THE CASE FOR ELIMINATING PROMOTER LIABILITY ON PREINCORPORATION AGREEMENTS

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INTRODUCTION

"Promoter" is a business term, broadly defined as an individual who assists in the formation of a corporation.[1] The promoter establishes the corporation's capability to do business,[2] which often depends upon the promoter securing contracts for the benefit of the corporation. Since these contracts are entered into prior to the formation of the corporation, they are termed "preincorporation contracts."[3]

Until 1976, Arizona law provided that all persons acting in the corporate name were liable for all debts incurred, even when the corporation did not yet exist.[4] Thus, promoters who incurred a preincorporation debt on behalf of a corporation could be held liable.[5]

In the late 1960's, the Arizona legislature formed a committee[6] to address the need for modernization of Arizona's corporation laws. The committee formulated the Arizona Business Corporation Act,[7] which the Arizona

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1. 1 G. HORNSTEIN, CORPORATION LAW AND PRACTICE § 91, at 92 (1959).

2. Promoters are defined in a comprehensive sense as: [T]hose who undertake to form a corporation and to procure for it the rights, instrumentalities and capital by which it is to carry out the purposes set forth in its charter, and to establish it as fully able to do its business. Their work may begin long before the organization of the corporation, in seeking the opening for a venture and projecting a plan for its development, . . . *Id.* § 91, at 92. *See also* Malisewski v. Singer, 123 Ariz. 195, 196, 598 P.2d 1014, 1015 (Ct. App. 1979) ("Those who take an active part in organizing the corporation prior to its coming into being are called promoters of the corporation.").

3. N. LATTIN, CORPORATIONS § 29, at 111 (2d ed. 1971) discusses preincorporation agreements as common transactions: "It is frequently desirable as a practical matter to obtain options, enter into contracts for the purchase of land, buildings, machinery and materials, and for the performance of services prior to the incorporation of the business unit for whose benefit such transactions are to be consummated." *Id.* Although this Note focuses on the effect of the amendment to the Arizona promoter liability statute, the analysis is limited to the applicability of the statute to a promoter's liability on preincorporation contracts. Promoters are not bound by law to sign preincorporation agreements. They execute those agreements that best inure to the benefit of the corporation. The liability that attaches to the promoter is the same as the liability that would have attached to the corporation had it formed, i.e., the promoter is liable on the preincorporation contract. Also, when several promoters are involved in a contract, joint and several liability attaches. ARIZ. REV. STAT. ANN. § 10-146 (1977).

4. ARIZ. REV. STAT. ANN. § 10-146 (1977) (effective July 1, 1976).

5. Spence v. Huffman, 15 Ariz. App. 99, 486 P.2d 211 (1971).

6. Committee of the Section of Corporation Law of the State Bar of Arizona.

7. ARIZ. REV. STAT. ANN. §§ 10-002 to -149 (1975).

legislature adopted in 1975. The Act took effect on July 1, 1976.[8] On February 10, 1976, the Arizona legislature introduced a bill that made corrective changes to the Corporation Act.[9] Among those changes was an amendment to Arizona Revised Statute section 10-146.[10]

This Note focuses on the amendment's interpretation. Clarification is important because of the amendment's ambiguous character. Prior to the statute, Arizona applied the common law rule of promoter liability on preincorporation agreements.[11] After the amendment, Arizona continued to apply the common law rule, thus giving no effect to the amendment.[12]

Initially, this Note addresses the common law liability of promoters on preincorporation agreements and compares common law to modern theories of liability. Next, possible interpretations of the Arizona statute are explored. The interpretive analysis includes a comparison with other states that have adopted substantially similar provisions. Finally, a recommendation is made as to the best possible interpretation of the amended statute.

