, 27 and 41 and the procedure of article 41(2) is followed, can the corporation be bound.<sup>92</sup>

#### b. Assumption

The majority of writers<sup>93</sup> offers another theory not within the scope of articles 26, 27 and 41 AKtG. They suggest the application of the law relating to *Geschaeftsfuehrung ohne Auftrag* (management of affairs without mandate). Article 677 BGB provides that,

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<sup>90</sup> *Entscheidungen des Reichsgerichts in zivilsachen* (Decisions of the *Reichsgericht* in civil matters), known as the RGZ. RGZ 54/280; 82/290; 83/373; 105/229; 143/373; 151/91.

Those decisions were decided before the statute of 1937. To-day the necessary contracts can bind the corporation only if they are included in the charter (AKtG s. 27). This requirement does not, of course, affect the view of identity between the promoter and the corporation. See Fischer, *Aktiengesetz, Grosskommentar*, para. 34, 10 (2nd ed., 1957).

<sup>91</sup> Brodmann, *Aktienrecht* (Berlin: 1928) para. 200; Fischer, 1 *Aktiengesetz*, para. 34 (1957); Ritter, *Aktiengesetz* (2nd ed., 1939), para. 34, 3b; Baumbach and Rueck, *Aktiengesetz* (1954), para. 34.1.

<sup>92</sup> Von Godin and Wilhelmi, *Aktiengesetz* (2nd ed., 1950), para. 34, 5.

<sup>93</sup> *Op. cit.*, n. 91.

A person who takes charge of an affair for another without having received a mandate from him or being otherwise entitled to do so in respect of him, shall manage the affair in such manner as the interest of the principal requires, having regard to his actual or presumptive wishes.

The promoter does not receive a mandate and is not otherwise entitled to act for a non-existent body; the requirements of article 677 BGB and thereupon article 683 BGB can be applied:

If the undertaking of the management of the affair is in accordance with the interest and the actual or presumptive wishes of the principal, the agent may demand reimbursement of his outlay as a mandatory.

The amount which the promoter can recover is limited by article 670 to that which is necessary under the circumstances, *i.e.*, all expenses which an ordinary, prudent and reasonable man would have incurred. He can also demand that the corporation release him from the burdens of the contract when it takes over the benefits, and according to article 683, may even sue the corporation to compel it to do so. However, the corporation, through its directors, must perform an unequivocal act evidencing an assumption of the obligation.

The vast majority of German authorities have come to the conclusion that apart from ss. 26, 27 and 41 AktG, the corporation is not *eo ipso* bound by the promoters' contracts. According to the theories of strict liability and of assumption,<sup>94</sup> the corporation must, after incorporation, take some action to ratify the contract. While the *Reichsgericht* applies the rules of agency without authority, to this situation, the majority of legal writers rely on article 683 BGB, which enables the corporation to release the promoter from pre-incorporation contracts. The *Reichsgericht's* view was affirmed by the *Bundesgerichtshof*, its successor, holding that the existing law does not exclude the possibility of a promoter acting in the name of a corporation not yet in existence, with the expectation that the corporation alone will be bound. A legal act in the name of a later created natural or corporate person is possible under German law.<sup>95</sup>

Summing up, the rights and liabilities of a corporation on promoters' contracts in German law, necessary contracts and pre-

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<sup>94</sup> *Supra*, at p. 532 and p. 533.

<sup>95</sup> BGH MDR 1955/727, a decision of 1955. See also *Hachenburg and Schilling, Kommentar zum Gesetz betr die Gesellschaften mit Beschränkter Haftung* (1956) para. 11, 4; Scholz, *Kommentar zum GmbH Gesetz* (2nd ed., 1950) para. 11, 7.

liminary expenses must be stated in the corporate charter to be binding automatically on the corporation (AKtG article 26); *Sacheinlagen* and contracts the objects of which can be defined as *Sachuebernahmen* must appear in the corporate charter and they become operative automatically on the company's registration (AKtG article 27); any other contract is not binding on the corporation and the promoter himself is liable (AKtG, article 41), and although the corporation can adopt the contract under article 34 AKtG or under article 177 BGB,<sup>96</sup> it does not affect the promoter's personal liability.

### Conclusion

The problems of pre-incorporation contracts have never been treated as difficulties of a highly specialised nature. A rule like that in *Kelner v. Baxter* springs from an attempt to deal with such contracts within the framework of the usual contractual rules when the only practical solution is to regard them as *sui generis*.

In abrogating the rules which have grown up by virtue of this critical and basic failure, the concentration has sometimes been on relieving the personal liability of the promoters, sometimes on ensuring that the company does not take benefits without payment, and in other instances on permitting the company to take such benefits if it so desires and thus providing the other party to such contracts with proper remedies. But in some instances to permit the company the choice of whether to accept or rescind a pre-incorporation contract will ensure only an enforced choice between acceptance of a financial burden and the necessity to rescind and face a suit for damages. This is easily demonstrated by the *O'Rorke v. Geary*<sup>97</sup> situation, where the third party built a bridge for the corporation. If the corporation adopts the contract then it is forced to pay the price under the contract, even if that price is inflated or unreasonable, and would not have been agreed by the board of the established company.

There is no reason why this important field of commercial law should remain neglected, technical and rigid. The various aspects of the subject should be revised; a solution based on a practical approach, tackling the problem *sui generis* might be of great help to the commercial and legal world.

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<sup>96</sup> BGB 177(1): If a person enters into a contract in the name of another without authority, the contract is valid in favour of and against the principal only if he ratifies it. See also: *Achilles and Grief*, BGB (1958), 84.

<sup>97</sup> 207. PG. 240. 56. Atl. 541. 1903.