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Incorporating the company

Required reading
EU: Directive (EU) 2017/1132, arts. 10, 11
D: AktG, §§ 23–41; GmbHG, §§ 1–11
UK: CA 2006, secs. 7–20
US: DGCL, §§ 101–108, 124; Model Act, § 2.04

INCORPORATION PROCEDURES AND LIABILITY FOR TRANSACTIONS

The procedures for setting up a corporation and the liability incurred by persons purporting to represent it before the incorporation process is complete are substantially similar in the United Kingdom, Germany and the United States, but do still display interesting differences. Differences arise from the types of documents that must be filed and the contents of such documents. Where, as in the United Kingdom, the composition of the board and the mode of appointing directors are determined solely by the constitutional documents, the drafting of these documents takes on more importance than in Germany, where such significant matters are determined without exception by the *Aktiengesetz*.[1] Differences also arise where one jurisdiction has mandatory prerequisites not found in the law of the other. Where, as in the European Union, strict procedures are prescribed for the constitution of a mandatory amount of minimum capital, the process of incorporation can become much more formal and time-consuming.[2] These aspects can in turn affect the court's

[1] See the discussion in Davies and Worthington (2016: mn. 3–13).
[2] The procedures for constituting capital will be discussed in Chapter 6.

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determination of fairness when incorporators enter into contracts before the body corporate has come into existence. Incorporation procedures thus exemplify the workings of corporate law models ranging from the most formalistic to the most informal, as well as how courts may react differently to problems thrown out by different statutory configurations.

The following section will present the incorporation procedures for each of our jurisdictions. Section II will discuss liability for pre-incorporation transactions.

I Incorporation procedures

A *Germany: the* Aktiengesellschaft

The formation process for the *Aktiengesellschaft* (AG) is tightly and exhaustively regulated in §§ 23–53 AktG, which provide detailed rules for checking the value of assets that the original shareholders contribute in exchange for their stock. The first step is for one or more incorporators to draft articles of incorporation (*Satzung*), which must be memorialized in the form of a notarized deed. The articles must contain the items listed in §§ 23(3)–(5), 26 AktG, which include:

- the name[3] and the domicile of the corporation;
- the object of the corporation;
- the amount of the share capital (which must be at least €50,000);
- a sub-division of the share capital into one or more class of either par value shares or shares without par value. In the case of par value shares, the *Satzung* must specify the nominal value and the number of shares of each nominal value. In the case of no-par shares, it must specify their number;
- the number of members of the *Vorstand* or the rules for determining such number;
- rules on how the company will make its official announcements;
- details of any special benefits, compensation or remuneration for incorporators, any in-kind shareholder contributions, and whether the company will acquire assets upon incorporation;
- the articles may deviate from the form provided for in the AktG only if expressly permitted by law pursuant to § 23(5) AktG.

[3] § 4 AktG; and §§ 17 *et seq.* HGB.

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Once the *Satzung* is complete and notarized, the incorporators must subscribe to all the shares in order to "establish" (*errichten*)[4] the company, at which point it gains the status of a "corporation in formation" (*Vorgesellschaft* or VorG), which is important for the liability of the incorporators. The shares are usually subscribed together with the notarization of the *Satzung* on a separate, notarized deed that includes the names of the incorporators, information on the shares, and the amount of the share capital paid in. A third, notarized deed must appoint the first supervisory board and the auditors for the first fiscal year.[5] The first supervisory board then appoints the first management board.[6]

As will be discussed in more detail in Chapter 6, an AG may issue shares with a "par" or "nominal" value (*Nennbetragsaktien*) or without such fixed value (*Stückaktien*), the latter shares each representing an equal portion of legal capital. German rules on payments for shares follow the (former) Second Company Law Directive (as of July 2017 part of Directive (EU) 2017/1132). Cash payments for shares must be at least one-quarter of their lowest issue price,[7] which would be their par value (if there is one), plus the whole share premium (if any),[8] to be put at the free disposal of management by payment to an account that the pre-company maintains with a qualified credit institution.[9] Any in-kind contributions (i.e. non-cash assets) must be for the full price, although a promise to transfer an asset to the corporation is valid payment if performed within five years.[10] The incorporators must prepare a written report on the formation process pursuant to § 32 AktG. If in-kind contributions are made or the corporation acquires assets, the report must include detailed information on the assets and their value, on the contracts related to the transfer of the assets, and on the historical costs connected with the acquisition or creation of the assets.[11] The members of the management and supervisory boards must examine and report

[4] § 29 AktG.
[5] § 30 AktG.
[6] § 30(4) AktG.
[7] §§ 9(1), 36a(1) AktG.
[8] § 36a(1) AktG.
[9] See § 54(3) AktG and Cahn and von Spannenberg in Spindler and Stilz (2015: § 54 mn. 68 *et seq.*).
[10] § 36a(2) AktG. The nature of contributions will be addressed in detail in Chapter 6.
[11] § 32(2) AktG.

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on the formation process.[12] If shares are allotted against an in-kind contribution,[13] a board member is also an incorporator, or an indirect subscriber receives a material benefit from the incorporation, an independent auditor must audit the formation process.[14] This will be discussed in more detail in Chapter 6.

Once all contributions have been made, the incorporators must apply to the court to have the AG registered in the commercial register (*Handelsregister*).[15] The application must be made by all the incorporators and all members of the management and supervisory boards.[16] The court will review the *Satzung* to ascertain that it contains all elements required by law and does not conflict with mandatory provisions of law, and check any report on in-kind contributions for plausibility.[17] If the court accepts the application for registration, it will enter the company's name, registered office, object, capital and managing directors in the commercial register,[18] and publish the registration in the online information system designated by the state justice administration.[19] Upon registration, the company acquires legal existence.[20]

B United Kingdom: the public limited company

The formation process for a public limited company (plc) is more flexible than for an AG. However, it follows the same basic steps of drafting constitutional documents and filing them with an official register, and continues to apply the EU requirements regarding in-kind contributions. The 2006 Act changed the traditional practice of requiring two separate documents – a "memorandum of association" and "articles of association" – for incorporating a company,[21] by reducing the "constitution"

[12] § 33(1) AktG.
[13] No audit is required if one of the exemptions of § 33a AktG, implementing art. 11 of the Second Directive, applies.
[14] § 33(2) AktG.
[15] § 36 AktG.
[16] § 36 AktG.
[17] § 38 AktG.
[18] § 39 AktG.
[19] § 10(1) HGB.
[20] § 41(1) AktG.
[21] This practice was likely an historical product of the royally chartered companies, for which the unchanging charter was supplemented by a more flexible "byelaws." See Davies (2003: 57).

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to the articles and any supplementing resolutions.[22] Although the 2006 Act does continue to refer separately to both "articles" and "memorandum," the latter is a bare undertaking, signed by each subscriber of the company's shares, that they:

- wish to form a company under the Companies Act, and
- agree to become members of the company and, in the case of a company that is to have a share capital, to take at least one share each.[23]

In connection with this transformation of the memorandum into a declaration of intent to incorporate, the 2006 Act converts the more "constitutive" memorandum provisions (such as the name, object and capital) of preexisting companies into provisions of the articles.[24] The 2006 Act also removes the requirement of a mandatory corporate object. Directive (EU) 2017/1132 requires the "statutes or the instrument of incorporation" to state "the objects of the company,"[25] but the UK government, in transposing the directive, interpreted this to mean that a company must state its objects if it has any, "but not as requiring the company to have objects."[26] As a result, the requirement that the memorandum specify an "object" or "purpose" for a company has been dropped. The Act now provides that "[u]nless a company's articles specifically restrict the objects of the company, its objects are unrestricted."[27] Because the memorandum now contains almost no information about the company, it must now be accompanied, in the filing with the companies registry, by an application for registration, which – pursuant to sections 9, 10, 12 and 13 of the Companies Act 2006 – contains:

- the company's proposed name;
- the sub-jurisdiction within the United Kingdom in which it is to be registered (i.e. England, Wales, Scotland or Northern Ireland);
- the company's intended, registered address;

[22] Sec. 17 CA 2006. Also see Davies and Worthington (2016: mn. 3–16).
[23] Sec. 8 CA 2006. This minimal content will eliminate the need to amend the memorandum at a later date, and thus, unlike its predecessor (see secs. 4(1) and 378(1) CA 1985), the 2006 Act makes no provision for such amendment.
[24] Sec. 28 CA 2006.
[25] Art. 3(b) Directive (EU) 2017/1132.
[26] Davies and Worthington (2016: mn. 7–29 footnote 89). As Davies and Worthington point out, removing the objects clause is a more radical way of eliminating the old and troublesome doctrine of *ultra vires*, a goal that clearly conforms to EU law. See art. 9 First Company Law Directive.
[27] Sec. 31(1) CA 2006.

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- whether the liability of members is to be limited, and, if so, by shares or by guarantee;
- whether the company is to be private or public;
- a statement of share capital and initial shareholdings;
- a statement containing the name of its proposed officers;
- a copy of its articles, unless it intends to use the default articles;[28] and
- a statement of compliance.