COMMON LAW LIABILITY OF PROMOTERS

English Common Law Rule

Under English common law, promoters were personally liable for preincorporation debts incurred in the corporate name.[13] The promoter incurred these debts by signing the name of an unformed corporation or by signing his own name while representing himself as an agent[14] of the corporation. Though acting as an agent, however, the principal[15] did not yet exist. The common law rule rigidly attached liability to promoters. Once liability attached, a promoter could not, under any circumstances, be relieved of liability.[16] Thus, the formation of the corporation and a subsequent ratification or novation,[17] did not release the promoter from liability.[18]

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8. H.R. 2315, 32d Leg., 1st Reg. Sess.,1975 Ariz. Sess. Laws § 2.

9. H.R. 2364, 32d Leg., 2d Reg. Sess., 1976 Ariz. Sess. Laws 587.

10. The 1975 version of section 10-146 read: "All persons who assume to act as a corporation without authority so to do or who procured incorporation through fraudulent misstatements or omissions of material fact in documents filed with the commission, shall be jointly and severally liable for all debts and liabilities incurred or arising as a result thereof." The 1975 version took effect on July 1, 1976. The 1976 amendment deleted the comma preceding "shall be jointly" and added a sentence: "Ratification of preincorporation acts constitute authority to act in a corporate capacity as used herein." ARIZ. REV. STAT. ANN § 10-146 (1977) (effective July 1, 1976).

11. *Spence*, 15 Ariz. App. 99, 486 P.2d 211.

12. *Malisewski*, 123 Ariz. 195, 598 P.2d 1014.

13. *See infra* note 16 and accompanying text.

14. "The one who is to act is the agent." RESTATEMENT (SECOND) OF AGENCY § 1 (1957).

15. "The one for whom the action is to be taken is the principal." *Id.*

16. Kelner v. Baxter, 2 L.R-C.P. 174 (1866), held that although it appeared upon the face of the agreement that defendants acted on behalf of the corporation, they became personally liable because there was no principal existing when the defendants signed the contract on behalf of the corporation. As such, the contract would be altogether inoperative unless it were binding on the defendants personally. *Id.* at 183. Since the court was unwilling to create a "nullity" of the contract, defendants were held liable. *Kelner* further stands for the proposition (rejected in most U.S. jurisdictions today) that even after the corporation has come into existence, a subsequent ratification does not relieve the promoter from liability. The *Kelner* court observed that "when the company came afterward into existence it was a totally new

American Common Law Rule

Most American jurisdictions have not followed the English common law rule. Nevertheless, the consequences of the United States common law rule are equally as harsh as the English rule. The widespread American rule is that, absent an agreement between the corporation and third party,[19] the promoter is held liable.[20] Thus, even after the corporation adopts or ratifies[21] the preincorporation agreement, the promoter is still liable.[22] There are, however,

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creature, having rights and obligations from that time, but no rights or obligations by reason of anything which might have been done before." *Id. But see* Newborne v. Sensolid, Ltd., [1953]1 All E.R. 708 , *appeal dismissed*, [1954]1 Q.B. 45 . *Kelner* and *Newborne* are starkly different from each other. The former firmly presumes that "when an 'agent' for an unformed company signs a contract entered on its behalf in representative form—'for and on behalf of XY Co. Ltd.—' the agent himself will be personally liable on the contract in order to give legal efficacy to a freely negotiated transaction." Sullivan, *The Liability of Promoters on Pre-Incorporation Contracts—Turning the Tables Too Far?*, 1983 CONV. & PROP. LAW. (n.s.) 119. By contrast, *Newborne* suggests that this presumption is abrogated if the promoter signs in the name of the company and then adds his name to authenticate the company's signature as in "ABC Co. Ltd., J.B. director." For a thorough discussion of the current status of English law on promoter liability see Sullivan, *supra*, at 119.

17. A "novation" is defined as:

> [T]he substitution of a new obligation for an existing one . . . made (a) by the substitution of a new obligation between the same parties with the intent to extinguish the old obligation, (b) by substitution of a new debtor in place of a former debtor with the intent to release the latter, or (c) by substitution of a new creditor in place of a former creditor with the intent to transfer rights of the former creditor to the new creditor.

Eckart v. Brown, 34 Cal. App. 2d 182, 187, 93 P.2d 212, 215 (1939). *See also* Jacobson v. Stern, 96 Nev. 56, 61, 605 P.2d 198, 201 (1980) ("Where there is a valid express or implied novation [by a corporation of a preincorporation contract made by a promoter], 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.").

