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Preincorporation Agreements

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PREINCORPORATION AGREEMENTS

The purpose of this comment is to determine the effect of preincorporation agreements with respect to the rights and liabilities of the promoter, who procures the contract, and the proposed corporation, on whose behalf it is made. The type of agreements treated in this discussion are generally those which deal with the buying, selling and leasing of property and other equipment which the proposed corporation will need when formed in order to function as a business. The main emphasis is placed on the different theories which have been used by the courts in determining the corporation's rights and liabilities on the preincorporation agreement. It should be remembered that the agreement in the particular case is an important factor which the court considers in determining the theory to be used to determine the liability of the corporation and the promoter. For purposes of identification, the promoter will be referred to as promoter, the corporation as corporation, and the party with whom the promoter is dealing as *T*. The word "promoter," as used herein, refers to the person who undertakes to form a corporation and to procure for it the rights, instrumentalities and capital by which it is to carry out the purposes set forth in its charter and to establish it as fully able to do business.¹ As such he is an intermediary between the corporation and the future stockholders, who in the aggregate will form the corporation.²

PROMOTER'S LIABILITY ON PREINCORPORATION CONTRACTS

The promoter is not an agent of the corporation later to be formed.³ The promoter himself is liable upon the contract made in behalf of the proposed corporation unless the person with whom he engages agrees that he is not to be liable or there is a novation among the parties after formation of the corporation, releasing the promoter from liability.⁴ The basis of this liability is the rationale that a person who contracts as an agent but who is without a principal is a principal himself, having all the rights and being subject

¹ This is the definition used in *Koppitz-Melchers, Inc. v. Koppitz*, 315 Mich. 582, 24 N.W.2d 220 (1946).

² *Cator v. Commonwealth Bonding and Cas. Ins. Co.*, 216 S.W. 140 (Tex. Comm. App. 1919).

³ *Byerly v. Camey*, 161 S.W.2d 1105 (Tex. Civ. App. 1942) *error ref. w.o.m.*; *Jones v. Smith*, 87 S.W. 210 (Tex. Civ. App. 1905).

⁴ *Mt. Pleasant Coal Co. v. Watts*, 151 N.E. 7 (Ind. Ct. App. 1926); *Cavaness v. General Corp.*, 272 S.W.2d 595 (Tex. Civ. App. 1954), *aff'd*, — Tex. —, 283 S.W.2d 33 (1955). Also the promoter is released from liability on a preincorporation contract in the event *T* accepts a new contract from the organized corporation which covers the same subject matter as the preincorporation contract. *Ennis Cotton-Oil Co. v. Burks*, 39 S.W. 966 (Tex. Civ. App. 1897).

to all the liabilities of a principal.⁵ However, the promoter is not personally liable on a contract made in the name of and solely on the credit of the future corporation, where the intention to bind only the future corporation is known to *T*, unless the contract is such that the corporation when formed has no power to assume it, e.g., such as a contract which is prohibited by the charter.⁶ A contract made by the promoter in behalf of the corporation and under express agreement that the corporation alone is to be bound, and that no personal liability is to exist against the contracting promoter, is valid, provided that the contract is one which the corporation, if it were then in existence, could legally make.⁷ The question of whether or not a contract was made by the promoter personally or on the credit of the corporation may be a question of either law or fact according to the circumstances.⁸ If it cannot be determined from the contract itself who is intended to be bound, parol evidence may be used to show the real intention of the parties as to whom they intended to be bound.⁹

THEORIES OF CORPORATE LIABILITY

A corporation cannot enter into a contract before its organization¹⁰ because there can be no liability without legal existence.¹¹ Therefore, a corporation, on its coming into existence, is not bound by agreements made by its promoters, even though the performance thereof results in benefits to the corporation.¹² However, if the corporation subsequently recognizes and treats the preincorporation contract as its own, this gives to the contract the legal effect it would have had, had the requisite corporate power existed when the contract was entered into.¹³ Various theories, which will be discussed below, have been advanced by the courts relating to the manner in

⁵ *Bibbee v. Root Glass Co.*, 67 S.W.2d 407 (Tex. Civ. App. 1934), *aff'd*, 128 Tex. 220, 96 S.W.2d 975 (1936); *Ennis Cotton-Oil Co. v. Burks*, 39 S.W. 966 (Tex. Civ. App. 1897).

⁶ *Schwedtman v. Burns*, 11 S.W.2d 349 (Tex. Civ. App. 1928).

⁷ *Weeks v. San Angelo Nat'l Bank*, 65 S.W.2d 348 (Tex. Civ. App. 1933) *error ref.*

⁸ *Schwedtman v. Burns*, 11 S.W.2d 349 (Tex. Civ. App. 1928).