As mentioned, the articles of a UK company are extremely important: they supplement the Companies Act by providing rules governing the internal affairs of the company. Incorporators may either draft articles or use the "default"[29] set of model articles issued by the Secretary of State,[30] which were drafted by BERR (now BEIS). Model articles for both private and public companies under the Companies Act 1985 were appended to that Act as Table A,[31] and BERR issued a new set of articles for the 2006 Act.[32] The incorporators must register the articles with the Companies Registry and indicate whether the model articles will be excluded in whole or in part; the model articles will apply to the extent that they are not excluded.[33]

The procedure followed at the companies registry is, for public companies, divided into two steps. First, if the filed memorandum and the other necessary information and documents meet the requirements of law, the registrar will issue a "certificate of incorporation," which constitutes "conclusive evidence" that the requirements of the Companies Act on registration have been met and the company is "duly registered" under that Act.[34] The effect of this registration is that the company becomes a "body corporate," "capable of exercising all the functions of an incorporated company."[35] This is subject to an additional certificate as to the amount of share capital.[36] The second step is

[28] The default articles prepared by BERR can be found in SI 2008 No. 3229.
[29] The word" default" in this context has a meaning completely different than in the debtor/creditor context. Here, it means provisions that apply unless the parties contract otherwise. The term is used frequently in discussing Anglo-American law because often large parts of the law may be overridden by contract and thus are mere "default" provisions.
[30] Sec. 19 CA 2006.
[31] SI 1985 No. 8 05.
[32] SI 2008 No. 3229.
[33] Sec. 20(1) CA 2006.
[34] Sec. 15 CA 2006.
[35] Sec. 16 CA 2006.
[36] Sec. 10 CA 2006.

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then to comply with requirements similar to those under German law regarding proof of paid-in capital before it may commence trading.[37] The relevant provisions of EU law[38] as were implemented in the United Kingdom require that the nominal share capital be at least the "authorised minimum" of £50,000,[39] and that the allotted shares are paid up in cash[40] at least to one-quarter of their nominal value.[41] The detailed rules on how such payments must be made, particularly with regard to in-kind contributions, are discussed in Chapter 6. The filing with the registrar must also specify at least an estimated amount of the company's preliminary expenses, any benefit paid or intended to be paid to any promoter of the company, and the consideration for the payment or benefit.[42] If the Registry is satisfied, it will issue a "trading certificate," which is "conclusive evidence" that the company is entitled to do business and exercise any borrowing powers.[43] Directors are jointly and severally liable to indemnify other parties for damages from transactions entered into before such certificate is issued.[44]

C *United States: the stock corporation*

As we have seen in earlier chapters, US corporate law is state law. Although the laws of the states differ, no US state requires formalities for incorporation that in any way approach those of Germany. Like all other states, the law of Delaware requires the filing of a certificate of incorporation with a state office (referred to as the "secretary of state") in order to establish a stock corporation.[45] This certificate need not be notarized and must contain only the names and addresses of the incorporators, the company's name and address, the corporate purpose (it is

[37] Sec. 761(1) CA 2006.
[38] The requirements originate in the Second Company Law Directive.
[39] Secs. 762(1), 763(1) CA 2006.
[40] Secs. 584, 583 CA 2006.
[41] Sec. 586(1) CA 2006.
[42] Sec. 762(1) CA 2006.
[43] Sec. 761(4) CA 2006.
[44] Sec. 767 CA 2006. It should be noted that this provision gives the directors twenty-one days to correct the situation, presumably by obtaining the certificate, before the liability is triggered. Liability for transactions entered into before incorporation or when incorporation is defective or null is discussed in Sections III and IV.
[45] § 103(a)(1) DGCL.

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sufficient to declare the corporate purpose as "to engage in any lawful act or activity"), the classes of stock authorized, including the number of shares and their par value or a statement that they are no par, as well as the rights of each class, and, if the powers of the incorporators are to terminate upon incorporation, the names and addresses of the initial directors.[46]

There are few *mandatory* requirements for the certificate. However, because most of the Delaware statute can be overridden by the certificate, the certificate *can* regulate almost every aspect of the company – from making shareholders liable without limit for debts and giving bondholders voting rights to taking away the board's powers and placing them in a shareholder council.[47] Procedural rules and powers of a subsidiary nature will then be expressed in by-laws that need be neither filed nor publicly disclosed. The required threshold for US incorporation is thus extremely low, but the work to be done to ensure the desired governance and financial structures for the company can be significant. Although lawyers and other advisors would be able to provide standard certificates and by-laws that companies can quickly adapt to their needs, the state does not get involved in this process, unlike the process employed in the United Kingdom.

The incorporators or initial directors (if named) must sign the certificate, file it with the secretary of state and pay all incorporation taxes.[48] Although the secretary will review the document for obvious errors, there is no substantive analysis of the document required or permitted by law. The corporation comes into existence at the moment that the certificate is duly filed with the secretary.[49] If, despite a good faith effort by the incorporators, the company does not legally come into existence because a formal requirement has not been fulfilled, some US states apply a doctrine of *de facto* corporation to limit the liability of incorporators. This is discussed in more detail in Section III of this chapter.

[46] § 102(a) DGCL.

[47] See e.g. § 102(b)(6) (permitting unlimited liability for shareholders), § 221 (permitting debt instruments to be treated functionally like shares) and § 141(a) DGCL (permitting the board's management authority to be transferred to other persons). Much of the internal affairs of the company will be regulated not by the certificate of incorporation, but through the "by-laws." See § 109 DGCL.

[48] § 103(c) DGCL.

[49] § 106 DGCL.

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II Liability of promoters before incorporation is complete

A Germany

As discussed, once a *Satzung* is complete and notarized and the incorporators have subscribed for all the shares, the corporation is considered "established" (*errichtet*), although it does not yet have legal personality.[50] The law expressly provides that the persons acting in the name of a stock corporation before its entry in the commercial register are liable for all obligations, and, if more than one person acts, then they are jointly liable.[51] This follows clearly from the imperative of article 7(2) of Directive (EU) 2017/1132.[52] Before the company is "established", it is considered a "pre-incorporation company" (*Vorgründungsgesellschaft*), which for dealings with third parties is understood to have the characteristics of a general partnership, with joint liability of the persons acting in concert, as provided in the statute. German (Civil Law!) judges have filled this gap between the laws on partnership and corporations by creating a more detailed set of rules for the corporate limbo between *Errichtung* and registration, and calling the result a "pre-company" (*Vorgesellschaft* or VorG). Courts have applied the VorG doctrine not only to the *Aktiengesellschaft*, but also to the GmbH. In fact, the leading decisions on the VorG arose from cases regarding similar problems in GmbHs, and courts then extended the doctrine by analogy to the AG. Such activity should make the comparative lawyer wary of characterizing the Civil Law court as a place of robotic application of codified rules.

The decisions of the High Federal Court make it clear that promoters may deal on behalf of the company before its entry in the commercial register, and that, when it is registered, the obligations that the promoters incur on the company's behalf within their delegated authority will automatically become obligations of the company, along with the assets of the *Vorgesellschaft*.[53] The underlying notion that the *Vorgesellschaft* and the company are identical associations, albeit in different stages of development, can be understood as a consequence of the statutory requirements that even prior to its registration the company

[50] § 29 AktG.
[51] § 41(1) AktG.
[52] "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 therefor, unless otherwise agreed." art. 7(2) Directive (EU) 2017/1132.
[53] BGHZ 80, 129, 140.

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(in formation) must have a management and a supervisory board as well as its own account to which contributions can be paid. Thus, before the company is registered, promoters and "active" shareholders are jointly and severally liable for obligations incurred in the name of the company in formation, but, once the company is registered, this liability ends and the company assumes all such obligations. "Active" shareholders in this context are understood to be those who have instructed the promoters or other agents to enter into transactions on behalf of the company.[54] Shareholders who merely contribute capital, but remain passive with respect to company activities, do not share this liability.

If, when the company is registered, its initial capital is insufficient to cover the debts of the VorG (i.e. the sum of liabilities plus equity exceeds assets), the promoters and active shareholders will be jointly liable to pay the shortfall.[55] Thus, no direct action for liability exists against these natural persons. It is necessary for creditors to act first against the company, and the existence of a shortfall will trigger the contribution liability of its promoters and active shareholders. Shareholders are liable to cover this shortfall in proportion to their shareholding, not severally for the whole amount.[56] However, the persons found liable will have an obligation to cover – again on a *pro rata* basis – amounts that others in the group of liable persons fail to pay. Unlike the situation of pre-incorporation liability, the absence of a specific instruction from shareholders to directors is not a relevant criterion for triggering post-incorporation liability. It is sufficient in this context that a shareholder has given his general consent to commence business operations prior to registration. Thus, even a passive investor can be caught by this liability.

B United Kingdom

Pursuant to Common Law, a company has no legal existence before it is incorporated. It is incapable of entering into a contract itself and equally incapable of acting through an agent.[57] As the case of *Kelner* v. *Baxter* in this chapter explains, it is impossible for a person to pretend to act as an

[54] The majority position is that an "active" shareholder who incurs liability for such transactions is one who exercises active influence on the decision to enter into the transaction (see BGHZ 47, 25, 27; BGHZ 65, 378, 380 *et seq.*).
[55] BGHZ 105, 300, 303.
[56] BGHZ 80, 129, 141.
[57] Pennington (2001: 100).

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agent for a principal that does not exist. A similar logic applies to attempted ratification. The Companies Act, like German law, follows article 7 of the Directive (EU) 2017/1132. The UK provision[58] implementing the relevant article of that Directive is discussed in the *Phonogram* decision, reprinted in part in this chapter.

Moreover, there would be no reason for the contract to become binding on the company if the company is subsequently established, and the company may not "ratify" a contract purported to be made on its behalf before it was incorporated,[59] although it would be free expressly to assume the contract like any other obligation. The latter could be a fresh contract that either inserts the company as an additional obligor or a "novation" that replaces the promoter with the company as sole obligor, in which case the company alone would acquire the rights and duties of the promoter on the contract.[60] Thus pre-incorporation contracts are binding on the persons concluding them. This includes not only the promoters, but also their counterparties; the agreement is effective in this manner even if all the persons who negotiate the contract are aware that the company has not yet been incorporated. The persons who purport to represent the company can enforce the contract against the other party by suing for damages or specific performance.

