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CROSSING TIME'S BOUNDARIES: A COMPARATIVE VIEW OF LEGAL RESPONSES TO THE PRE-INCORPORATION CONTRACT

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This article outlines the problems attendant on the conclusion of contracts intended to be performed by a company, though entered into by a promoter or interested party before the company's formation. Such pre-incorporation contracts, widely used as a vehicle for obliging co-contractants, are nonetheless not without difficulties, notably in cases where liability for performance or non-performance is at issue. It is the purpose of this article to take a comparative view of how these questions have been dealt with in a number of Commonwealth countries, including the United Kingdom, as well as in Europe, where the company law harmonisation initiative has attempted to create a unique rule to apply to both common law and civil law jurisdictions.

I. INTRODUCTION

One of the curiosities of law is how companies make contracts before they are incorporated and come into existence. The answer is strictly that they cannot because they are not in existence at any conceivable moment when the contract is negotiated, when it is agreed and when steps for its formal validity to be recognised by a court are taken. This is a logical consequence of the fact that capacity to contract is only accorded to persons capable of being recognised at law. In fact, as an entity recognised and created only by operation of law, the company can only contract when the law deems it to come into existence. At this time, the company receives whatever powers the law and its constitution accord to it. At first sight, however, it may seem a curious proposition that a company should need to enquire about what happens before its creation. This is, however, to underestimate the amount of activity that takes place as a result of entrepreneurial acts during a period of promotion of the company yet to be formed. These include such tasks as the location of sponsors and investors, agreeing terms for the supply of goods and services, the location of premises for business, the hiring of employees and the opening of banking and credit facilities and incidental arrangements too numerous to mention. In many cases, the formation of the company that is to be the conduit for these activities is an afterthought, coming at the end of the process by which the entrepreneur or promoter sets the business vehicle in motion. Often, this is by means of an off-the-shelf purchase of a pre-existing incorporated company, occasionally by an incorporation during the final stages of the process of promotion. Given the ready availability of formation agents and the companies they incorporate, it may be legitimately asked

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whether pre-incorporation contracts are a topic that should excite any response from practitioners or academics.

The issue, nevertheless, of how the benefit of these arrangements is to be transferred to the company is more than just a formalistic concern of the founders of the company. Where the benefit is ultimately revealed as a burden, there is an argument that the company should be protected against an arrangement that will lie to its detriment. Where the benefit inures, the promoter or entrepreneur will need to know that the company will adopt and perform the contract, thus freeing them from liability on an arrangement they have entered into while the company remains without existence. In the case of third parties, they will need to know with some certainty the identity of the parties to perform the contract and how liability will attach to themselves and to their contracting partners. These are not issues of abstract legal thought but of pragmatism. Nevertheless, the law evinces some difficulty in describing the process by which the contract transits from one state, that prior to the company's formation, to the second state, following its incorporation, and how the contract effectively alters form with the change in the parties to the contract's performance. The position in jurisprudence has been uncertain and various definitions have been advanced to describe this process, sometimes wrongly used and, more often than not, confusingly applied. In many Commonwealth countries that inherited the common law, the rule on pre-incorporation contracts has been altered, because of the inconvenience that it poses. On the other hand, the United Kingdom and Ireland have been subject to European legislation in the shape of the *First Directive*,[1] which saw light in 1968 and which was incorporated into the domestic laws of member states of the European Community (later Union) as they joined. It is the purpose of this article to look at the developments in the United Kingdom and in a number of other jurisdictions that have taken place since the emergence of that rule at common law. Furthermore, some examples will be drawn from European jurisdictions adhering to civil law, where the *First Directive* is also of application. This article will attempt to show that, in the United Kingdom at least, pre-incorporation contracts continue to pose problems for the law and yet have not, since the transposition of the *First Directive* in 1973, been deemed a subject worthy of proper reform.

II. The Position at Common Law

It is instructive to begin by looking at the position of pre-incorporation arrangements at common law. One of the first things that must be noted is that most of the standard forms of contract variation do not serve to describe the situation of pre-incorporation contracts. Agency, subrogation and ratification are apparently impossible because of the non-existence of the principal at the time the contract is made, this resulting from an elementary principle of the law of agency.[2] Adoption of the contract followed by ratification is difficult because of a lack of privity between the company and the third party, although an early case, later disavowed, did attempt to put forward the view

[1] EC, *First Council Directive* 68/151/EEC of 9 March 1968 on co-ordination of safeguards for the protection of the interests of members and others [1968] O.J.L. 65/8 [*First Directive*]. These safeguards are required by Member States of companies within the meaning of the second paragraph of Art. 58 of the EC Treaty with a view to making such safeguards equivalent throughout the European Community.

[2] *Kelner v. Baxter* (1866) LR 2 CP 174 [*Kelner*].

that enforcement would be allowed on equitable grounds.[3] This raises the question of what happens to expenses incurred by promoters before incorporation and may put them personally into a difficult position.[4] There is also an issue of whether part performance and the transfer of benefits, especially that derived from services provided before incorporation, operate so as to prevent the company, in line with another elementary principle of contract law, from electing to have the benefit and not the burden of contract. Again, a possible response is that a claim might be founded in equity, but no presumption would operate so as to imply the existence of a contract or indeed that any contract between a promoter and a third party would entitle the third party to sue the company to recover expenses.[5] The use of a constructive trust, by which the promoter is trustee for the rights of the third party, entitling the third party to sue the company, has been advanced. It has not found, however, much favour in the courts of England and Wales, given that there may be some uncertainty about the content and extent of any trust that was purported to be created.[6] In Scotland, however, the use of the *jus quaesitum tertio* could in theory provide a benefit for the company to be formed, but only if the promoter has signed as principal and the contract has expressly provided for the company to benefit.[7] One remaining possibility is that the promoters enter into a contract expressly with the third party and, following incorporation, assign this to the company. This has, however, the double disadvantage that it does not operate as a release of pre-assignment liability and any indemnity or immunity offered by the company to them does not absolve them of liability.[8]

The standard analysis of what happens, which is accepted by most commentators, is that the company in effect makes a new, or in other words novates, the contract with the third party. This view was first advanced in the case of *Natal*,[9] where an option to take a lease over land thought to be coal-bearing was exercised by the company upon test boring revealing it to be the case. Despite this, the court held that the company's acts were equivocal and insufficient to constitute the making of a new contract giving the company the option to exercise. This is because novation implies that an element of the contract has changed, not merely the identity of the would-be contracting parties. So, carrying out the contract entered into by the third party with the promoter is insufficient, although the variation of one of the terms may be so.[10] This may give rise to problems of subtlety and distinction where an

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3 See J. Gross, "Pre-Incorporation Contracts" (1971) 87 Law Q. Rev. 367 at 373, citing the case of *Spiller v. Paris Skating Rink Company* (1878) 7 Ch D 368.