⁹ *Cavaness v. General Corp.*, 272 S.W.2d 595 (Tex. Civ. App. 1954), *aff'd*, — Tex. —, 283 S.W.2d 33 (1955); *Weeks v. San Angelo Nat'l Bank*, 65 S.W.2d 348 (Tex. Civ. App. 1933) *error ref.*

¹⁰ *Wenzel v. Brooks-Asbeck Inc.*, 211 S.W.2d 611 (Tex. Civ. App. 1948) *error ref. n.r.e.*; *Exline-Reimers Co. v. Lone Star Life Ins. Co.*, 171 S.W. 1060 (Tex. Civ. App. 1915).

¹¹ *Exline-Reimers Co. v. Lone Star Life Ins. Co.*, 171 S.W. 1060 (Tex. Civ. App. 1915).

¹² *Stringer v. Electronics Supply Corp.*, 23 Del. Ch. 79, 2 A.2d 78 (1938); *Hart-Toole Furniture Co. v. Shahan*, 220 S.W. 181 (Tex. Civ. App. 1920); *American Home Life Ins. Co. v. Jenkins*, 138 S.W. 424 (Tex. Civ. App. 1911).

¹³ *Harris Tourist Bed Co. v. Whitbeck*, 147 Okla. 109, 294 Pac. 800 (1930); *Trinity Fire Ins. Co. v. Kerrville Hotel Co.*, 129 Tex. 310, 103 S.W.2d 121 (1931).

which a corporation becomes liable on a preincorporation contract.

Ratification

A corporation, after it comes into existence, may ratify a contract made by its promoter before it was formed.¹⁴ Such a contract after ratification becomes the contract of the corporation, which is entitled to the benefits thereof and is liable thereon.¹⁵ Ratification may be express or implied,¹⁶ and no formal resolution of the board of directors is required to effect it.¹⁷

It would seem that the ratification theory is not applicable because, technically speaking, ratification implies a person existing at the time the contract was made, on whose behalf the contract might have been made.¹⁸ This proposition is based on the "relation back" theory that to have a ratification the person sought to be bound must have been in existence at the time the original contract was made.¹⁹

Adoption

A corporation may adopt a contract made by its promoter prior to its organization.²⁰ It is not required that there be a new consideration 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 to support the corporation's adoption of the contract.²¹ When the corporation adopts the contract, it then becomes liable for full performance thereon and not merely for the reasonable value of the benefits which it has received.²² The corporation adopting a preincorporation contract also adopts the related

¹⁴ *Boatright v. Steinite Radio Corp.*, 46 F.2d 385 (10th Cir. 1931); *Pearl Realty Co. v. Wells*, 164 Miss. 300, 145 So. 102 (1933); *Walnut Park Lumber and Coal Co. v. Roane*, 171 Wash. 362, 17 P.2d 896 (1933).

¹⁵ *Ibid.*

¹⁶ *Boatright v. Steinite Radio Corp.*, 46 F.2d 385 (10th Cir. 1931).

¹⁷ *Indianapolis Blue Print and Mfg. Co. v. Kennedy*, 215 Ind. 409, 19 N.E.2d 554 (1939).

¹⁸ *Weatherford, M.W.&N.W. Ry. v. Granger*, 86 Tex. 350, 24 S.W. 795 (1894). Also see *Breckenridge City Club v. Hardin*, 253 S.W. 873 (Tex. Civ. App. 1923).

¹⁹ *Kelner v. Baxter, L.R.* 2 C.P. 174 (1866); *Rowray v. Casper Mut. Bldg. & Loan Ass'n*, 48 Wyo. 290, 45 P.2d 7 (1935).

²⁰ *Huron Printing and Bindery Co. v. Kittleson*, 4 S.D. 520, 57 N.W. 233 (1894); *Farrell v. Drumm Floral Co., Inc.*, 125 S.W.2d 606 (Tex. Civ. App. 1939) *error dismissed*.

²¹ *Hart-Toole Furniture Co. v. Shahan*, 220 S.W. 181 (Tex. Civ. App. 1920). Also see *Seifert v. Gildersleeve*, 84 Colo. 31, 268 Pac. 589 (1928). *But see Neosho Motor Co. v. Smith*, 59 S.W.2d 802 (Mo. Ct. App. 1933).