C United States

The corporate statutes of the US states continue the Common Law position that a corporation does not exist before it is incorporated. Corporate existence arises upon due filing of the certificate of incorporation with the appropriate secretary of state.[61] Pursuant to general principles of agency law in the United States, if a person purports to conclude an agreement acting as agent for a non-existent principal, she herself is bound by the agreement.[62] As a result, a third party who enters into a contract with a promoter when the company is in formation creates one of four situations:

[58] Sec. 51(1) CA 2006, and, in the 1985 Act, sec. 36C.
[59] *Natal Land and Colonization Company Ltd* v. *Pauline Colliery and Development Syndicate Ltd* [1904] AC 120, 126.
[60] Pennington (2001: 101).
[61] § 106 DGCL; and § 2.03(a) Revised Model Business Corporation Act.
[62] Restatement of Agency 2d, § 326.

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- a revocable offer to the non-existent corporation, which the latter can accept when formed;
- an irrevocable offer, which the corporation can accept (within a limited time) when formed;
- an agreement with the promoter, whose duties the corporation may assume when formed; or
- an agreement with the promoter, who will remain liable even if the corporation assumes the obligations from the agreement.[63]

The intentions of the parties will determine which of these options are applied to a contract between a promoter and the third party.[64] For example, if the contract calls for performance even before the company is established, this would tend to indicate a contract with the promoter. If the intention of the parties cannot be clearly determined, courts will usually hold that the promoter must perform the contract. Thus, a contract solely with the promoter is the default position unless the parties prove otherwise. If the corporation begins to perform the contract after formation, this could lead to a novation, depending on the circumstances. The *Jacobson* decision, reprinted in part in this chapter, discusses the kinds of facts that might lead to the state of affairs referred to in the third and fourth bullet points of the previous list.

III Liability of shareholders when attempt at incorporation is defective

A Germany

To cater for the unlikely event that a *Satzung* has been drafted and the company has been registered but the company is neither validly incorporated nor merits a declaration of nullity, German scholars and courts have developed the doctrine of "defective corporation" (*fehlerhafte Gesellschaft*). This area, like that of the VorG, is governed by decisions primarily concerning entities other than the AG; the court has issued decisions primarily regarding commercial partnerships (OHGs) and silent partnerships (*stille Gesellschaften*). In comparison to the United States and United Kingdom, the court which registers an AG focuses on the *Satzung* to a somewhat

[63] Restatement of Agency 2d, § 326, Comment (b).
[64] See e.g. *Company Stores Development Corp.* v. *Pottery Warehouse, Inc.*, 733 SW 2d 886 (Thenn. App. 1987).

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greater degree, making it unlikely that a defective stock corporation can arise if there is no cause for a declaration of nullity.

Under the "defective corporation" doctrine, it would be necessary that a *Satzung* in fact be drafted and that there be dealings with third parties on behalf of the company. The primary thrust of the doctrine is that the company may not be wound up from its point of establishment (*ex tunc*), but only from the moment that the defect is proven (*ex nunc*), which creates significant stability for the contractual rights and obligations of both third parties and shareholders incurred during the life of the company.[65] This doctrine does not alter the statutory rule enacted to implement the liability requirement of Directive (EU) 2017/1132, as discussed.

B United Kingdom

For the same reasons mentioned in regard to Germany, the chance of a defective incorporation (one that factually occurs but legally is invalid) is slight in the United Kingdom. If the company has not been formed, pre-incorporation liability would apply, and, if the company has been formed, it will rarely be open to challenge. Pursuant to the Companies Act 2006, the companies registrar, who acts in a quasi-judicial capacity, must examine the incorporation documents filed and register the company only after becoming "satisfied that the requirements of [the Companies Act] as to registration are complied with."[66] As a result, the certificate of incorporation that the registrar issues is "conclusive evidence that the requirements" of the Act have been met.[67] As such, an allegation of a "defective" incorporation cannot stand against the "conclusive evidence" of the certificate. There are, however, cases where assertions of nullity may arise, as discussed in Section IV.

C United States

US law is obviously not subject to article 7 of Directive (EU) 2017/1132, and it also has a less rigorous registration process. However, like the policy evidenced in the German doctrines of the VorG and defective corporations, US courts are very interested in creating an environment of

[65] BGHZ 55, 5, 8.
[66] Sec. 14 CA 2006.
[67] Sec. 15(4) CA 1985.

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trust and fairness for the conduct of business. Under US principles of agency law, if persons hold themselves out to be directors or officers of a corporation while entering into a transaction with a third party, and the corporation turns out not to have been properly incorporated or is later incorporated and then goes bankrupt without making payment on the contract, the third party may look to the individuals associated with the defective entity for performance. These persons have two defenses at their disposal: (1) although a *de jure* corporation did not arise, there was a *de facto* corporation that should be understood to have adopted the contract for performance; and (2) the third party should be estopped from asserting a claim against the promoter because she intended to contract with the corporation and the liability of the individual promoter, director or shareholder would be an element for which she did not bargain and thus she should not be able to recover from them.

The idea behind the status of the *de facto* corporation is that trust in the market should not suffer because of the imperfect fulfillment of technicalities or because of formal errors in the incorporation process, and normal business dealings should not be burdened with the high costs of investigating the valid corporate existence of every contractual counterparty. Delaware recognizes *de facto* corporations, while the Model Act does not. The prerequisites for achieving the status of a *de facto* corporation are discussed in *North Delaware A-OK Campground*, reprinted in part in this chapter. Note how the court has recourse to legal scholarship in reaching its decision. The use of authoritative scholarship is supposed to be a trait of Civil Law courts, but not of courts in Common Law jurisdictions. Why does the Delaware court turn to legal treatises? What sort of issue are they addressing? The *Timberline Equipment Company* decision, also in this chapter, presents the position under the Model Act, which has statutorily eliminated the theory of *de facto* incorporation. How do the laws and the approaches to the law differ in these two cases? Under Delaware law, *de facto* incorporation is available when there is a good faith effort to incorporate, and, under the Model Act, a "knowing" failure to incorporate disallows a finding of incorporation. Do these two sets of law differ in substance?

The defense of estoppel presents a completely different theory. It rests neither on the presence of good faith nor on the nature of the error in the incorporation process, but on the parties' expectations when contracting. If the third party knew and accepted the corporation as his counterparty, why should he be given the un-bargained-for advantage of holding

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the promoter, director or shareholder liable for performance?[68] This doctrine is discussed in the *Timberline* decision.

IV Declaring a corporation null and void

In many jurisdictions, a material and incurable error in obtaining a formal deed, permission or other act will render the content of the formal act null and void *ab initio*. This can also apply to corporations, which would entail substantial disruption of commercial dealings, as all rights and obligations of third parties and shareholders *vis-à-vis* the corporation would cease to exist. Directive (EU) 2017/1132 seeks to contain such risks by restricting judicial declarations of nullity to an exclusive set of grounds:

- the failure to execute a constitutive document or comply with legal formalities;
- a company's objects are unlawful or contrary to public policy;
- the constitutive document omits the name of the company, the amount of the capital subscriptions, the total capital subscribed or the objects of the company; or
- the failure to comply with minimum capital requirements.[69]

Because, as mentioned, a declaration of nullity of the company *ex tunc* would also nullify the rights and obligations received and incurred by a company since it came into existence, thereby creating possible hardships for shareholders and third parties, the Directive subjects the company to orderly insolvency proceedings in the event it is declared null. Thus, nullity entails the winding up of the company (i.e. orderly dissolution) with preservation of commitments entered into by or with the company, and the holders of shares in the capital remain obliged to pay up any outstanding capital subscribed.[70] This relatively obscure provision on nullity became standard reading for every student of EU law through the ECJ's *Marleasing* decision, reprinted in part in this chapter. In *Marleasing*, the Court explained that a national court must interpret national law so as to give effect to the provisions of an EU directive (here,

[68] On this point, see Gevurtz (2000: 63).
[69] Art. 11(b) Directive (EU) 2017/1132.
[70] Art. 12(5) Directive (EU) 2017/1132.

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the exclusive list of grounds for nullity of Directive (EU) 2017/1132, thus declaring that EU law has "direct" application in the member states.[71]

A Germany

Germany has implemented the (former) First Company Law Directive in the *Aktiengesetz*. An exclusive list of the grounds for nullity are provided,[72] a declaration of nullity can only be sought through the courts, and only within three years after the registration of the company.[73] The effect of such a declaration is forward-looking, not retroactive.[74] German law also provides a company with an opportunity to cure the offending defect before declaring it null.[75]

B United Kingdom

Directive (EU) 2017/1132 states that "Member States may not provide for the nullity of companies otherwise than" for those grounds it lists.[76] Given this wording, it appears that UK law does not violate the Directive by failing to provide for nullity at all in the Companies Act. However, one scholar, R. R. Drury, has pointed out that UK courts will in fact declare companies null and void if they are either formed to pursue an object that is illegal or pursue the activity of a trade union (which may not be organized in corporate form).[77] As Drury points out, there is no provision for a preservation of previous transactions or an orderly winding up of the company as required by EU law. The registrar's examination of the memorandum, the conclusiveness of the certificate of incorporation, and the politically sensitive matter of declaring a labor union null and void have probably led to the fact that no UK case has appeared on this question before the ECJ.