4 See N. Grier, *UK Company Law* (Chichester: Wiley, 1998) at 141, who states that this would not be a problem in Scotland, where in *Park Business Interiors Ltd v. Park* (1991) SLT 818, the company had accepted expenses as consideration for the allotment of shares, it being understood that, although not automatically liable, a company could agree to accept reasonable expenses incurred in good faith.

5 See Gross, *supra* note 3 at 374-377.

6 *Ibid.* at 377-379.

7 See B. Pillans & N. Bourne, *Scottish Company Law* (London: Cavendish, 1999) at 30, citing *Cumming v. Quartzag Ltd* (1981) SLT 205. The view is taken that, as derived from MacQueen, "Promoter's Contracts, Agency and the Jus Quaesitum Tertio" (1982) SLT (News) 257, the advent of statutory reform renders this argument redundant.

8 See R. Pennington, *Company Law* (London: Butterworths, 2001) at 104.

9 *Natal Land Co & Colonization Ltd v. Pauline Colliery and Development Syndicate Ltd* [1904] AC 120 [*Natal*].

10 *Howard v. Patent Ivory Manufacturing Company* (1888) 38 Ch D 156.

argument arises as to whether or not the nature of the performance has been sufficient to indicate that variation has occurred. Furthermore, *Natal* is stated to be authority for the proposition that where a company carries out what it thinks to be performance of the contract, that act merely constitutes an offer, the third party being required to accept, else there is no new contract.[11] However, as in the case of an assignment-type situation, even if the novated agreement is deemed to come into existence, where does this leave the performance obligations or liabilities that arise from the 'first' contract? It may be particularly unfair to leave either party, whether promoter or third party, to suffer these burdens. A pragmatic response might be for promoters to buy off-the-shelf companies and make contracts in its name, thus avoiding any issue arising. Although most cases where pre-incorporation contracts are subsequently performed by the company can be analysed in terms of novation, its acceptance remains entirely dependent on the other party's goodwill. In instances of disputes, though these may be uncommon, it is unlikely that the third party will wish to have its contract analysed as a species of novation and risk losing the right to proceed against the promoter.

English law has developed in quite a distinct way to deal with the question of identity of the contracting parties. It in fact attempts to distinguish between two situations. The first is where there is evidence that the third party intends to contract with the promoter, in anticipation of the formation of the company, in which case the promoter is normally liable (in effect a deemed principal in his own right). The second is where it is the intention that the third party contracts with the company, but, the company being non-existent, any contract becomes a nullity. In *Kelner*,[12] wine merchants had offered to sell stock to promoters of a company to be formed to run a hotel. The hotel business was being carried out, the wine was delivered and used, the incorporation conducted and the would-be directors purported to ratify the purchase, albeit a few short days before incorporation. When subsequently the company failed, Kelner sued the promoters in their personal capacity and it was held that they remained personally liable. In fact, the case is authority for the proposition that any person purporting to make a contract on behalf of a company to be formed will remain liable. The logic of this case is impeccable: there being no company, there could be no contract with it, it being impossible to deem the promoters' statements to amount to an agreement to pay contingent on the formation of the company.[13] It is the rule in *Kelner*, as this doctrine is more popularly known as, that has become the mainstay of the common law in this field and which has been adopted elsewhere.[14] The second fact situation, which results in the contract being deemed not to exist, is illustrated by the case of *Newborne*,[15] where the sale of ham to the defendant

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[11] See Pennington, *supra* note 8 at 101, who also states that American jurisprudence analyses the situation more generously by holding the pre-incorporation contract to be a continuing offer capable of being accepted by the company through the performance of any act referable to that contract.

[12] *Supra* note 2.

[13] *Ibid.* per Erle C.J., who dismisses in clear terms the once-held belief that an 'inchoate liability' could be incurred on behalf of a 'proposed company,' thus adopting in company law the general rule in contract with respect to a non-existent principal.

[14] See Pillans & Bourne, *supra* note 7 at 29, citing the 1894 extension to Scotland of this doctrine in the case of *Tinnevelly Sugar Refining Company Ltd and Others v. Mirrlees, Watson and Yaryan Company Ltd* (1894) 21R 1009 (purported sale of equipment to a company subsequently found to be defective).

[15] *Newborne v. Sensolid (GB) Ltd* [1954] 1 QB 45 [*Newborne*].

fell through because the defendant refused to accept delivery. In fact, the defendant acted this way because the market had fallen, but pleaded that, when the contract was made, the company had not been incorporated and neither the company nor the promoter, who had continued the action personally, could enforce it. In this case, the court agreed because the contract was supposed to be with the company. Its non-existence went to the root of the contract and therefore there was no contract.