²² *Phil H. Pierce Co. v. Rude*, 291 S.W. 974 (Tex. Civ. App. 1927) *error dismissed*; *Hinkley v. Sagemiller*, 191 Wis. 512, 210 N.W. 839 (1926).

acts of its promoter.²³ Further, after the corporation adopts a pre-incorporation agreement and *T* acquiesces in this adoption, he is estopped to deny that he is bound by all the terms of the contract.²⁴

As to what constitutes adoption, the following have been held to accomplish such a result. When a corporation brings suit upon the preincorporation contract, this is, of itself, an adoption of the contract.²⁵ The corporation's demanding payment under the contract is sufficient also.²⁶ No clearer evidence of adoption is needed than the undisputed fact that the corporation accepted the benefits of the contract or that it carried it out in detail.²⁷ Yet where benefits go to the existence of the corporation, something more is required than a mere acceptance of these benefits which the corporation has no power to reject without abolishing itself.²⁸ For example, the use of the charter and by-laws for which the promoter has contracted is not an adoption of the promoter's contract,²⁹ and the corporation is not liable unless it is so provided in the charter or by-laws.³⁰

Novation

Some courts apply the novation theory of liability. In every novation there are four requisites: (1) a previous valid obligation; (2) an agreement of all the parties to the contract; (3) the extinguishment of the old contract; and (4) the validity of the new one.³¹ A novation may be accomplished by the substitution of a new obligation between the same parties with the intent to extinguish the old obligation,³² the substitution of a new obligor in place of the old one with intent to release the latter³³ or the substitution of a new obligee in place of the old one with the intent to transfer the rights of the latter to the former.³⁴

²³ Burns v. Veritas Oil Co., 230 S.W. 440 (Tex. Civ. App. 1921); American Home Life Ins. Co. v. Compere, 159 S.W. 79 (Tex. Civ. App. 1913). Also see Harowitz v. Weehawke Trust and Title Co., 10 N.J. Misc. 417, 159 Atl. 384 (1932).

²⁴ Bonham Cotton Compress Co. v. McKellar, 86 Tex. 694, 26 S.W. 1056 (1894).

²⁵ Moore v. Dallas Post Card Co., 215 S.W.2d 398 (Tex. Civ. App. 1948) *error ref. n.r.e.*

²⁶ *Ibid.*

²⁷ *In re Ballou*, 215 Fed. 810 (E.D. Ky. 1914); Dealers Granite Corp. v. Faubion, 18 S.W.2d 737 (Tex. Civ. App. 1929); Phil H. Pierce Co. v. Rude, 291 S.W. 974 (Tex. Civ. App. 1927) *error disp.*

²⁸ United German Silver Co. v. Branon, 92 Conn. 266, 102 Atl. 647 (1917); Indianapolis Blue Print and Mfg. Co. v. Kennedy, 215 Ind. 409, 19 N.E. 2d 554 (1939).

²⁹ Jones v. Smith, 87 S.W. 210 (Tex. Civ. App. 1905).

³⁰ Hackney v. York, 18 S.W.2d 923 (Tex. Civ. App. 1929).

³¹ United States Gypsum Co. v. Snyder-Ashe Co., 139 Cal. App. 731, 34 P.2d 767 (1934); Lincoln v. King, 193 S.W.2d 437 (Tex. Civ. App. 1946); Johnson v. Harrington, 139 S.W.2d 202 (Tex. Civ. App. 1940) *error disp. judgm. cor.*

³² Lincoln v. King, 193 S.W.2d 437 (Tex. Civ. App. 1946).

³³ Wright Titus, Inc. v. Swafford, 133 S.W.2d 287 (Tex. Civ. App. 1939) *error disp. judgm. cor.*

³⁴ Kirkup v. Anaconda Amusement Co., 59 Mont. 469, 197 Pac. 1005 (1921).

A novation between the same parties by a substitution of a new agreement for the old would not serve to make a corporation liable on a preincorporation contract made by the promoter because such a method of novation would necessarily be between the promoter and *T*.

As to a novation where one debtor or obligor is substituted for another (thereby releasing the other), there must be an agreement to that effect among all three parties, and a presumption of intention to release the first debtor will not arise from the mere taking of the second.³⁵ This type of novation does not have to be in writing or even evidenced by express words, but it may be proved as an inference from the acts and conduct of the parties and other facts and circumstances.³⁶ Therefore, it appears that a corporation may become liable on a preincorporation contract and the promoter released from liability if he, the corporation and *T* all agree to that effect. Williston states that it seems more to correspond with the intention of the parties to suppose that where the corporation assents to the preincorporation contract, it assents to take the place of the promoter—a change of parties to which *T* assented in advance.³⁷ A novation would then occur which would discharge the promoter as the corporation assumed the obligation. This would appear to be reasonable in a proper case where it was contemplated in advance by *T* that the corporation should succeed to the rights and liabilities arising under the contract, and the promoter should be discharged. However, where *T* does not know a corporation is to be formed which would succeed to the rights and liabilities arising under the contract made by the promoter, it is difficult to find an assent by *T* since he could hardly assent to something of which he had no knowledge. However, the discharge of the promoter and the assent to the corporation taking his place may be implied where *T* acquiesces in the transfer of the contract from the promoter to the corporation.³⁸ It should be remembered that if any of the essential prerequisites of a novation is wanting, there can be no novation.³⁹

Continuing Offer

The continuing offer theory of liability of the corporation on a preincorporation agreement is based on the proposition that the

³⁵ *Chastain v. Cooper & Reed*, 152 Tex. 322, 257 S.W.2d 422 (1953).