[71] See Case C-106/89, *Marleasing SA* v. *La Comercial Internacional de Alimentacion SA* [1990] ECR I-4135, paras. 7–12.
[72] § 275(1) AktG.
[73] § 275(3) AktG.
[74] § 277 AktG.
[75] § 276 AktG.
[76] Art. 11(1) Directive (EU) 2017/1132.
[77] Drury (1985: 649 *et seq.*); Davies and Worthington (2016: mn. 4–35 – 4–37).

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C *United States*

Pursuant to Delaware law, the Delaware Court of Chancery has broad jurisdiction to take action having the same impact as a declaration of nullity. It may "revoke or forfeit the charter of any corporation for abuse, misuse or nonuse of its corporate powers, privileges or franchises."[78] The Model Act gives similar power to the secretary of state in circumstances where the corporation fails to comply with its obligations under the Model Act.[79] In a situation comparable to the UK case of a labor union illegally being formed as a corporation, the Delaware court has revoked the charter of a non-profit corporation whose activities in fact contradicted its declared status as non-profit.[80] Delaware courts may also "administer and wind up the affairs of any corporation whose charter shall be revoked or forfeited."[81] Since a corporation may only be established for "any lawful business,"[82] the Delaware Court of Chancery has also used its power to revoke the charter of a corporation engaged in a sustained course of fraud, immorality or violation of statutory law.[83]

QUESTIONS FOR DISCUSSION

A and B want to sell used cars. In February, they agree to establish a GmbH with a share capital of €25,000, which they each are to subscribe 50 percent. The articles of incorporation are notarized in April. Pursuant to these articles, A is appointed as the managing director of "A and B Used Cars GmbH." In April, A and B pay €6,250 each into an account set up for the company. On 25 April, A files for registration of the company. Registration procedures usually take several months, and the company is registered on 31 August. A and B are eager to get "their" business started immediately. They agree that A will commence business activities prior to the registration of the company.

In May, A, acting as director of "A and B Used Cars GmbH i.G." (i.e. "in formation"), purchases a piece of land for the company's car lot from S for €200,000. In June, A buys a used Mercedes from G for €25,000.

1. In September, S wants to know who is liable for payment of the purchase price for the real estate.
2. In June, G asks you from whom he may demand payment of the €25,000 for the Mercedes.

[78] § 284(a) DGCL.
[79] § 14.20 Model Act.
[80] *Southerland, ex rel. Snider* v. *Decimo Club, Inc.,* 142 A 786 (Del. Ch. 1928).
[81] § 284(b) DGCL.
[82] § 101(b) DGCL.
[83] *Young* v. *National Association for Advancement of White People,* 109 A 2d 29 (Del. Ch. 1954).

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Cases

MARLEASING SA V. LA COMERCIAL INTERNACIONAL DE ALIMENTACION SA

European Union, Court of Justice
[1990] ECR I-04135
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[*Text edited*]
[*Text omitted*]

Grounds

1. By order of 13 March 1989 . . . the Juzgado de Primera Instancia e Instruccion No 1, Oviedo, referred a question to the Court pursuant to Article 177 of the EEC Treaty for a preliminary ruling on the interpretation of Article 11 of Council Directive 68/151/EEC of 9 March 1968 on coordination of safeguards which, for the protection of the interests of members and others, are required by Member States of companies within the meaning of the second paragraph of Article 58 of the Treaty, with a view to making such safeguards equivalent throughout the Community.

2. Those questions arose in a dispute between Marleasing SA, the plaintiff in the main proceedings, and a number of defendants including La Comercial Internacional de Alimentacion SA (hereinafter referred to as 'La Comercial'). The latter was established in the form of a public limited company by three persons, including Barviesa SA, which contributed its own assets.

3. It is apparent from the grounds set out in the order for reference that Marleasing's primary claim, based on Articles 1261 and 1275 of the Spanish Civil Code, according to which contracts without cause or whose cause is unlawful have no legal effect, is for a declaration that the founders' contract establishing La Comercial is void on the ground that the establishment of the company lacked cause, was a sham transaction and was carried out in order to defraud the creditors of Barviesa SA, a co-founder of the defendant company. La Comercial contended that the action should be dismissed in its entirety on the ground, in particular, that Article 11 of Directive 2009/101/EC, which lists exhaustively the cases in which the nullity of a company may be ordered, does not include lack of cause amongst them.

4. The national court observed that in accordance with Article 395 of the Act concerning the Conditions of Accession of Spain and the Portuguese Republic to the European Communities (Official Journal 1985 L 302, p. 23), the Kingdom of Spain was under an obligation to bring the directive into effect as from the date

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(*CONT.*)

of accession, but that that had still not been done at the date of the order for reference. Taking the view, therefore, that the dispute raised a problem concerning the interpretation of Community law, the national court referred the following question to the Court:

> 'Is Article 11 of Council Directive 68/151/EEC of 9 March 1968, which has not been implemented in national law, directly applicable so as to preclude a declaration of nullity of a public limited company on a ground other than those set out in the said article?'

[*Text omitted*]

6. With regard to the question whether an individual may rely on the directive against a national law, it should be observed that, as the Court has consistently held, a directive may not of itself impose obligations on an individual and, consequently, a provision of a directive may not be relied upon as such against such a person . . .

7. However, it is apparent from the documents before the Court that the national court seeks in substance to ascertain whether a national court hearing a case which falls within the scope of Directive 68/151 is required to interpret its national law in the light of the wording and the purpose of that directive in order to preclude a declaration of nullity of a public limited company on a ground other than those listed in Article 11 of the directive.

8. In order to reply to that question, it should be observed that . . . the Member States' obligation arising from a directive to achieve the result envisaged by the directive and their duty under Article 5 of the Treaty to take all appropriate measures, whether general or particular, to ensure the fulfilment of that obligation, is binding on all the authorities of Member States including, for matters within their jurisdiction, the courts. It follows that, in applying national law, whether the provisions in question were adopted before or after the directive, the national court called upon to interpret it is required to do so, as far as possible, in the light of the wording and the purpose of the directive in order to achieve the result pursued by the latter and thereby comply with the third paragraph of Article 189 of the Treaty.

9. It follows that the requirement that national law must be interpreted in conformity with Article 11 of Directive 68/151 precludes the interpretation of provisions of national law relating to public limited companies in such a manner that the nullity of a public limited company may be ordered on grounds other than those exhaustively listed in Article 11 of the directive in question.

10. With regard to the interpretation to be given to Article 11 of the directive, in particular Article 11(2)(b), it should be observed that that provision prohibits the laws of the Member States from providing for a judicial declaration of nullity on grounds other than those exhaustively listed in the directive, amongst which is the ground that the objects of the company are unlawful or contrary to public policy.

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(*CONT.*)

11. According to the Commission, the expression 'objects of the company' must be interpreted as referring exclusively to the objects of the company as described in the instrument of incorporation or the articles of association. It follows, in the Commission' s view, that a declaration of nullity of a company cannot be made on the basis of the activity actually pursued by it, for instance defrauding the founders' creditors.

12. That argument must be upheld. As is clear from the preamble to Directive 68/151, its purpose was to limit the cases in which nullity can arise and the retroactive effect of a declaration of nullity in order to ensure 'certainty in the law as regards relations between the company and third parties, and also between members' (sixth recital). Furthermore, 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'. It follows, therefore, that each ground of nullity provided for in Article 11 of the directive must be interpreted strictly. In those circumstances the words 'objects of the company' must be understood as referring to the objects of the company as described in the instrument of incorporation or the articles of association.

13. The answer to the question submitted must therefore be that a national court hearing a case which falls within the scope of Directive 68/151 is required to interpret its national law in the light of the wording and the purpose of that directive in order to preclude a declaration of nullity of a public limited company on a ground other than those listed in Article 11 of the directive.

[*Text omitted*]

KELLY A. CLEARY V. NORTH DELAWARE A-OK CAMPGROUND, INC., ET AL.

Superior Court of Delaware
CA No. 85C-OC-70, 1987 Del. Super. LEXIS 1374
[*Text edited; footnotes omitted*]

VINCENT A. BIFFERATO, Judge

. . . Plaintiff Kelly A. Cleary claims she was injured when the saddle of a horse she was riding at Double J Riding Stables in Bear, Delaware, came loose. She was a paying customer at the riding stable, and believes she was injured because of negligence.

Ms. Cleary sued North Delaware A-OK Campground, Inc. ("A-OK"); Cedrick D. Justis, Chairman of the Board of A-OK and landlord of the property on which

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(CONT.)

Double J Riding Stables is located; and Thomas and Betty Hutchens, as owners and operators of Double J Riding Stables, or as agents or joint venturers of A-OK and Mr. Justis.

Defendants respond by saying Ms. Cleary has sued the wrong parties. The Hutchens claim to have never done business as Double J Riding Stables. Rather, a separate corporation, "Double Jay, Inc." does business as Double J Riding Stables.

Betty Hutchens is the wife of Dewey G. Hutchens (50 percent shareholder of Double Jay, Inc.) and mother of Thomas D. Hutchens (25 percent shareholder of Double Jay, Inc.). Mrs. Hutchens claims she has never been a stockholder, officer or director of Double J, Inc., and that she has never been employed by the corporation.

Affidavits support the contention that Thomas D. Hutchens' interest in Double Jay, Inc. is purely financial, as a 25 percent stockholder. He claims not to be an officer, director, or employee.

A-OK is a corporation which operates a picnic ground and campground in the general vicinity of Double J Riding Stables. Defendants claim there is absolutely no connection between A-OK and Double Jay, Inc. and/or Double J Riding Stables. The corporation's stockholders are completely different. Plaintiff argues that A-OK is vicariously liable for the acts of its alleged joint venturer or agent, Double J Riding Stables.