Kelner and *Newborne*, however, can be regarded as being decided on the evidence, the former because the defendants had signed as agents for a 'proposed' company (the offer having been made in those terms), while the latter may be distinguished because the company name appeared on the contract followed by a purported subscription by the plaintiff as authorised signatory for the company. This results in the distinction being drawn between a situation where the parties know the company is to be formed and contract accordingly (in which case the 'agent' is personally liable) and where the company is believed to exist. The result in factual terms, however, may be purely fortuitous, as the case-law amply illustrates, as well as entirely dependent on the recall of contracting parties as to whether they believed or knew the company to exist. Professor Sealy objects to the fine distinction here, stating that *Newborne* could have been decided as a case of breach of warranty of authority by an agent, although this was rejected at first instance by Mr Justice Park, as an agent can impliedly warrant the existence of a non-existent thing, thus preserving the contract.[16] A similar view is shared by one commentator, who doubts the soundness of a decision that in effect distinguished between the situation of a promoter as defendant and as plaintiff, while there is no evidence that it mattered to either party whether the contract was personally made or for the company. This results in a technical distinction between *Kelner* and *Newborne* that may be unsupportable.[17] Whatever the analysis, it is clear that the rule in *Kelne*r remained one to which there was 'widespread and common opposition'[18] and calls were made for changes. In fact, in 1962, the Jenkins Committee had recommended that companies be given the power unilaterally to adopt contracts made before incorporation, whether in their names or on their behalf. This power, being unilateral, would not be dependent on the consent of the other contracting parties being obtained.[19] An abortive *Companies Bill 1973* would have followed this recommendation in its Clause 6, but the *Bill* was lost due to political vicissitudes.

III. Statutory Reforms: The European Community Project

Coincidentally, the topic of pre-incorporation contracts had been aired during the debate over the contents of the projected company law harmonisation programme within the European Community (later Union), which had been proceeding apace since the mid-1960s. In the context of company law, the harmonisation initiative

[16] See L. Sealy, *Cases and Materials in Company Law* (London: Butterworths, 2001) at 29, where the result of the contrast between both cases is described as leading to 'fine distinctions' and arguments over form and substance, 'fortunately' settled by the *Phonogram* case, *infra* note 28.

[17] See Gross, *supra* note 3 at 383-385.

[18] *Ibid.* at 367.

[19] U.K., H.L., "Report of the Company Law Committee", Cmnd 1749 in *Sessional Papers*, Vol. 89 (1963) 105 at para. 54(a) (President: Lord Jenkins). This recommendation was the genesis of reforms that were subsequently attempted in Commonwealth countries on the model of the Ghana *Companies Bill 1961* (subsequently enacted as the *Companies Code 1963* (Act 179)): see *infra* note 58.

has concentrated on elements of the framework for company operations, including matters such as issues of share allotment and pre-emption rights, listing particulars, format of accounts and qualification of auditors as well as disclosure of information. There have been to date some nine *Company Law Directives* in these mainly technical areas, the very first of these texts, enacted in 1968, covering the topics of minimum publicity, lack of legal capacity and nullity of the company. It contained a preamble stating that 'the protection of third parties must be ensured by provisions which restrict to the greatest possible extent the grounds on which obligations entered into in the name of the company are not valid.'[20] This protection required consequent provisions in the body of the text dealing with the issues of ultra vires and pre-incorporation contracts. Accordingly, Article 7 of the *First Directive*, dealing with the position of pre-incorporation contracts, provided that: 'If, before a company being formed has acquired legal personality, action has been carried out in its name and the company does not assume the obligations arising from such action, the persons who acted shall, without limit, be jointly and severally liable therefore, unless otherwise agreed.'[21]

What is now section 36C of the *Companies Act 1985* was enacted upon accession by the United Kingdom to the European Community so that: 'a contract which purports to be made by or on behalf of a company when the company has not been formed has effect, subject to any agreement to the contrary, as one made with the person purporting to act for the company or as agent for it, and he is personally liable on the contract accordingly.'[22] The idea behind this enactment was that parties should have security of transaction and be able to avoid the consequences of any contract being declared a nullity. It is clear that, unless the third party explicitly agrees to forgo the protection, there is an enforceable contractual obligation as against the promoter.[23] Despite the benefit this clearly poses, there are said to be a number of difficulties with the way in which the draftsman has approached the problem of transposing the directive into domestic law.[24] There are, for example, some interpretative difficulties: notably whether there is a distinction between the liability regimes in the case of someone signing as an agent and where the signature is in pursuance of authority to act for the company. This is because of the wording of the final clausal limb beginning 'and.' Professor Prentice agrees with Professor Schmitthoff that it is to be read disjunctively so that the liability attaches irrespective of the capacity in which the individual contracts.[25] Nevertheless, a second interpretation problem

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20 *First Directive*, *supra* note 1, fifth preambular clause (not numbered in the original text).

21 The French version, which is the original text, differs slightly, in that it reads: "Si des actes ont été accomplis au nom d'une société en formation, avant l'acquisition par celle-ci de la personnalité morale, et si la société ne reprend pas les engagements résultant de ces actes, les personnes qui les ont accomplis en sont solidairement et indéfiniment responsables, sauf convention contraire." This importance of any distinction is canvassed in the case of *Phonogram*: see *infra* note 28.

22 Formerly *European Communities Act 1972* (U.K.), c. 68, s. 9(2), later *Companies Act 1985* (U.K.), c. 6, s. 36(4), renumbered s. 36C by the operation of the *Companies Act 1989* (U.K.), c. 40.

23 See P. Davies, *Gower and Davies' Principles of Modern Company Law* (London: Sweet and Maxwell, 2003) at 100. This was one of the points argued in the *Phonogram* case: see *infra* note 28.

24 See D. Prentice, "Section 9 of the European Communities Act" (1973) 89 Law Q. Rev. 518 at 531-533. The use of the directive form, although politically acceptable, is criticised in some instances as permitting too flexible a transposition.