18. *Kelner*, 2 L.R-C.P. 174. *But see Newborne*, 1 All E.R. 708.

19. A novation is an agreement between the two contracting parties to release the promoter from liability. *See supra* note 17.

20. *See, e.g., Jacobson*, 96 Nev. 56, 605 P.2d 198; Allen Steel Supply Co. v. Bradley, 89 Idaho 29, 402 P.2d 394 (1965). "[L]iability of the corporation by adoption does not, absent a novation, end the liability of the promoter to the third party." *Jacobson*, 96 Nev. at 61, 605 P.2d at 201. *See also* Buffington v. Bardon, 80 Wis. 635, 50 N.W. 776 (1891). In *Buffington*, defendants combined to form a corporation and, acting under the name of the corporation, contracted with plaintiff for his architectural services. Plaintiff performed the work and defendants failed to pay. Defendants contended that liability extended solely to the corporation and not to them as individual promoters. The court rejected defendant's argument, observing:

> The law is that a corporation is liable for its own acts only after it has a legal existence. Until that time no one, whether a promoter or not, can sustain to the corporation the relation of agent. Were this not so, we would have an agent without a principal, which is an absurdity.

Id. at 639, 50 N.W. at 777

21. Technically, there is a difference between the concepts of ratification and adoption. Under the proper use of the terms, ratification of preincorporation contracts is not possible. This is due to the common law theory that a principal cannot ratify an agreement to which it was not an original party. Under the theory of adoption, however, a corporation may accept a preincorporation contract along with all debts and liabilities attendant thereto. These two terms have come closer together in meaning and it is customary for courts and petitioners alike to use them interchangeably. 1A W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 207, at 428 (rev. perm. ed. 1983).

22. Adoption can be implied or express. An implied adoption occurs by the corporation's acceptance of benefits under the contract. *See* 1A W. FLETCHER, *supra* note 21, § 211, at 445. An express adoption occurs by formal acknowledgement of the contract. *Id.*

several recognized theories that relieve promoters of personal liability for preincorporation agreements.[23] The most popular theory is adoption.[24] Under the adoption theory, corporate liability replaces personal liability when the newly formed corporation adopts the preincorporation agreement.[25]

To ameliorate the hardships of the American common law rule, most courts place great emphasis on the intention of the parties.[26] Close examination is given to the surrounding facts and circumstances to determine whether the parties intended to hold the corporation, the promoter, or both, liable.[27] If the parties intend to relieve the promoter of liability, or if the third party looks solely to the corporation for performance, no liability attaches.[28]

The principles underlying the common law rule are grounded in agency law. A principal is necessary for the agent's legal existence.[29] If an agent acts for a principal when, in fact, none exists, he is individually liable.[30] Promoters that act for unformed corporations act for principals that do not exist. It logically follows that a promoter cannot be the agent of an unformed corporation. Therefore, promoters that enter preincorporation contracts on behalf of the unformed corporation are liable for breach of the agreement. Even after the corporation adopts or ratifies the contract, the promoter cannot, absent a novation, be released from his obligations.[31] This common law logic is the apparent position adopted in Arizona, despite the language of Arizona Revised Statute section 10-146.

See also Burman v. Gurwicz, 189 N.J. Super. 89, 458 A.2d 1311 (1981). Under the common law rule, a promoter may be liable even if the corporation has accepted benefits pursuant to the contract. 1A W. FLETCHER, *supra* note 21, § 215, at 466.

23. An analysis of all the theories upon which a promoter can escape liability for a preincorporation agreement is beyond the scope of this Note. The more common theories are ratification, adoption, continuing offer, novation, and new contract. Except as necessary for the discussion of this Note, these theories will not be addressed. For a complete discussion of these theories *see* Maloney, *Pre-Incorporation Contracts: A Statutory Solution?*, 10 CAN. BUS. L.J. 409, 417 (1985).