Cedrick D. Justis, a defendant, and his brother, Robert Justis, own the land upon which the campground and riding stables are located. Mr. Justis is also a stockholder and chairman of the Board of A-OK. He leases the ground to Double Jay, Inc., pursuant to an oral lease.

Double J Riding Stables began operating on or about April 21, 1983. The principals immediately took steps to have the business incorporated. Apparently, due to the unavailability of the corporate name, "Double J, Inc.," the business' accountant failed to file the Certificate of Incorporation with the Secretary of State until December 16, 1983, approximately two months after Ms. Cleary was injured. Still, defendants claim a de facto corporation existed at the time of the accident, insulating defendant Thomas Hutchens from personal liability.

In summary, defendants suggest that each defendant should be dismissed because none of them owned or operated Double J Riding Stables, and that summary judgment should be granted.

Plaintiff opposes the motion for summary judgment. She claims that there is a question of fact regarding the relationship between A-OK and Double J Riding Stables. She provides information showing A-OK advertised that it had horseback riding at its facility. Apparently, these ads referred to the services of Double J Riding Stables.

As to Cedrick D. Justis, Ms. Cleary presents two advertising pamphlets which state that "the Justis Family" is the "host" at the campground.

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(*CONT.*)

Ms. Cleary also directs the Court to the April 12, 1984 edition of the local newspaper in which the author states "[Betty Ann] Hutchens . . . also works with her husband, their son and two of their three daughters in the family business, Double J Riding Stables, Bear." Plaintiff's Exhibit J. She believes this indicates the existence of a mere partnership, not an insulating de facto corporation.

[*Text omitted*]

The Court agrees with defendants here. The fact that A-OK advertises the availability of the nearby riding stables does not make it an owner or operator. A-OK also advertises, under "59 Fun Things to See and Do While at North Del A-OK," in the brochure marked "Plaintiff's Exhibit C," visits to Longwood Gardens and Winterthur Museum. To claim that A-OK owns or operates these facilities because it takes advantage of their physical proximity is absurd . . .

Next, Mrs. Cleary emphasizes that two of the pamphlets state that "the Justis Family" are the "hosts" of the campground . . .

While Mr. Justis, as owner of the land upon which the campground is located, and a stockholder of the corporation which operates the campground, is a "host" of the campers, he is no more than a landlord as to the riding stables' property. The brochures merely speak to his status as "host" of the campground, not the riding stables. Since the plaintiff was allegedly injured by negligent actions of employees of the riding stables, and not due to any dangerous condition on the land, Mr. Justis, as landlord, has no legal vulnerability . . . Ms. Cleary then argues that an April 12, 1984 *Wilmington News Journal* newspaper article creates a material question of fact regarding Betty Ann Hutchens' status. Without discussing the article's admissibility, the Court notes first that the article does not state that Mrs. Hutchens owns or operates the business. It merely states that she "works with her husband, their son and two of their three daughters in the family business, Double J Riding Stables, Bear." At most, according to the article, she is an employee. She cannot be liable, as an agent, for the torts of her principal unless she participated in them . . .

Ms. Cleary also claims the article raises a material question of fact as to Thomas Hutchens. Thomas Hutchens was sued as "Thomas Hutchens, doing business as Double J Riding Stables." The article only alludes to the fact that he was an employee, not an owner or operator, or one "doing business as Double J Riding Stables." Plaintiff does not allege that he was the negligent employee, but instead seems to attack him in his status as a 25 percent shareholder of Double J, Inc. Therefore, the article does not give rise to a material issue of fact as to Thomas Hutchens.

Mrs. Cleary goes on to stress that Thomas Hutchens may be liable in his individual capacity as a "partner" of Double Jay, Inc. Defendants respond by noting that there was no partnership but, instead, a "de facto" corporation in existence at the time of the accident. Defendants claim Thomas Hutchens is insulated by the corporate veil.

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(CONT.)

So, the Court must determine if Double J, Inc. was a de facto corporation on or about October 16, 1983, the date of the accident.

A de jure corporation exists when there is substantial compliance with all mandatory conditions precedent to incorporation. H. Henn and J. Alexander, *Law of Corporations* 329 (3rd ed. 1983). In Delaware, a corporation does not come into existence until the Certificate of Incorporation is duly filed with the Secretary of State. 8 Del. C. § 106 (1983). There is no question here that despite the principals' efforts to incorporate on April 21, 1983, the Certificate of Incorporation for Double Jay, Inc. was not actually filed until December 16, 1983. Therefore, there was no de jure corporate existence on October 16, 1983, the date of the accident.

However, a corporation which fails to qualify as de jure may still assume "de facto" corporate status. Henn and Alexander at 329; R. Stevens, *Handbook on the Law of Corporations*, §§ 26–27 (2nd edn., 1949); Comment, *Defective Incorporation: De facto Corporations by Estoppel*, and § 21–2054, 5 8 Neb.Law Review 763 (1979); Note, *The Defacto Doctrine in Montana*, 39 Mont. Law Review 305 (1978).

In Delaware, a business organization seeking de facto status must meet three general requirements: there must be "a general law under which a corporation may lawfully exist; a bona fide attempt to organize under the law and colorable compliance with the statutory requirements; and actual use or exercise of corporate powers in pursuance of such laws." . . .

Delaware has a general law under which a corporation may lawfully exist . . . There was a good faith attempt to incorporate here, and colorable compliance with the statutory requirements. Double Jay made a bona fide attempt to incorporate on April 21, 1983 under the name Double J Inc. After a two-month delay, the parties were informed that the name was unavailable, and the accountant filed for a corrected name. Another delay regarding filing fees, which was apparently not the principal's fault, occurred. The Certificate of Incorporation was not filed until December 16, 1983.

The business did exercise its corporate power here, as of April 21, 1983. As of that date, it took several steps which indicated its use of corporate powers. It began operations as a business. It obtained an IRS corporate identification number. It made an election for Subchapter S status.

The factors for de facto status have been satisfied.

Generally, a stockholder cannot be held personally liable for tortious acts of the corporation unless he has participated or aided in the commission of the acts. See generally, Henn and Alexander at 546; 18A Am.Jur. 2d, Corporations § 851. Innocent stockholders of a de facto corporation have the same rights and are entitled to the same protection as stockholders of a corporation de jure. 18 CJS. Corporations § 96. Therefore, Thomas Hutchens cannot be held personally liable for the alleged torts of the de facto corporation.

[*Text omitted*]

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TIMBERLINE EQUIPMENT CO., INC. V. DAVENPORT

Supreme Court of Oregon (*en banc*)
514 P 2d 1109 (1973)
[*Text edited; some footnotes omitted*]

DENECKE, Justice

Plaintiff brought this action for equipment rentals against the defendant Dr. Bennett and two others. In addition to making a general denial, Dr. Bennett alleged as a defense that the rentals were to a de facto corporation, Aero-Fabb Corp., of which Dr. Bennett was an incorporator, director and shareholder. He also alleged plaintiff was estopped from denying the corporate character of the organization to whom plaintiff rented the equipment. The trial court held for plaintiff. Dr. Bennett, only, appeals.

On January 22, 1970, Dr. Bennett signed articles of incorporation for Aero-Fabb Co. The original articles were not in accord with the statutes and, therefore, no certificate of incorporation was issued for the corporation until June 12, 1970, after new articles were filed. The leases were entered into and rentals earned during the period between January 22nd and June 12th . . .

ORS 57.321 of the Oregon Business Corporation Act . . . is virtually identical to s 56 of the Model Act [now § 2.03]. The Comment to the Model, prepared as a research project by the American Bar Foundation and edited by the American Bar Association Committee on Corporate Laws, states:

> 'Under the Model Act, de jure incorporation is complete upon the issuance of the certificate of incorporation, except as against the state in certain proceedings challenging the corporate existence . . .'
>
> 'Under the unequivocal provisions of the Model Act, any steps short of securing a certificate of incorporation would not constitute apparent compliance. Therefore a de facto corporation cannot exist under the Model Act.'

[*Text omitted*]

ORS 57.793 provides:

> 'All persons who assume to act as a corporation without the authority of a certificate of incorporation issued by the Corporation Commissioner, shall be jointly and severally liable for all debts and liabilities incurred or arising as a result thereof.'

This is merely an elaboration of s 146 of the Model Act [now § 2.04]. The Comment states:

> 'This section is designed to prohibit the application of any theory of de facto incorporation. The only authority to act as a corporation under

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(CONT.)

> the Model Act arises from completion of the procedures prescribed . . . No other means being authorized, the effect of section 146 is to negate the possibility of a de facto corporation.'
>
> 'Abolition of the concept of de facto incorporation, which at best was fuzzy, is a sound result. No reason exists for its continuance under general corporate laws, where the process of acquiring de jure incorporation is both simple and clear. The vestigial appendage should be removed.' 2 Model Business Corporation Act Annotated s 146 . . .

In *Robertson* v. *Levy* . . . the court held the president of a defectively organized corporation personally liable to a creditor of the 'corporation.' The applicable legislation was similar to Oregon's. The court held the legislation ended the common-law doctrine of de facto corporation.

The Alaska court upheld the cancellation ground that the applicant had not yet been issued its certificate of incorporation at the time the permit was issued. *Swindel* v. *Kelly* . . . Alaska has a statute similar to Oregon's. The court commented: 'The concept of de facto corporations has been increasingly disfavored, and Alaska is among the states whose corporation statutes are designed to eliminate the concept.' . . .

[*Text omitted*]

We hold the principle of de facto corporation no longer exists in Oregon.