25 *Ibid.* at 531.

arises as to how the agreement to release liability should be manifested in for example a *Newborne* situation, where it might be argued that signature for a corporation, but not as an agent, would implicitly betoken agreement to release that individual from liability, in other words accepting that the company, even if not existing, is the principal.[26] Even if these interpretative difficulties are put aside, it is still clear that the problems of how companies are to ratify pre-incorporation contracts and how promoters may be released following novation are not treated in the enactment, thus giving rise to the justifiable view that the changes introduced by the statutory regime are 'inadequate in that they only partially deal with the problem.'[27]

In the years following the enactment of section 9(2) of the *European Communities Act 1972*, there appeared to be a relative dearth of cases in this area. The first opportunity for consideration of the impact of the section came in *Phonogram*,[28] where the question of whether the statutory provisions had superseded the common law remedy and, it being the case, the potential overlap between them was decided. This involved a company to be formed to manage a pop group called Cheap Mean and Nasty, for which finance was obtained from a record company in the sum of £6000. The company, to be called (with perhaps a degree of prescience) Fragile Management Limited, was not formed, although the promoter signed the agreement purportedly on its behalf and the group never played. On a suit for the recovery of the amount advanced, it was held that the promoter was personally liable as he had purported to act for a non-existent company. Arguments were advanced in the case hinging on whether Article 7 of the *First Directive*, which refers in the French versions to the phrase *société en formation*, a term that has a technical meaning in civil law systems and is normally applied to the period between signature of statutes and fulfilment of the legal obligations attached to incorporation, could apply to the case. Lord Denning chose to go by the terms of the statute,[29] which he held to apply, dismissing another argument on whether 'purports' meant a representation that the company was in existence, as both parties knew quite clearly it was not. It was also in this case that Lord Denning addressed the distinctions that had built up between the lines of jurisprudence represented by *Kelner* and *Newborne*, holding that the statute had obliterated these 'fine distinctions' and that it applied irrespective of the state of knowledge of the parties. In fact, in an expressive sweep of the common law, Lord Denning held that however the promoter signed, whether as agent or purported authenticator of the company's signature, without express words of exclusion in relation to liability, the promoter remained bound. However, Lord Justice Oliver did not think that the pre-statute cases turned on such subtle distinctions, but on what the parties' real intentions were; in other words, irrespective of the conditions under which the signature was appended to the document. Although Lord Justice Oliver makes the point that the statute renders cases going before largely irrelevant, his Lordship's view is supported by academic opinion briefly summarising the differences between the common law and the statute as being one of presumption, the

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[26] *Ibid.* at 532.

[27] *Ibid.* at 553.

[28] *Phonogram Ltd v. Lane* [1981] 3 WLR 736 [*Phonogram*].

[29] A number of authors criticise this approach, viewing it as contrary to the spirit of European law not to seek to use the *Directive* or its contents as a guide for interpreting the domestic measures, for which see N. Green, "Security of Transactions after Phonogram" (1984) 47 Mal. L. Rev. 671 at 684-686.

common law not containing any, being dependent on the parties' intentions, while the statute sets up the presumption that the promoter is liable, unless express exclusion is made. For cases falling outside the statute, the common law and its remedies remain of interest.[30]

A later curiosity in jurisprudential terms is the case of *Cotronic*,[31] where a person had acted erroneously on behalf of a company that he discovered later to be non-existent, because it had been struck off. Despite the person subsequently incorporating a new company with the same name, litigation ensued, the question being whether there had indeed been a contract at the time both parties assumed the company was in existence. Although it was held that the person acting for the company was entitled to payment on a *quantum meruit* basis, there was in fact no contract capable of existing. Neither the new incorporation nor section 36C[32] could assist where the issue was of a post-dissolution contract. This case must be held to turn on its own facts and does not assist the resolution of pre-incorporation agreements. The section also does not assist where it is a question of a change of name. In *Oshkosh*,[33] the promoter bought an off-the-shelf company and changed its name, not, however, without entering into a contract to purchase goods. An action to make the promoter personally liable failed in this case as well as in *Badgerhill*,[34] where the company was in fact in existence, but had been described for the purposes of the contract by an incorrect name. An argument was also advanced and sustained that section 36C[35] was not to apply in the case of companies to be incorporated outside the United Kingdom.[36] The situation was subsequently corrected by means of a statutory instrument in 1994 extending section 36C[37] expressly to foreign companies.[38] Admittedly, in all of these cases, breach of warranty of authority could possibly be of assistance in rendering liable a person purporting to act as an agent for a company that is not subsequently formed. It is interesting that the breach of warranty formula also appears in American jurisprudence, where it is said to underlie the doctrine of promoter's liability and provide a more beneficial setting in the event claims are made.[39]

The jurisprudential landscape settled down after these decisions and reported cases declined somewhat in number. A trio of cases then appeared ending with *Braymist*,[40] which incidentally clarified the position of the rights of promoters to pursue third

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[30] See P. Davies, *supra* note 23 at 100. See also Green, *ibid.* at 676-677, who is of the view that the common law remedy remains preserved despite the advent of the statute.

[31] *Cotronic (UK) Ltd v. Dezonie* [1991] BCLC 721[*Cotronic*].

[32] *Companies Act 1989*, *supra* note 22.

[33] *Oshkosh B'Gosh Inc v. Dan Marbell Inc Ltd* [1989] BCLC 507 [*Oshkosh*].

[34] *Badgerhill Properties Ltd v. Cottrell* [1991] BCLC 805 [*Badgerhill*].

[35] *Companies Act 1989*, *supra* note 22.

[36] See Pillans & Bourne, *supra* note 7 at 31, citing *Rover International Ltd v. Cannon Film Sales Ltd* [1987] 1 WLR 1597. This case is also criticised in Davies, *supra* note 23 at 101, n. 73 and A. Griffiths, "Agents without Principals: Pre-Incorporation Contracts and Section 36C of the Companies Act 1985" (1993) 13 L.S. 241 at 250-251 on grounds that it represents a serious setback to the *First Directive's* harmonisation objectives. A previous case (in *pari materia*), *Janred Properties Ltd v. ENIT* (14 July 1983) (unreported), is outlined and criticised in Green, *supra* note 29 at 682-684.

[37] *Companies Act 1989*, *supra* note 22.

[38] Regulation 3 of the *Foreign Companies (Execution of Documents) Regulations 1994*, S.I. 1994/950.

[39] See Gross, *supra* note 3 at 381 and jurisprudence cited there.