24. An "adoption" may be defined as "any words or acts of responsible officers showing assent or approval, by accepting the benefits of the contract, by proceeding to perform or suing to enforce it." H. BALLANTINE, BALLANTINE ON CORPORATIONS § 38, at 110 (1946). *See also infra* note 25.

25. 1A W. FLETCHER, *supra* note 21, § 207, at 427. American courts generally hold that a contract made by the promoters of a corporation on its behalf may be adopted, accepted or ratified by the corporation when organized, and that the corporation is then liable, both at law and in equity, on the contract itself, and not merely for the benefits it has received.

26. 1A W. FLETCHER, *supra* note 21, § 215.

27. *Id.*

28. Because such a determination is necessarily made on a case-by-case basis, there is a possibility of different results from jurisdiction to jurisdiction. The problem of varying results is evidenced by the mass of conflicting case law. *See, e.g.*, 1 H. OLECK, MODERN CORPORATION LAW § 40 (1958). It is impossible to draw a generalization in the form of a statement of definite and inviolable principles about the law of promoters' contracts. Oleck suggests that a "perfunctory and mechanical" adherence to formal theories of contract law should be discarded in favor of a "careful consideration of the apparent intent of the parties." *Id.* at 227-28.

29. *Buffington*, 80 Wis. at 639, 50 N.W. at 778.

30. *Id. See also* 1 H. OLECK, *supra* note 28, § 39, at 199.

31. 1 H. OLECK, *supra* note 28, § 39, at 200.

INTERPRETING THE ARIZONA STATUTE

Pre-Statutory Arizona Law

The Arizona statute, which forms the basis for promoter liability on preincorporation contracts, is titled "Unauthorized Assumption of Corporate Powers."[32] This statute is virtually identical to the provision in the 1969 Model Business Corporation Act.[33] The Arizona statute, however, was not adopted until 1976.

Prior to the 1976 adoption of section 10-146, Arizona courts addressed the issue of promoter liability only once, in *Spence v. Huffman*.[34] In *Spence*, the Arizona Court of Appeals held that, absent a contrary agreement, a promoter incurs personal liability with respect to any transaction entered into in behalf of an unformed corporation.[35] The decision fell squarely within the common law rule and was consistent with decisions in other jurisdictions.[36]

After The Amendment

Interpretive difficulty arises from the adoption of the 1976 amendment to the Arizona statute.[37] As amended, the statute further provides that

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32. ARIZ. REV. STAT. ANN. § 10-146 (1977) (effective July 1, 1976).

33. The 1969 Model Act provision provides that "[a]ll persons who assume to act as a corporation without authority so to do shall be jointly and severally liable for all debts and liabilities incurred or arising as a result thereof." 2 MODEL BUSINESS CORP. ACT § 146, at 908 (1971). Prior to its amendment, the Arizona statute differed by adding the clause "or who procured incorporation through fraudulent misstatements or material omissions of material fact in documents filed with the commission" between the terms "do" and "shall." ARIZ. REV. STAT. ANN. § 10-146 (1977) (effective July 1, 1976). The 1988 supplement to the MODEL BUSINESS CORP. ACT renumbers the provision to § 2.04 and retitles it, "Liability for Preincorporation Transactions." 1 MODEL BUSINESS CORP. ACT § 2.04 (Supp. 1988).

34. Plaintiff contracted to sell his employment agency to defendant. Defendant was to pay $5,000 plus interest and pay off certain creditors. It was defendant's contention on appeal that the trial court erred in finding him personally liable because a contemplated corporation not organized at the time of the agreement was intended to be held liable. *Spence*, 15 Ariz. App. 99, 486 P.2d 211. *See also Malisewski*, 123 Ariz. 195, 598 P.2d 1014.

35. The precise language of the court on the issue was as follows:

> The general rule is that where a corporation is contemplated but has not been organized at the time when a promoter makes a contract for the benefit of the corporation, he is personally liable on it, or incurs a personal liability with respect to the transaction in the absence of contrary agreement with the other contracting party.