The defendant also contends that the plaintiff is estopped to deny that it contracted with a corporation.

The doctrine of 'corporation by estoppel' has been recognized by this court but never fully dissected . . . Corporation by estoppel is a difficult concept to grasp and courts and writers have 'gone all over the lot' in attempting to define and apply the doctrine. One of the better explanations of the problem and the varied solutions is contained in Ballantine, *Manual of Corporation Law and Practice* ss 28–30 (1930):

> 'The so-called estoppel that arises to deny corporate capacity does not depend on the presence of the technical elements of equitable estoppel, viz., misrepresentations and change of position in reliance thereon, but on the nature of the relations contemplated, that one who has recognized the organization as a corporation in business dealings should not be allowed to quibble or raise immaterial issues on matters which do not concern him in the slightest degree or affect his substantial rights.' Ballantine, supra, at 92.

As several writers have pointed out, in order to apply the doctrine correctly, the cases must be classified according to who is being charged with estoppel. Ballantine, supra, at 91; 1 Hornstein, *Corporation Law and Practice* s 30, p. 31, n. 6 (1959).

When a defendant seeks to escape liability to a corporation plaintiff by contending that the plaintiff is not a lawful corporate entity, courts readily apply the doctrine of corporation by estoppel. *Thompson Optical Institute* v. *Thompson* . . .

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(*CONT.*)

well illustrates the equity of the doctrine in this class of cases R. A. Thompson carried on an optical business for years. He then organized a corporation to buy his optical business and subscribed to most of the stock in this corporation. He chaired the first meeting at which the Board resolved to purchase the business from him. The corporation and Thompson entered into a contract for the sale of the business which included a covenant by Thompson not to compete. Thereafter, Thompson sold all of his stock to another individual. Some years later Thompson re-entered the optical business in violation of the covenant not to compete. The corporation brought suit to restrain Thompson from competing. Thompson defended upon the ground that the corporation had not been legally organized. We held, 'The defendant cannot be heard to challenge the validity of the contract or the proper organization of the corporation.' . . .

The fairness of estopping a defendant such as Thompson from denying the corporate existence of his creation is apparent.

On the other hand, when individuals such as the defendants in this case seek to escape liability by contending that the debtor is a corporation, Aero-Fabb Co., rather than the individual who purported to act as a corporation, the courts are more reluctant to estop the plaintiff from attacking the legality of the alleged debtor corporation. Ballantine, supra, at 96; 8 Fletcher, *Cyclopedia of the Law of Private Corporations* (perm. ed.) s 3914, p. 228.

The most appealing explanation of why the plaintiff may be estopped is based upon the intention of the parties. The creditor-plaintiff contracted believing it could look for payment only to the corporate entity. The associates, whatever their relationship to the supposed corporate entity, believed their only potential liability was the loss of their investment in the supposed corporate entity and that they were not personally liable . . .

From the plaintiff-creditor's viewpoint, such reasoning is somewhat tenuous. The creditor did nothing to create the appearance that the debtor was a legal corporate entity. The creditor formed its intention to contract with a debtor corporate entity because someone associated with the debtor represented, expressly or impliedly, that the debtor was a legal corporate entity.

[*Text omitted*]

The trial court found, and its findings are supported by the evidence, that all the defendants were partners prior to January 1970 and did business under the name 'Aero-Fabb Co.' Not until June 1970 were the interests in this partnership assigned to the corporation 'Aero-Fabb Co.' and about the same time the assumed business name 'Aero-Fabb Co.' was cancelled.

The trial court found, and the evidence supported the finding, that two of the leases entered into by plaintiff were with 'Kenneth L. Davenport, dba Aero-Fabb Co.' The other was with 'Kenneth L. Davenport, dba Aero-Fabb Corp.' 'Aero-Fabb

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(CONT.)

Corp.' was never the corporate name; the name of the corporation for which a certificate was finally issued was 'Aero-Fabb Co.' The correspondence and records of plaintiff sometimes referred to the debtor as 'Aero-Fabb Co.' and others as 'Aero-Fabb Corp.'

. . . [P]laintiff's salesman said Mr. Davenport, speaking for the organization, stated several times that he was in a partnership with Drs. Gorman and Bennett. The salesman was dubious and checked the title to the land on which the debtors' operation was being conducted and found it was in the name of the three defendants as individuals.

A final question remains: Can the plaintiff recover against Dr. Bennett individually?

In the first third of this century the liability of persons associated with defectively organized corporations was a controversial and well-documented legal issue. The orthodox view was that if an organization had not achieved de facto status and the plaintiff was not estopped to attack the validity of the corporate status of the corporation, all shareholders were liable as partners. This court, however, rejected the orthodox rule. In *Rutherford* v. *Hill* . . . we held that a person could not be held liable as a partner merely because he signed the articles of incorporation though the corporation was so defectively formed as to fall short of de facto status. The court stated that under this rule a mere passive stockholder would not be held liable as a partner. We went on to observe, however, that if the party actively participated in the business he might be held liable as a partner . . .

The Model Act and the Oregon Business Corporation Act, ORS 57.793, solve the problem as follows:

> 'All persons who assume to act as a corporation without the authority of a certificate of incorporation issued by the Corporation Commissioner, shall be jointly and severally liable for all debts and liabilities incurred or arising as a result thereof.'

We have found no decisions, comments to the Model Act, or literature attempting to explain the intent of this section.

We find the language ambiguous. Liability is imposed on '(a)ll persons who assume to act as a corporation.' Such persons shall be liable 'for all debts and liabilities incurred or arising as a result thereof.'

We conclude that the category of 'persons who assume to act as a corporation' does not include those whose only connection with the organization is as an investor. On the other hand, the restriction of liability to those who personally incurred the obligation sued upon cannot be based upon logic or the realities of business practice. When several people carry on the activities of a defectively organized corporation, chance frequently will dictate which of the several active principals directly incurs a certain obligation or whether an employee, rather than an active principal, personally incurs the obligation.

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(*CONT.*)

We are of the opinion that the phrase, 'persons who assume to act as a corporation' should be interpreted to include those persons who have an investment in the organization and who actively participate in the policy and operational decisions of the organization. Liability should not necessarily be restricted to the person who personally incurred the obligation.

[*Text omitted*]

There is evidence from which the trial court could have found that while Drs. Bennett and Gorman, another defendant, entrusted the details of management to Davenport, they endeavored to and did retain some control over his management. All checks required one of their signatures. Dr. Bennett frequently visited the site and observed the activity and the presence of the equipment rented by plaintiff. He met with the organization's employees to discuss the operation of the business. Shortly after the equipment was rented and before most of the rent had accrued, Dr. Bennett was informed of the rentals and given an opinion that they were unnecessary and ill-advised. Drs. Bennett and Gorman thought they had Davenport and his management 'under control.'

This evidence all supports the finding that Dr. Bennett was a person who assumed to act for the organization and the conclusion of the trial court that Dr. Bennett is personally liable.

Affirmed.

KELNER V. BAXTER

Court of Common Pleas
(1866–67) LR 2 CP 174
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[*Text edited; headnotes and footnotes omitted*]

[*Text omitted*]

[Kelner sold wine for a livelihood. He dealt with Baxter for a sale of wine. Baxter purported to act for a company named "The Gravesend Royal Alexandra Hotel Company, Limited" (directors: Baxter, Edmands, Dales, Macdonald, Hulse, Calisher), but this company was not yet formed when the transaction was concluded. The contract was concluded with the exchange of correspondence reprinted immediately below this summary. The wine was delivered and consumed, but not paid for. When the company was formed, it formally ratified the contract. However, it became insolvent and never paid Kelner. The latter sued Baxter and the other persons who signed the sales contract. They claimed that the company, not the signatories personally, were liable for performance on the contract.]

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(*CONT.*)

"To John Dacier Baxter, Nathan Jacob Calisher, and John Dales, on behalf of the proposed Gravesend Royal Alexandra Hotel Company, Limited.

"Gentlemen, – I hereby propose to sell the extra stock now at the Assembly Rooms, Gravesend, as per schedule hereto, for the sum of 900£, payable on the 28th of February, 1866.

(Signed) "John Kelner."

Then followed a schedule of the stock of wines, &c., to be purchased, and at the end was written as follows:

"To Mr. John Kelner.

"Sir, We have received your offer to sell the extra stock as above, and hereby agree to and accept the terms proposed.

(Signed) "J. D. Baxter,
"N. J. Calisher,
"J. Dales,

"On behalf of the Gravesend Royal Alexandra Hotel Company, Limited."