[40] *Braymist Ltd v. Wise Finance Company Ltd* [2002] EWCA Civ 127 (20 February 2002) [*Braymist*].

parties, contrary to many of the previous cases which concerned themselves solely with the issue of liability. The first case, *HOK Incorporated*,[41] involved planning and design works for a sports arena in Hanover, Germany, for which a company would be incorporated. When the project grounded to a halt, the plaintiffs, who had expended a considerable sum in reliance on at first a letter of intent and subsequently a draft contract, issued on behalf of 'Arena Hanover AG (in formation),' claimed against the defendants in their personal capacity. Liability hinged in part on whether the term 'contract' in the statute could cover a quasi-contractual situation where parties carried out work in the expectation that a formal contract would eventually ensue. The judge, Colin Reese Q.C., held that the situation could be analysed either as an inferred contract containing an implied term as to reasonable remuneration (which would ordinarily be superseded by any subsequent formal contract) or that the letter of intent and subsequent documents could form an offer that had been accepted by the plaintiffs by performance of their services. In either event, a contract that could come within the terms of the statute had been created and, in the absence of the formation of the company, the defendants would be personally liable. In *Braymist*, solicitors made a contract as agents and on behalf of a company for the sale of land to the third party. The company was not incorporated at the time the contract was made, the land being held by an associated company. The purchasers cavilled and refused to perform, upon which the vendors claimed to forfeit the deposit and sought damages for breach of contract. At first instance, Mr Justice Etherton held that section 36C[42] conferred both liabilities and rights, entitling the vendors to pursue their claim. The judge's reasoning was that the *First Directive* did not exclude the general law relating to contract, but merely created a specific regime in the case of pre-incorporation contracts. On the basis of the mutuality principle in contract law, it would not be unfair or unworkable for either party to be able to enforce the agreement. In any event, reading section 36C[43] literally, where it states that contracts are to have effect as if made with the promoter personally, would, in his view, require recognition of the promoter's capacity to sue.

In the Court of Appeal, Lady Justice Arden was of the view that, in considering the rule in *Newborne*, the Jenkins Committee had made two recommendations, the first being that agents should be able to sue and be sued on a pre-incorporation contract and, second, that companies be able to adopt such contracts, upon which the agent's liability should cease.[44] The transposition of the *First Directive's* terms, which were a compromise between the various systems of law then in force in the European Community, into United Kingdom law was in different terms to the Jenkins Committee's recommendations. Ostensibly for third party protection, the *First Directive* does not speak of the validity of obligations entered into by agents who are effectively rendered principals in such contracts, nor does it speak of whether the agent, who has become such a principal, should be able to enforce that contract.[45] Section 36C[46] goes further than the *First Directive* and should not be read in a

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41 *Hellmuth Obata and Kassabuam Incorporated v. Geoffrey King and Gernot Frauenstein* [2000] EWHC (Technology) 64 (29 September 2000) [*HOK Incorporated*].

42 *Companies Act 1989*, *supra* note 22.

43 *Ibid.*

44 *Newborne*, *supra* note 15 at para. 47.

45 *Ibid.* at paras. 51, 54.

46 *Companies Act 1989*, *supra* note 22.

limitative fashion so as to narrow its effect to what is required by the European text, which is personal liability on the part of the agent, but should be given its natural meaning so as to leave any question of enforcement to the general law.[47] The submission that the end-clause to the section solely on the question of liability is declaratory of the intent of the whole section and does not lend support to the contention that the agent may sue was expressly rejected. The end-clause is operative, in the view of the judges, on the question of liability, but does not affect the operation of the general law.[48] The decision in *Braymist* was followed in short order by that in *Gibson*,[49] where the attempt by the defendants to discharge liability onto a subsidiary company for works performed by the claimant failed. The defendants had contended, for the purposes of defending an adjudication, that there was no contract between the named parties and also disputed the entitlement of the plaintiff to bring a claim in his personal capacity. The court accepted the argument that the plaintiff could bring a claim, whether in his personal capacity or on behalf of a company he had subsequently formed, in both of which capacities he had received moneys from the defendants. There the case law rests for the moment, but it is by no means an ideal situation, given the views reflected in the case law made by judges as to the defects in section 36C that demonstrate the need to deal with this area in short order.

IV. The Impact of the *First Directive* in Other European States

The language of the *First Directive* was limited to the issue of liability of promoters for pre-incorporation contracts. It did not necessarily alter the position with respect to whether ratification was possible and any release from liability in the event of ratification. The opportunity had been taken in Ireland, however, to deal with the first issue (and possibly the second), amendments to the *Companies Act 1963* having been made prior to the enactment of the *First Directive*. These stated that ratification by the company was possible. The effect would be that the company would be bound by the contract and derive any benefit accorded by it as if the company had been in existence at the date the contract was made.[50] Before ratification, the promoter remained liable (in the absence of express agreement to the contrary) and, although section 37 is not entirely clear on this point, the assumption must be that the company acquired liability post-ratification and that the liability is backdated accordingly.[51] However, the question of any remaining liability for the promoter, perhaps by way of conjoint liability, is not treated in the enactment of this provision, nor is the ability of the company to repudiate liability on discovery of new facts. The use of this backdating provision is also seen in the French adoption of the *First Directive*, which was translated into the *Civil Code*, where it is stated that: 'those persons who have acted on behalf of a company being formed before its incorporation are bound by obligations, arising from any acts which have been accomplished, jointly and

47 *Ibid.* at paras. 57-59.
48 *Ibid.* at paras. 59 (Arden L.J.), 74 (Latham L.J.) and 80-81 (Judge L.J.).
49 *Gibson v. Imperial Homes* [2002] EWHC 676 (QB) (27 February 2002) [*Gibson*].
50 *Companies Act 1963*, No. 33 of 1963, s. 37(1). This section is to be re-enacted by means of a new Companies Bill in which it features as clause 19.
51 *Ibid*., s. 37(2).