Spence, 15 Ariz. App. at 100, 486 P.2d at 212. The court further noted, contrary to the common law rule established in *Newborne*, 1 All E.R. 708, that "[t]he promoter is likewise personally liable on or with respect to such transaction, in the absence of an express agreement otherwise, when he executes a contract in the name of the proposed corporation." *Spence*, 15 Ariz. App. at 100, 486 P.2d at 212. This latter part may not apply, however, when the promoter executes the contract as a representative of the corporation — as in, "MFG, for XYZ Corporation." If this is so, then *Spence* is not contrary to the reasoning of *Newborne*.

36. *See, e.g.*, Ennis Cotton-Oil Co. v. Burks, 39 S.W. 966 (Tex. Civ. App. 1897); Mt. Pleasant Coal Co. v. Watts, 91 Ind. App. 501, 151 N.E. 7 (1926); RKO-Stanley Warner Theatres, Inc. v. Graziano, 467 Pa. 220, 355 A.2d 830 (1976).

37. This assumes, however, that there was no difficulty with the interpretation of section 10-146 prior to the adoption of the 1976 amendment. As will be discussed later, provisions similar to section 10-146 have been interpreted differently in other jurisdictions. *See, e.g.*, Timberline Equipment Co., Inc. v. Davenport, 267 Or. 64, 514 P.2d 1109 (1973); Sherwood & Roberts-Oregon, Inc. v. Alexander, 269 Or. 389, 525 P.2d 135 (1974). *See infra* notes 66-76 and accompanying text.

"ratification of preincorporation acts constitutes authority to act in a corporate capacity as used herein."[38] The problem lies in determining the intent of the amendment. Does it effectively provide for the elimination of promoter liability upon subsequent ratification or adoption by the corporation? Or, does it merely provide for corporate liability?

One possible interpretation of the amended statute is that the Arizona legislature clarified its intent to codify the common law rule. Arizona case law supports the proposition that the statute should be interpreted as retaining the common law rule.[39] Indeed, no contrary interpretation has been given to the statute after its amendment.

Other Arizona case law, however, supports the proposition that the legislature intended to change Arizona's codification of the common law.[40] When the legislature amends a statute, it is presumed that they intended to change existing law.[41] Additionally, Arizona courts presume that the legislature acts with purpose.[42] Retaining the common law interpretation of the amended statute presumes that the legislature intended a futile act.[43] Even if the legislature merely intended to clarify the statute, it was unnecessary because it had been interpreted consistent with the common law.

Another presumption is that an amendment changes rather than clarifies a prior statute.[44] This presumption, however, only applies when the statute contained no ambiguity prior to amendment.[45] Since the law in its pre-amendment status was not ambiguous, it needed no clarification.[46] In keeping with the rules of statutory construction, therefore, the amendment should be interpreted as changing the statute.

TWO POSSIBLE INTERPRETATIONS OF SECTION 10-146

Following the amendment of the Arizona statute, two interpretations are possible. First, the amended statute may eliminate promoter liability for preincorporation contracts that the corporation subsequently adopts. This interpretation leaves the corporation solely liable. Second, the amended statute may retain the common law rule, imposing promoter liability even when the corporation subsequently adopts the contract.[47] This interpretation imposes

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38. ARIZ. REV. STAT. ANN. § 10-146 (1976).

39. "We are not to presume that the Legislature has repudiated the common law without a clear manifestation that such was its intent." Estate of Thelen v. Dockery, 9 Ariz. App. 157, 160, 450 P.2d 123, 127 (1969).

40. Brown v. White, 2 Ariz. App. 295, 297, 408 P.2d 228, 230 (1965).

41. *Id.*

42. City of Mesa v. Killingsworth, 96 Ariz. 290, 294, 394 P.2d 410, 413 (1964).

43. *Id.*

44. State v. Sweet, 143 Ariz. 266, 269, 693 P.2d 921, 924 (1985).

45 *Id.* at 269, 693 P.2d at 924.