³⁶ *Commercial Nat'l Bank v. Poulos*, 8 S.W.2d 222 (Tex. Civ. App. 1928).

³⁷ 1 WILLISTON, *THE LAW OF CONTRACTS* § 306 (1936).

³⁸ *Bradshaw v. Jones*, 152 S.W. 695 (Tex. Civ. App. 1913) *error ref.*

³⁹ *Erwin v. White*, 54 S.W.2d 867 (Tex. Civ. App. 1932); *Scott v. Wyoming Oils*, 52 Wyo. 417, 75 P.2d 764 (1938).

proposal of one seeking to contract with a corporation through its promoter should be regarded as a continuing offer by *T* which the corporation may accept after it is organized.⁴⁰ Such a continuing offer, unless withdrawn by *T*, is deemed to be accepted by the corporation by the exercise of any right consistent with the existence of the contract.⁴¹ A similar approach employed by other courts holds that the corporation may exercise its right to contract by accepting the contract made for it and adopting it as the corporation's own; this doctrine rests upon the ground that the promoter's contract with *T* was in the nature only of a proposal or open offer, which the corporation could accept or reject after coming into existence.⁴²

It appears that this latter approach differs from the former in that the promoter's contract is treated as the offer, whereas in the former approach the offer made by *T* to the promoter, and not the promoter's contract itself, is deemed to be the continuing offer.

The relevance of this distinction would lie in the liability of the promoter. The promoter would not be liable if the continuing offer to the corporation is regarded as the proposal or offer of *T* to the proposed corporation. However, if the continuing offer is regarded as the promoter's contract with *T*, then the promoter is liable even though the corporation accepts the contract, unless there is a valid novation or other agreement that the promoter shall not be liable.

The continuing offer theory would seem to be applicable only where *T* knows that a corporation is to be formed and it is intended that the offer be to the corporation. As in the novation theory, it would be difficult to presume that *T* could intend to make a continuing offer to one of whose contemplated existence he was unaware.

CONCLUSION

The use of the term ratification is misleading because in strict legal theory there can not be ratification of an agreement by a person who was not in existence at the time the agreement to be ratified was made. However, employing the term is not harmful because it is used in a non-technical sense,⁴³ and in many courts ratification is synonymous with adoption, and no distinction is made between them. Adoption is probably the more appropriate theory of corporate liability because it is not hampered by the "relation back"

⁴⁰ Hackbarth v. Wilson Lumber Co., 36 Ida. 628, 212 Pac. 969 (1923).

⁴¹ Weatherford M.W.&N.W. Ry. v. Granger, 86 Tex. 350, 24 S.W. 795 (1894).

⁴² Mitchell v. Grass Valley Gold Mine Co., 206 Cal. 609, 275 Pac. 418 (1929); Wall v. Niagra Mining and Smelting Co., 20 Utah 474, 59 Pac. 399 (1899).

⁴³ Jones v. Smith, 87 S.W. 210 (Tex. Civ. App. 1905).

rule. However, in an adoption, the promoter remains liable. The novation theory releases the promoter from liability, but the assent of *T* is required to accomplish such a result. If the promoter wishes to avoid liability in the first instance, the continuing offer theory is the one he should seek to have applied in his case. Better still, the promoter should not accept the offer himself, but have it expressly understood that the offer is to the proposed corporation only and he is not to be liable.

As stated earlier, the agreement in the particular case is an important factor which the court considers in determining the theory to be used to decide the question of liability in the corporation and the promoter. In the final analysis, as far as the corporation is concerned, if the facts are such that the corporation should be liable in order for justice to be done, any of the theories discussed will suffice, since the end result of all the theories is approximately the same. However, liability of the promoter is not accomplished under all the theories. The ratification and adoption theories hold the promoter liable. The novation theory finds the promoter released from liability, and if the continuing offer theory is applied, the liability of the promoter is dependent upon whether he accepted the offer himself or whether the offer was accepted by the corporation only. Due to the many different fact situations which arise, it would seem to be desirable for the courts to avoid adopting any of the theories dogmatically but to utilize all to do justice among the parties.

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