severally in the case of commercial companies... The company which has been lawfully incorporated may take up the agreements which were subscribed [to by those persons], these [agreements] being deemed to have been entered into [by the company] *ab initio*.'[52] The use of this deeming provision is hedged about by carefully detailed stipulations in subsidiary legislation, which basically require the company to annexe to its constitution a list of contracts and agreements to be ratified.[53]. In the absence of a mention in the annexe or indeed any proof that the company in general meeting subsequently ratified the contract, the promoter remains liable to the exclusion of the company.[54] It has been held, however, that subsequent ratification can occur by conduct.[55] This seems to be a limited exception to the otherwise strict formulaic approach of the statutory provisions. In the Netherlands, the *Civil Code* contains provisions designed to follow the text of the *First Directive*. Accordingly, promoters of a company, a term that encompasses those who subsequently go on to become managing and supervisory directors as well as shareholders, remain jointly and personally liable unless the company ratifies the engagement undertaken on its behalf. Unratified agreements are not enforceable as against the company.[56] Nevertheless, ratification may be termed an act of mismanagement where the company is unable to honour its obligations and the promoter knows or is deemed to know of this, keeping the promoter liable. In fact, a presumption is raised that ratification amounts to mismanagement if the company becomes insolvent within a year of its incorporation.[57] It seems that the adoption of the *First Directive* provisions in all the countries surveyed certainly went beyond the text. This is perhaps testimony to the fact that problems of ratification and liability are universal and it is interesting to note the similar responses of Ireland (a common law country) and France and the Netherlands (civil law jurisdictions) to these problems. The point may be made that transposition of the *First Directive* in the United Kingdom could well have included the recommendations of the Jenkins Committee as to reforms without breaching any of the usual requirements for implementation of European texts.

V. Examples of Developments in the Commonwealth

It is reported that the rigidity of the rules on pre-incorporation contracts had been mitigated in some jurisdictions at an early stage: South Africa in 1929, Kansas and Michigan in 1939, Ghana and Ireland in 1963, Israel in 1965 and Ontario in 1970.[58] In Malaysia, a provision was inserted into the *Companies Act 1965*[59] to allow for ratification using the language of the Ghanaian and Irish enactments.[60] Very little

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[52] Art. 1843 C. civ. [translation by the author].

[53] Decree no. 78-704 of 3 July 1978. (French Government)

[54] Cass. com., 3 April 1973, Rev. Soc. 1974.90.

[55] Cass. com., 28 October 1974, Rev. Soc. 1976.75.

[56] *Dutch Civil Code*, section 2:203/93(2).

[57] *Ibid.*, section 2:203/93(3).

[58] See Gross, *supra* note 3 at 367. The Ghanaian and Irish provisions are identically worded, the obvious source being the draft by Gower of the Ghana *Companies Code 1963*. It is interesting to see that many Commonwealth countries have taken up precisely this wording within their companies enactments.

[59] Act 125 (Reprint-2000).

[60] *Ibid.*, s. 35. See M. Arjunan, *Company Law in Malaysia: Cases and Commentary* (Kuala Lumpur: Malayan Law Journal, 1998) at 67-69.

case law has been decided on this provision, one of the sole examples being on the issue of ratification in the case of the purchase of an off-the-shelf company (incorporated using a name that was subsequently changed), where it was held that if the company were incorporated prior to the contract, the provision was inapplicable as the transaction could be analysed as one of simple assignment. Only in the case of a true post-transaction incorporation could the provision be invoked.[61] It is argued it may also be invoked for the benefit of a company following incorporation under a different name (to that appearing in the contract), where the company is in substance the same as the one that is mentioned in the contract.[62] The equivalent provision in Singapore[63] has been interpreted as allowing for both express and implied ratification in the case of *Cosmic*.[64] This case involved a letter by company promoters to one of their number offering him the position of Chairman of the company for life. Following incorporation, a resolution was passed in general meeting repeating, albeit in slightly different terms, the substance of the letter. A dispute then ensued when the company sought to remove the Chairman. The Privy Council held that the letter amounted to a pre-incorporation contract and that, notwithstanding the difference in terms, the resolution could be interpreted as amounting to implicit ratification of the agreement. The argument is made that conduct by any of its duly constituted corporate organs that could be interpreted as ratification will amount to such.[65] Nevertheless, ratification remains entirely a discretionary act by the company (acting through its organs or agents) and, in its absence, the promoter will continue to be liable.[66] It is not entirely certain, however, that ratification, even if complete, will operate to release the promoter from personal liability. In the absence of a term to the contrary, a reasonable argument may be made that ratification will normally be interpreted as operating a release.[67]

In Jersey, the point raised by *Braymist* is dealt with by providing that a promoter is 'personally bound on the transaction and entitled to its benefits.'[68] The ratification point is also dealt with by allowing the company to adopt any transaction either within the time allotted by the contract or at any reasonable time after incorporation, adoption being signified by any act or conduct that may be taken as signifying its intention. Adoption by the company will discharge the promoter from any liability and entitlements.[69] In Guernsey, however, a different treatment of pre-incorporation

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61 *Ahmad bin Salleh v. Rawang Hill Resorts Sdn. Bhd.* [1995] 3 MLJ 211.

62 See W. Woon, *Company Law* (Hong Kong: Sweet and Maxwell (Asia), 1999) at 99.

63 *Companies Act 1967*, Cap. 50, 1994 Rev. Ed. Sing., s. 41.

64 *Cosmic Insurance Corporation Ltd v. Khoo Chiang Poh* [1981] 1 M.L.J. 61 [*Cosmic*]. This decision is criticised in W. Woon, "A Cosmic Saga" (1983) 25 Mal. L. Rev. 399 on the grounds that unilateral variation of the terms of a contract cannot normally occur upon ratification, but that the case can be explained if the resolution is analysed as making explicit an implicit understanding (that the appointment would comply with the company constitution) operating at the time of the conclusion of the contract.

65 See Woon, *supra* note 64 at 99, n. 54.

66 *Ibid.* at 100, citing *Quah v. Probo Pacific Leasing Ltd* [1993] 1 S.L.R. 14.

67 *Ibid.* at 100.

68 *Companies Law 1991*, Cap. 13.125, art. 21(1). See the similar language in the Bahamas *Companies Act 1992,* Act No. 18 of 1992, s. 22(1).