46. *See* Thompson & Green Machinery Co., Inc. v. Music City Lumber Co., Inc., 683 S.W.2d 340, 345 (Tenn. Ct. App. 1984), where the court found "nothing ambiguous" about a statute virtually identical to Arizona's statute. *But see Sherwood*, 269 Or. 389, 525 P.2d 135 (1974), discussed *infra* notes 67-70 and accompanying text, where the Oregon Supreme Court clearly found a similar statute ambiguous.

47. The latter view protects innocent third parties by enabling them to recover from persons who set up fraudulent corporations or where the corporation has no assets to meet the plaintiff's loss. On the other hand, the plaintiff may be able to recover on a suit in quasi-contract for unjust enrichment. *See, e.g.*, Van Duker v. Fritz, 222 Cal. App. 2d 228, 35 Cal. Rptr. 55,

joint and several liability, even where the corporation is subsequently held liable.[48]

Currently, Arizona's case law supports the second interpretation. No cases have been decided supporting the interpretation that the corporation should be solely liable after adoption or ratification of a preincorporation agreement. The only basis for the common law interpretation, however, is the common law itself.[49] The statute's interpretation can be changed by releasing the promoter from liability upon the corporation's adoption of the preincorporation agreement. Recent Arizona decisions suggest, however, that the Arizona courts may ultimately favor retention of promoter liability consistent with the common law.[50]

The conceptual problem of interpreting the amendment may have been solved in *Malisewski v. Singer*.[51] The Arizona Court of Appeals decided *Malisewski* after the statute's amendment. The *Malisewski* court applied common law principles and held that a promoter is not relieved of liability even though the previously non-existent corporation ratified the agreement, thereby assuming liability.[52] The problem, however, is that the *Malisewski* court did not rely on the statute to make its decision. Rather, the court relied on a Pennsylvania case, *RKO-Stanley Warner Theatres, Inc. v. Graziano*.[53] Thus, the question remains how section 10-146 should be interpreted.

Despite the fact that the *Malisewski* court never applied the statute, the decision may nevertheless support the common law interpretation. This support rests upon the decision's timing. Because *Malisewski* was decided after the amendment, the court may implicitly have interpreted the statute to retain the common law. *Booker Custom Packing v. Sallomi*[54] supports this proposition.

In *Booker*, the Arizona Court of Appeals rejected the defendant's contention that he could not be held liable because the plaintiffs thought they were dealing with a corporation and not with an individual.[55] The *Booker*

(1963) (quasi-contract protection undermines arguments holding both the promoter and the corporation liable).

48. 1A W. FLETCHER, *supra* note 21, § 190, at 343. "[I]t is not inconsistent for a party to pursue a claim against both the promoter and the corporation." *Id.* at 344. *See also Malisewski*, 123 Ariz. at 197, 598 P.2d at 1016 (The doctrine of election of remedies does not bar suit on a partnership theory because the plaintiff originally elected to sue the corporation.).

49. This premise overlooks the enforcement of the common law rule in instances of fraud. Such liability can, however, be attached as an exception to the former interpretation.

50. *See Spence*, 15 Ariz. App 90, 486 P.2d 211, and *Malisewski*, 123 Ariz. 195, 598 P.2d 1014. *See also* Booker Custom Packing Co., Inc. v. Sallomi, 149 Ariz. 124, 716 P.2d 1061 (Ct. App. 1986), and Crown Zellerbach Corporation v. Farrel, 149 Ariz. 6, 716 P.2d 67 (Ct. App. 1986), where the Arizona Court of Appeals indicates the same intention. In *Crown*, a supplier brought an action against the president of a foreign corporation and his wife claiming that defendant never paid for goods delivered. Plaintiffs contended that the president was personally liable for the corporate obligation under section 10-146. The court held, however, that section 10-146 was applicable only to domestic corporations. By so holding, the court implicitly acknowledged that section 10-146 was a remedy for holding promoters liable for corporate debts. *Id.* at 7, 716 P.2d at 68.

51. 123 Ariz. 195, 598 P.2d 1014 (Ct. App.1979).

52. *Id.* at 197, 598 P.2d at 1016.