[*Text omitted*]

ERLE, CJ

I am of opinion that this rule should be discharged. The action is for the price of goods sold and delivered: and the question is whether the goods were delivered to the defendants under a contract of sale. The alleged contract is in writing, and commences with a proposal addressed to the defendants, in these words: – "I hereby propose to sell the extra stock now at the Assembly Rooms, Gravesend, as per schedule hereto, for the sum of 900£., payable on the 28th of February, 1866." Nothing can be more distinct than this as a vendor proposing to sell. It is signed by the plaintiff, and is followed by a schedule of the stock to be purchased. Then comes the other part of the agreement, signed by the defendants, in these words, – "Sir, We have received your offer to sell the extra stock as above, and hereby agree to and accept the terms proposed." If it had rested there, no one could doubt that there was a distinct proposal by the vendor to sell, accepted by the purchasers. A difficulty has arisen because the plaintiff has at the head of the paper addressed it to the plaintiffs, "on behalf of the proposed Gravesend Royal Alexandra Hotel Company, Limited," and the defendants have repeated those words after their signatures to the document; and the question is, whether this constitutes any ambiguity on the face of the agreement, or prevents the defendants from being bound by it. I agree that if the Gravesend Royal Alexandra Hotel Company had been an existing company at this time, the persons who signed the agreement would have signed as agents of the

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(*CONT.*)

company. But, as there was no company in existence at the time, the agreement would be wholly inoperative unless it were held to be binding on the defendants personally. The cases referred to in the course of the argument fully bear out the proposition that, where a contract is signed by one who professes to be signing "as agent," but who has no principal existing at the time, and the contract would be altogether inoperative unless binding upon the person who signed it, he is bound thereby: and a stranger cannot by a subsequent ratification relieve him from that responsibility. When the company came afterwards into existence it was a totally new creature, having rights and obligations from that time, but no rights or obligations by reason of anything which might have been done before. It was once, indeed, thought that an inchoate liability might be incurred on behalf of a proposed company, which would become binding on it when subsequently formed: but that notion was manifestly contrary to the principles upon which the law of contract is founded. There must be two parties to a contract; and the rights and obligations which it creates cannot be transferred by one of them to a third person who was not in a condition to be bound by it at the time it was made. The history of this company makes this construction to my mind perfectly clear. It was no doubt the notion of all the parties that success was certain: but the plaintiff parted with his stock upon the faith of the defendants' engagement that the price agreed on should be paid on the day named. It cannot be supposed that he for a moment contemplated that the payment was to be contingent on the formation of the company by the 28th of February. The paper expresses in terms a contract to buy. And it is a cardinal rule that no oral evidence shall be admitted to shew an intention different from that which appears on the face of the writing. I come, therefore, to the conclusion that the defendants, having no principal who was bound originally, or who could become so by a subsequent ratification, were themselves bound, and that the oral evidence offered is not admissible to contradict the written contract.

WILLES, J

I am of the same opinion. Evidence was clearly inadmissible to shew that the parties contemplated that the liability on this contract should rest upon the company and not upon the persons contracting on behalf of the proposed company. The utmost it could amount to is, that both parties were satisfied at the time that all would go smoothly, and consequently that no liability would ensue to the defendants. The contract is, in substance, this, – "I, the plaintiff, agree to sell to you, the defendants, on behalf of the Gravesend Royal Alexandra Hotel Company, my stock of wines;" and, "We, the defendants, have received your offer, and agree to and accept the terms proposed; and you shall be paid on the 28th of February next." Who is to pay? The company, if it should be formed. But, if the company should

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not be formed, who is to pay? That is tested by the fact of the immediate delivery of the subject of sale. If payment was not made by the company, it must, if by anybody, be by the defendants. That brings one to consider whether the company could be legally liable. I apprehend the company could only become liable upon a new contract. It would require the assent of the plaintiff to discharge the defendants. Could the company become liable by a mere ratification? Clearly not. Ratification can only be by a person ascertained at the time of the act done, – by a person in existence either actually or in contemplation of law; as in the case of assignees of bankrupts and administrators, whose title, for the protection of the estate, vests by relation ... I would refer to Gunn v. London and Lancashire Fire Insurance Company, where this Court, upon the authority of Payne v. New South Wales Coal and International Steam Navigation Company, held that a contract made between the projector and the directors of a joint-stock company provisionally registered, but not in terms made conditional on the completion of the company, was not binding upon the subsequent completely registered company, although ratified and confirmed by the deed of settlement: and Williams, J, said, that, "to make a contract valid, there must be parties existing at the time who are capable of contracting." That is an authority of extreme importance upon this point; and, if ever there could be a ratification, it was in that case. Both upon principle and upon authority, therefore, it seems to me that the company never could be liable upon this contract ... Putting in the words "on behalf of the Gravesend Royal Alexandra Hotel Company," would operate no more than if a person should contract for a quantity of corn "on behalf of my horses." ...

[*Text omitted*]

PHONOGRAM LTD V. LANE

Court of Appeal [1982] QB 938

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[*Text edited; headnotes and footnotes omitted*]

LORD DENNING MR

In 1973 there was a group of "pop" artists. They included two gentlemen called Brian Chatton and John McBurnie. The suggestion was that they should perform under the name "Cheap Mean and Nasty." A company was going to be formed to run the group. It was to be called "Fragile Management Ltd."

Before the company was formed, negotiations took place for the financing of the group. It was to be financed by one of the subsidiaries of a big organisation called

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(*CONT.*)

the Hemdale Group. It was eventually arranged that money should be provided by Phonogram Ltd. The agreed amount was £12,000, and the first instalment was to be £6,000. The first instalment of £6,000 was paid.

But the new company was never formed. The group never performed under it. And the £6,000 was due to be repaid. But it was never repaid. Phonogram Ltd then tried to discover who was liable to repay the money. Mr. Roland Rennie was the man who had negotiated on behalf of Phonogram. Mr. Brian Lane was the man who had negotiated on behalf of the new company which was to be formed. I will read the letter from Mr. Rennie to Mr. Lane of July 4, 1973. It is the subject matter of this action:

> "Brian Lane, Esq.,
> Fragile Ltd,
> 39 South Street,
> London, W1.
> "Dear Brian,
>
> "In regard to the contract now being completed between Phonogram Ltd and Fragile Management Ltd concerning recordings of a group consisting of Brian Chatton, John McBurnie and one other with a provisional title of 'Cheap Mean and Nasty' and further to our conversation this morning, I send you herewith our cheque for £6,000 in anticipation of the contract signing, this being the initial payment for the initial LP called for in the contract. In the unlikely event that we fail to complete within, say, one month you will undertake to repay us the £6,000. As per our telephone conversation the cheque has been made payable to Jelly Music Ltd. For good orders sake, Brian, I should be appreciative if you could sign the attached copy of this letter and return it to me so that I can keep our accounts people informed of what is happening.
>
> "Yours sincerely,
> "Roland G. Rennie
> "Signed by . . . for and on behalf of Fragile Management Ltd."

That was signed by Mr. Lane. So there is the written contract embodying the agreement between those concerned. An invoice was sent by Phonogram Ltd . . .

The money was paid over. According to the accounts, it went into the account of Jelly Music Ltd, which was one of the subsidiaries of the Hemdale Group of which Mr. Lane, with others, was a director.

The first question is whether, on the true construction of the contract, Mr. Lane made himself personally liable. As I read the words of the contract – "I send you herewith our cheque for £6,000" and "In the unlikely event that we fail to complete within, say, one month you will undertake to repay us the £6,000" – the word "you"

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referred to Mr. Lane personally. The cheque was made out in favour of Jelly Music Ltd only as a matter of administrative convenience (as the judge found). It did not affect the fact that the agreement to repay was made by Brian Lane: especially when it is realised that it was known to all concerned that Fragile Management Ltd had not been formed. So I would have construed the contract, without recourse to any other aids, as making Mr. Lane personally liable.

But Phillips J construed the contract differently. He had heard a lot of evidence. He said in his judgment: "But I am quite satisfied that the events of July 4 did not of themselves involve a contract with Mr. Lane personally."

I will accept for the moment that the judge was correct in so holding. Even so Phonogram Ltd say that the law of England has been much altered by section 9 (2) of the European Communities Act 1972. It says:

> "Where a contract purports to be made by a company, or by a person as agent for a company, at a time when the company has not been formed, then subject to any agreement to the contrary the contract shall have effect as a contract entered into by the person purporting to act for the company or as agent for it, and he shall be personally liable on the contract accordingly."

That seems to me to cover this very case. The contract purports to be made on behalf of Fragile Management Ltd, at a time when the company had not been formed. It purports to be made by Mr. Lane on behalf of the company. So he is to be personally liable for it.

Mr. Thompson, on behalf of Mr. Lane, argued very skilfully that section 9(2) did not apply. First, he said: "Look at the directive under the European Community law which led to this section being introduced." It is Council Directive of March 9, 1968 (68/151/EEC). In 1968 English was not one of the official languages of the European Community. So Mr. Thompson referred us to the French text of article 7 of the Directive:

> "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 resultant de ces actes, les personnes qui les ont accomplis en sont solidairement et indéfiniment responsables, sauf convention contraire."

Mr. Thompson says that, according to the French text, that Directive is limited to companies which are "en formation," that is companies which have already started to be formed.

Mr. Thompson's submission is reinforced by passages from a French textbook – *Ripert, Traité Elémentaire de Droit Commercial*, 7th ed. (1972). As I read the passage at pp. 601 and 604 of that treatise – interpreting the French as best

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I can – in the case of a French company or société there may be, recognised by law, a period of time while a company is in the course of formation when people have put their signatures to what I may call "the articles of association." That period is called the period when the société is "en formation." At p. 604 a parallel is drawn with a baby at the time of gestation – between the time of conception and the time of birth – and a company when it is "en formation."

I reject Mr. Thompson's submission. I do not think we should go by the French text of the Directive. It was drafted with regard to a different system of company law from that in this country. We should go by section 9(2) of our own statute, the European Communities Act 1972. Under article 189 of the EEC Treaty, directives are to be binding only in so far as the spirit and intent are concerned. Article 189 says:

> "... A directive shall be binding, as to the result to be achieved, upon each member state to which it is addressed, but shall leave to the national authorities the choice of form and methods."

Section 9(2) is in accordance with the spirit and intent of the Directive. We should go by our own statute, and not by the Directive (68/151/EEC).

That brings me to the second point. What does "purports" mean in this context? Mr. Thompson suggests that there must be a representation that the company is already in existence. I do not agree. A contract can purport to be made on behalf of a company, or by a company, even though that company is known by both parties not to be formed and that it is only about to be formed.