69 *Companies Law 1991*, *ibid.*, art. 21(2). In Bahamas *Companies Act 1992*, *ibid.*, s. 22(2)-(3) uses slightly different language, deeming the company to be bound as if it were a party from the date the contract was formed, while the Jersey enactment seems to bind the company and release the promoter only from the date of adoption being signified.

contracts obtains. These contracts are deemed to be provisional only and not binding until the date on which the company is entitled to commence business.[70] In fact, if the company commences business or exercises any borrowing powers before that date, the promoter will attract criminal liability. This does not exclude other forms of liability, for example by reason of non-performance of any obligation under the transaction and damages to third parties that may be harmed.[71]

By far the most comprehensive and complex treatments in statutory form of the pre-incorporation contract are those in Australia and New Zealand. In Australia, the provisions exclude the operation of any other rule of law applicable to these contracts inasmuch as the rights and liabilities of the parties are concerned.[72] Under the provisions, a contract entered into purportedly on behalf of a company or that benefits that company may be ratified, providing the company is registered, within the time period stipulated in the contract or, failing which, a reasonable period thereafter. At that point, the company becomes bound by the contract and entitled to any benefit it confers.[73] Damages are payable by the promoter if the company is not registered or if it does not ratify that or a substitute contract, the assessment of damages being made on the basis that the contract was entered into by the company but subsequently not performed.[74] Furthermore, where the company has been registered, a court may order it to shoulder all or part of the promoter's burden and also make payments or transfer property received because of the contract.[75] Where the company does ratify the contract but subsequently fails in its performance, the promoter may also be made liable along with the company.[76] The promoter may receive a release from the third party waiving liability, but is not entitled to receive an indemnity from the company.[77]

In New Zealand, pre-incorporation contracts are defined to include contracts made by promoters in contemplation of the company being formed as well as those purporting to be made by companies prior to their formation, covering both *Kelner* and *Newborne* situations clearly.[78] Ratification may take place within a specified time period or any reasonable period, in this case after incorporation, as opposed to after contract formation as in Australia.[79] Companies may signify their ratification in any manner permitted by law and contracts become valid and enforceable as if the company had been a party at their conclusion.[80] What is interesting in New Zealand is that statutory implied terms are written into pre-incorporation contracts. There are two: first, a term that the company will be formed within the time period specified

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[70] *Companies Law 1994*, No. XXIII of 1994, art. 15(1).

[71] *Ibid.*, art. 15(2).

[72] *Corporations Act 2001* (Cth.), s. 133. The provisions also have the benefit of avoiding the rule in *Newborne*, *supra* note 15, rendered applicable in Australia by the decision in *Black v. Smallwood* (1966) 117 CLR 52.

[73] *Ibid.*, s. 131(1).

[74] *Ibid.*, s. 131(2).

[75] *Ibid.*, s. 131(3).

[76] *Ibid.*, s. 131(4).

[77] *Ibid.*, s. 132.

[78] *Companies Act 1993*, (N.Z.) 1993/105, s. 182(1). These reforms originated in the *Companies Amendment Act (No. 2) 1983* that introduced a new s.42A into the *Companies Act 1955* (then the main Act).

[79] *Ibid.*, s. 182(2).

[80] *Ibid.*, s. 182(3)-(4).

in the contract or, failing which, a reasonable time and, second, that the company will ratify the agreement, again within any time period specified or a reasonable time after its formation.[81] Damages are payable, as in Australia, on the basis of non-performance of a contract that has been ratified.[82] Where a contract is not ratified, the company may be directed to return property received under any arrangement and the court may order any other relief it thinks fit. In fact, the court is empowered to validate the contract in whole or in part to give effect to any relief it orders for a party to that contract.[83] Promoters may also be the subject of an order granting damages or relief in substitution for or together with the company.[84] Nevertheless, a promoter may also be discharged from liability, even if the company does not ratify the pre-incorporation contract, where it enters into a similar or substitute agreement.[85] The scope of these provisions is quite extensive and seems to deal with most aspects raised in the case law analysis of the problems inherent in pre-incorporation contracts.

VI. Economic and Reform Arguments

The treatment of the *First Directive* in other European states and the statutory changes in Commonwealth countries seem to indicate that pre-incorporation contracts present a particular problem that, despite the inconvenience of passing legislation, requires resolution. The Law Commission of England and Wales[86] came close to dealing with the issue in the report that was the basis for the *Contracts (Rights of Third Parties) Act 1999*.[87] Part VIII reported the outcome of consultations on the issues of designation, existence and ascertainability of third parties. In dealing with whether the existence of the third party was necessary at the time any contract was concluded, the Law Commission accepted the view that prospective beneficiaries should not be excluded merely because they were not in existence at the time arrangements are made to benefit a class of which they would later form a part, for example future employees under an agreed salary review scheme, and accordingly recommended the rule that became section 1(3) of that Act.[88] In making this recommendation, the Law Commission accepted that the reforms would potentially extend to a beneficiary in the form of a company that was not incorporated at the time of the contract, in effect a classic pre-incorporation contract situation and that, therefore, the articulation of the proposals and the rules on pre-incorporation contracts had to be considered.[89] The conclusion that the Law Commission came to, in agreement with views expressed by the New Zealand Law Commission at the time of its own reforms on the same subject matter, was that conferring a benefit to sue or enforce provisions of a contract in a situation where the company was not to become a party to the contract was not the same as the factual matrix in the usual pre-incorporation situation, where it

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81 *Ibid*., s. 183(1).

82 *Ibid*., s. 183(2).

83 *Ibid*., s. 184(1)-(2).

84 *Ibid*., s. 185.

85 *Ibid*., s. 183(3).

86 U.K., Law Commission, *Privity of Contract: Contracts for the Benefit of Third Parties* (Report No. 242) Cm 3329 (1996).

87 (U.K.) 1999, c.31.

88 *Supra* note 86 at paras. 8.5-8.8.