53. 467 Pa. 220, 355 A.2d 830 (1976).

54. 149 Ariz. 124, 716 P.2d 1061 (Ct. App. 1986).

55. *Id.* at 126, 716 P.2d at 1063.

court held that this interpretation was inconsistent with section 10-146.[56] *Booker*, however, can be distinguished because the corporation in question was never formed, nor was there any good faith attempt to incorporate.[57] This fact supports the professed function of section 10-146[58]—the elimination of the concept of de facto corporations, in conjunction with another Arizona statute.[59] Since the corporation was never in existence and, therefore, could not ratify an agreement, it was not necessary for the court to interpret the statute's amendment.[60]

STATE COMPARISONS

In searching for a proper interpretation of Arizona's amended statute, it is instructive to look at other states with substantially similar statutory provisions. Courts in Oregon,[61] Washington,[62] Tennessee[63] and the District of Columbia[64] interpret their promoter liability statutes consistent with the common law rule. Oregon's statutory provision is identical in substance to the 1969 Model Act provision,[65] while Washington and the District of Columbia have identical provisions to the Model Act. Arizona's provision, before the amendment, was virtually identical to the Model Act.[66]

A discussion of other states' interpretations is instructive because it demonstrates the difficulty that inheres in the statute's interpretation. According to the rules of statutory construction, when a statute is unambiguous and the legislature amends it, they intend to effect a change in the statute.[67] If such a change is intended, then it is likely that the interpretation of the statute will also change.

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56. *Id.*
57. *Id.*
58. *See* ARIZ. REV. STAT. ANN. § 10-146 (Supp. 1987); T.K. Distributors Inc. v. Soldevere, 146 Ariz. 150, 704 P.2d 280 (Ct. App. 1985).
59. ARIZ. REV. STAT. ANN. § 10-056 (1977). The effect of section 10-056 is to give the corporation legal existence upon the filing of articles of incorporation. In *T.K. Distributors*, section 10-056 was interpreted as abolishing the doctrine of de facto corporations. *T K. Distributors*, 146 Ariz. at 152, 704 P.2d at 282. Although the court gave justification for the interpretation, its effect is taken from the MODEL BUSINESS CORP. ACT § 56 (1969), which is virtually identical to ARIZ. REV. STAT. ANN. § 10-056 (Supp. 1988). The comment to the model provision states that since the provision of the Model Act is unequivocal, "any steps short of securing a certificate of incorporation would not constitute apparent compliance." MODEL BUSINESS CORP. ACT § 146 (comment) (1971). Therefore a de facto corporation cannot exist under the Model Act. The Revised Model Business Corporation Act (1987) has substantially the same provision.
60. That is, all persons who act as a corporation without authority, are held liable for all debts and liabilities arising from their acts. The court actually cited the amended statute. No new interpretation, however, was given to it. Again, this begs the question of how to interpret the statute.
61. *Sherwood*, 269 Or. 389, 525 P.2d 135. *See* OR. REV. STAT. § 57.793 (1953) (repealed 1987).
62. Heintze Corp., Inc. v. Northwest Tech-Manuals, Inc., 7 Wash. App. 759, 502 P.2d 486 (1972). *See* WASH. REV. CODE § 23A.44.100 (1965).
63. *Thompson*, 683 S.W.2d 340.
64. Robertson v. Levy, 197 A.2d 443 (D.C. 1964). *See* D.C. CODE ANN. § 29-950 (1973). The D.C. Code has since been renumbered to D.C. CODE ANN. § 29-399.40 (1981).
65. *See supra* note 33.
66. *See supra* note 33 and accompanying text.
67. *See supra* text accompanying notes 40-46.