The third point made by Mr. Thompson was that a company can be "a person" within the second line of section 9 (2). Mr. Thompson says that Jelly Music Ltd was "a person" which was purporting to contract on behalf of Fragile Management Ltd. I do not agree. Jelly Music Ltd were not entering into a contract. Mr. Lane was purporting to do so.

So all three of Mr. Thompson's points fail.

But I would not leave the matter there. This is the first time the section has come before us. It will have much impact on the common law. I am afraid that before 1972 the common law had adopted some fine distinctions. As I understand *Kelner* v. *Baxter* (1866) LR 2 CP 174 it decided that, if a person contracted on behalf of a company which was nonexistent, he himself would be liable on the contract. Just as, if a man signs a contract for and on behalf "of his horses," he is personally liable. But, since that case was decided, a number of distinctions have been introduced by Hollman v. Pullin (1884) Cab. & Ell. 254; *Newborne* v. *Sensolid* (Great Britain) Ltd [1954] 1 QB 45 and *Black* v. *Smallwood* (1965) 117 CLR 52 in the High Court of Australia. Those three cases seem to suggest that there is a distinction to be drawn according to the way in which an agent signs a contract. If he signs it as "agent for 'X' company" – or "for and on behalf of 'X' company" – and there is no such body as "X" company, then he himself can be sued upon it. On the

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other hand, if he signs it as "X" company per pro himself the managing director, then the position may be different: because he is not contracting personally as an agent. It is the company which is contracting.

That distinction was disliked by Windeyer J in *Black* v. *Smallwood*. It has been criticised by Professor Treitel in *The Law of Contract*, 5th ed. (1979), p. 559. In my opinion, the distinction has been obliterated by section 9(2) of the European Communities Act 1972. We now have the clear words, "Where a contract purports to be made by a company, or by a person as agent for a company, at a time when the company has not been formed . . ." That applies whatever formula is adopted. The person who purports to contract for the company is personally liable.

[*Text omitted*]

. . . The words "subject to any agreement to the contrary" mean – as Shaw LJ suggested in the course of the argument – "unless otherwise agreed." If there was an express agreement that the man who was signing was not to be liable, the section would not apply. But, unless there is a clear exclusion of personal liability, section 9(2) should be given its full effect. It means that in all cases such as the present, where a person purports to contract on behalf of a company not yet formed, then however he expresses his signature he himself is personally liable on the contract.

[*Text omitted*]

JACOBSON V. STERN

Supreme Court of Nevada
605 P 2d 198 (1980)
[*Text edited; footnotes omitted*]

[*Text omitted*]

In January, 1969, Jacobson contacted Stern and asked him to draw plans for Jacobson's new hotel/casino [the "Kings Castle"] at Lake Tahoe. Stern immediately began preliminary work on the project and contacted soil engineers and surveyors in this regard. At this time Stern dealt directly with Jacobson, who referred to the project as "my hotel," and with Taylor of Nevada which was to be the general contractor.

On February 18, 1969, Stern wrote to Jacobson detailing, among other things, the architect's services and the fee. Stern's plans were subsequently discussed by the two men and Stern's fee was agreed to be $250,000. Stern was told by Jacobson to proceed, and he completed the preliminary plans by March . . . highrise foundation . . . on May 1, 1969 . . . Stern testified at trial that by May 6, 1969, at least 60% of the architectural services were complete . . . A letter from Jacobson to

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Stern, written March 10, 1970, acknowledges that the parties entered into a contract in April, 1969, but no written contract was ever admitted into evidence despite Jacobson's testimony that such a document was executed.

At the same time . . . Jacobson was negotiating financing and setting up business structures to own and manage the property. On May 1, 1969, Jacobson acquired all of the stock of ALW, Inc., a corporation which had previously operated a casino on this site, and which was to operate the Kings Castle. Levin-Townsend Computer Corporation subsequently purchased 20% of the ALW, Inc. stock for $300,000. On May 9, 1969, a business structure for ownership of Kings Castle was set up and a number of documents were executed. The business structure included the formation of Lake Enterprises, a corporation of which Jacobson was the sole stockholder and president. Kings Castle, Limited Partnership was formed with Lake Enterprises, Inc. as the general partner and Jacobson and others as limited partners. Jacobson was the most substantial investor in Kings Castle, Limited Partnership, with investments in excess of $3 million.

After May 9, 1969, ALW, Inc. operated the hotel and casino and Kings Castle, Limited Partnership, leased the land. All monies were subsequently paid and received through these two entities. Stern billed Jacobson beginning in June of 1969. Some of the billings were disputed, but Stern was in fact paid $30,000 on June 13, 1969; $30,000 on August 11, 1969; $58,000 on September 12, 1969, and $32,000 on October 17, 1969. All of the checks were drawn on the account of ALW, Inc.; only one of the checks was signed by Jacobson.

The Kings Castle opened in July 1970. On February 3, 1972, ALW, Inc., as owner of Kings Castle and Casino, filed its petition for arrangements under Chapter XI of the Bankruptcy Act. Stern did not file a claim in that proceeding. [In separate proceedings, a court awarded Stern $132,590.37 plus interest against Jacobson personally.]

[*Text omitted*]

In this appeal Jacobson contends: (1) that there was insufficient evidence presented at trial to support the judgment of his personal liability; (2) that the obligations of Jacobson were adopted by ALW, Inc., and that such adoption constituted a novation; and, (3) that it was improper for the court to assess costs against Jacobson for a continuance of the trial.

1. Appellant contends there is no evidence to support the district court's findings that Stern was not dealing with any of the existing corporate entitles; Levin-Townsend Computer Corporation; Bonanza No. 2; J. J. Enterprises; Jacobson as agent for any of these; or with Jacobson as agent for Kings Castle or any other principal.

The evidence shows that Jacobson was, in the early months of 1969, President of J. J. Enterprises, which wholly owned Bonanza No. 2, and Chairman of the Board of

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Caesar's Palace. There is no evidence, however, that at that time Jacobson was acting on behalf of any of these entities in contracting for the building of Kings Castle Casino, and this is born out by the fact that none of these entities subsequently became involved with the Kings Castle Casino. Although Stern may have known of Jacobson's affiliations, and known that many of the same people who owned and managed the Bonanza were involved in the Kings Castle project, there is little evidence, if any, that he contracted with Jacobson in any capacity connected with those existing corporations. There is no evidence the Levin-Townsend Computer Corporation had anything more than a 20% ownership interest in ALW, Inc. The record is also devoid of evidence that they were involved with Stern directly, or that Jacobson ever represented them in negotiations with Stern.

Kings Castle, Limited Partnership, and Lake Enterprises, Inc., did not exist until May 9, 1969. ALW, Inc. existed from 1965, but Jacobson had no connection with it at all until he purchased the stock on May 1, 1969. The contract for architectural services, which was certainly for the benefit of ALW, Inc. and Kings Castle, Limited Partnership, was made before May 1, 1969. Stern maintains that he had a contract with Jacobson from February 18, 1969, and Jacobson admits a contract as of April 1969, but in any event the contract was in existence before Kings Castle, Limited Partnership, and Lake Enterprises, Inc., and before Jacobson's involvement with ALW, Inc. Thus, none of these corporations could contract, or have Jacobson contract for them because they were not yet organized.

Appellant, citing *Gillig & Co.* v. *Lake Bigler Road Co.* . . . further argues that a course of conduct between the parties created a presumption that Jacobson was acting as agent of J. J. Enterprises, as owner of the Bonanza. The record supports the determination that there was no course of dealing or custom and practice between these parties which would tend to establish Jacobson's agency for J. J. Enterprises in his relationship with Stern in the Kings Castle.

In the absence of any evidence to the contrary, and in the presence of testimony by Stern that he thought he was dealing with Jacobson as an individual, the district court concluded that the contract was made between Jacobson, as promoter of the Kings Castle project, and Stern. A contract with the promoter is not one with the corporation absent some subsequent corporate act or agreement . . . Thus, the district court properly found Jacobson, as promoter, liable on the contract.

2. Under Nevada law, if a pre-incorporation contract made by a promoter is within the corporate powers, the corporation may, when organized, expressly or impliedly ratify the contract and, thus, make it a valid obligation of the corporation. If the corporation accepts the benefits of the contract, it will be required to perform the contractual obligations . . . The evidence supports a finding that the ALW corporation accepted the benefits of the contract for architectural services, and in fact adopted the contractual obligations and made partial payments on the

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obligation. However, liability of the corporation by adoption does not, absent a novation, end the liability of the promoter to the third party.

Appellant argues that there was, in fact, a novation by ALW, Inc. in its adoption of all agreements as its corporate liabilities. Where there is a valid express or implied novation, the corporation is substituted for the promoter as a party to the contract in all respects, and the promoter is divested of his rights and released of his liabilities. In order to constitute a valid novation, however, the creditor must assent to the substitution of a new obligor, but this assent may be inferred from his acceptance of part performance by the new obligor, if the performance is made with the understanding that a complete novation is proposed.

Appellant contends that, because the evidence shows that after May 1, 1969, Stern probably knew, or should have known, that he was performing for the benefit of ALW, Inc., and was paid by ALW, Inc., he impliedly consented to a novation. There is no evidence, however, showing that Stern agreed to the substitution of ALW, Inc. for Jacobson in the contract, or that he performed with the knowledge or understanding that a novation was proposed . . . In fact he maintained throughout that he had contracted with Jacobson and felt that Jacobson was personally liable on the contract. The intent of the parties to cause a novation must be clear. The trial court found there was no novation and that Stern never agreed to release Jacobson from his obligations. We agree with this finding.

[*Text omitted*].

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