89 *Ibid.* at paras. 8.9-8.10.

was intended that the company become in due course a party to that agreement and obtain rights under that contract.[90] Nevertheless, the Law Commission accepted that one of the difficulties with pre-incorporation contracts, that of giving the company a right of action, could be mitigated by the reforms in contract law, but that general reform to the law on pre-incorporation contracts was more properly the subject of specialist legislation and would have to await an initiative in the company law field.[91] Accordingly, there would be no provisions in the legislation to be brought forward as a result of the report dealing with the issue.[92] Professor Sealy agrees that the impact of according rights as opposed to obligations on the as yet unformed company would in no way make the company a full party to the contract, but could be used by promoters as a device, by their agreeing for consideration that the company have the option of entering into a contract on pre-determined terms.[93]

The Company Law Review, which began in 1998, has the overall objective of simplifying the structure of United Kingdom law. It sets out to do this by promoting competitiveness, striking the proper balance between the interests of participants in corporate life so as to promote 'straightforward, cost-effective and fair' regulation, and promoting consistency, predictability and transparency in the law.[94] It has not to date dealt with the issue of pre-incorporation contracts and the matter remains without mention in the final documents of the Review produced in 2002-2003.[95] An explanation for this apparent oversight may be found in the writings of Professor Cheffins, who argues that the United Kingdom has less of a tradition of using what he terms 'permissive' or 'enabling' rules.[96] These are rules whose primary function is to allow participants in corporate life to opt into provisions authenticating transactions of 'doubtful legal validity' so as to yield, once any transaction costs are taken into account, 'significant beneficial outcomes' for them, for example by reducing the incidence of costs and the risk of litigation.[97] The example he sets out when dealing with an instance of where a permissive rule has not been introduced, although arguably it would be very welcome, is that of pre-incorporation contracts, where section 36C[98] affords what he calls a degree of protection 'open to question' and that this type of contract remains on an 'uncertain legal footing.' He points to support for this by commentators in the field as well as the examples of changes in Canada, Barbados and New Zealand as pointing the way for Parliament to enact a similar measure, something he believes would be a 'positive step.'[99] The economic benefit of such a step is lent credibility by an analysis of the impact of particular liability rules in different situations where the performance of pre-incorporation contracts is

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[90] *Ibid.* at paras. 8.11-8.13.

[91] *Ibid.* at paras. 8.14-8.15.

[92] *Ibid*. at paras. 8.16.

[93] See Sealy, *supra* note 16 at 34.

[94] DTI, Modern Company Law for a Competitive Economy: Final Report (2001) at 3, para. 1.3, online: Company Law Review <http://www.dti.gov.uk/cld/final_report/ch_1.pdf>.

[95] Except in an outline of the European instruments existing in the field where it is mentioned under the rubric of the *First Directive*, *supra* note 1.

[96] See B. Cheffins, *Company Law: Theory Structure and Operation* (Oxford: Oxford University Press, 1998) at 252.

[97] *Ibid.* at 250.

[98] *Companies Act 1989*, *supra* note 22.

[99] *Ibid.* at 252-253, citing *Business Corporations Act,* R.S.C. 1985 c. C-44, s. 14, *Companies Act 1982*, Cap. 308, s. 16 and *Companies Act 1993*, (N.Z.) 1993/105, s. 182 respectively.

being assessed.[100] Based on three criteria: whether incorporation occurs, whether the company is willing to perform and whether it is able to do so (for example, it may be disabled through insolvency), the analysis defines which of three potential liability regimes would be the most efficient: a non-enforcement rule that would prevent the third party from suing (as in *Newborne*), a personal liability rule (as in *Kelner* obliging promoters to pay) or a corporate liability rule (rejected by *Kelner*).[101] The optimal rule for contracts in which the company is incorporated and is able to perform is the corporate liability rule, irrespective of whether the company is willing to perform, the argument being that parties would self-enforce contracts where the company is willing to perform and that, where the company is not so willing, personal liability would be sub-optimal because it places an unnecessary burden on the promoter where it would be more equitable for the shareholders to do so.[102] There is the question of whether it would remain equitable for shareholders to bear this risk in the absence of specific knowledge of the contract in question, although, in France, the possible objection that shareholders do not possess the knowledge to appreciate the additional risks posed by such contracts is mitigated by the express requirement to expressly annex these to the statutes of the company. In any event, Whincop argues that those contract types, where either the company is not incorporated or it becomes disabled from performing (through insolvency), are situations where personal liability is optimal, because the information asymmetry, where the promoter possesses more information than the third party, would, unless the promoter were obliged to disclose through liability, result in the third party bearing a greater burden than justified.[103] In either event, the imposition of liability is something that market forces and the contents of contracts negotiated by parties do not necessarily achieve without there being legislation on a primary or default rule. This is one of the reasons that would militate in favour of legislative intervention in this field.

VII. Summary

The history behind the development of the doctrine relating to pre-incorporation contracts is characteristic of the story of the common law: the desire to provide a pragmatic solution to a problem confronting the judges of the day. Nonetheless, the subsequent history, which reveals confusion within the case law and a desire to adhere to precedent (even if curious and inapt to the reality of the situation), is also a feature of the unique system that is the common law. In the present state of the law, especially in the United Kingdom, it may seem foolhardy for entrepreneurs to make contracts prior to incorporation and, indeed, foolish, if the costs of incorporation are low and even off-the-shelf companies or same-day incorporations may be bought for relatively little, when compared to the value represented by the contracts that may be in dispute. What is evident from the paucity of reported cases in this field, however, is that a conclusion would tend to one of two possibilities: first, that the concept is not a problem for the entrepreneur or promoter who regularly transfer

[100] See M. Whincop, *An Economic and Jurisprudential Genealogy of Company Law* (Ashgate: Aldershot, 2001) at 59-64.
[101] *Ibid.* at 60-61.
[102] *Ibid.* at 62.
[103] *Ibid.* at 63-64.

contracts to the entities they create and then carry them out through the company or, second, that, even if it is a problem, which might only be the case in a limited number of instances, company promoters and directors behave in a pragmatic manner and engage in avoidance strategies from the outset. It is really only where either the company is not formed or one of the parties seeks to repudiate an obligation that the issue tends to arise. Whatever the final analysis, it is clear that it should be made easier for companies to have the benefit of these important arrangements and that there are sound legal and economic reasons for doing this. What is also clear is that legislative reforms are the best (and only) way of achieving this. For the United Kingdom, in particular, these reforms are very much overdue and it is regrettable that they do not seem to have been addressed as part of the Company Law Review Programme, excellent as it is in many other respects. It may be strongly argued that it is entirely open to the United Kingdom to enact reforms, on terms similar to those applying in many other Commonwealth countries, which would not infringe the obligations inherent in the United Kingdom's membership of the European Union and, in particular, the terms of the *First Directive*, and that these should be undertaken at the earliest opportunity.