The Oregon Supreme Court interpreted Oregon's promoter liability statute and noted its ambiguous character.[68] This ambiguity led the court to reject the common law interpretation in *Sherwood & Roberts-Oregon, Inc. v. Alexander*.[69] The *Sherwood* court held that, due to the ambiguity of the Oregon statutory provision, the common law rule governing preincorporation contracts was not codified by Oregon law.[70] Indeed, the *Sherwood* court held that no "intimation" of the interpretation that the statute codified the common law rule governing preincorporation contracts could be found in all the literature on the Model Business Corporation Act.[71] Further, such an interpretation was not suggested in the wording of the statute.[72]

The Oregon court's position is only superficially inconsistent with the Arizona court's interpretation of the statute. This is true despite the fact that Arizona's common law interpretation is grounded in the statute.[73] The *Sherwood* court held the statute inapplicable because of its ambiguous character and then applied the common law rule. The common law rule, however, is precisely the interpretation that the *Sherwood* court sought to avoid giving the statute.[74] The result is thus consistent with Arizona's interpretation of section 10-146.

In contrast to *Sherwood*, the Washington Court of Appeals in *Heintze Corp., Inc. v. Northwest Tech-Manuals, Inc.*,[75] held that the common law rule of promoter liability on preincorporation agreements has been codified by

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68. *Timberline*, 267 Or. 64, 514 P.2d 1109. In *Timberline*, plaintiff brought an action against defendants as individuals of a corporation for equipment rental past due. Defendants protested against personal liability contending that the rentals were made to a de facto corporation. The *Timberline* court held that de facto corporations no longer existed in Oregon and that the phrase "all persons who assume to act as a corporation" was not necessarily restricted to those persons who incurred the obligation. Liability could extend to persons who had an investment in the corporation and who actively participated in the decision-making process of the corporation. *Id.* at 69, 74-74, 514 P.2d at 1111, 1113-14.

69. 269 Or. at 395, 525 P.2d at 138 (1974).

70. The common law rule governing preincorporation contracts was stated in *Sherwood* as: "[S]ettled by the authorities that a promoter, though he may assume to act on behalf of the projected corporation and not for himself, will be personally liable on his contract unless the other party agreed to look to some other person or fund for payment." *Id. (citing* King Features Syndicate v. Courvier, 241 Iowa 870, 875, 43 N.W. 2d 718, 722 (1950))

71. *Sherwood*, 269 Or. at 395, 525 P.2d at 138.

72. *Id.* The *Sherwood* Court, observed:

> Because the statute was intended to abolish the common law doctrine of de facto corporations, *because it was not intended to apply to the common-law rules governing preincorporation agreements, and because it does not by its terms unambiguously apply to a promoter's liability for preincorporation agreements,* we hold the statute is not applicable and the common-law rule governing the liability of promoters for preincorporation agreements applies.

269 Or. at 395, 525 P.2d at 138 (emphasis added).

73. Prior to the statute, Arizona's stance on promoter liability was consistent with the American common law. *See Spence*, 15 Ariz. App. 99, 486 P.2d 211. After the statute, the American common law interpretation continued. *See Malisewski*, 123 Ariz. 195, 598 P.2d 1014.

74. *Sherwood*, 269 Or. at 395, 525 P.2d at 138. After concluding that the statute was not intended to apply to common law rules governing preincorporation agreements, the *Sherwood* court held that "the common law rule governing the liability of promoters for preincorporation agreements applie[d]." The court reached this conclusion by reasoning that the statute did not "unambiguously apply to common law rules governing preincorporation agreements" and because no support for this interpretation could be found in the Model Business Corporation Act. *Id.*

Washington law.[76] The interpretation of the Washington statute is consistent with the interpretation given by Arizona courts to the unamended Arizona statute. The *Heintze* court held that it was not error for the trial court to hold the defendants personally liable on a lease that was executed prior to the incorporation of their business.[77] Liability, the court held, was clearly established by statute.[78] The same interpretation was given to the District of Columbia statute in *Robertson v. Levy*,[79] and the Tennessee statute in *Thompson & Green Machinery v. Music City Lumber*.[80]

In summary, other state court interpretations support a common law interpretation of the Arizona promoter liability statute. The problem, of course, is that only Arizona has amended its statute.[81] Since neither the Oregon, Washington, nor the District of Columbia legislatures have amended their statute, case law from these states is of little help in interpreting the effect of the amendment on the Arizona statute. Nonetheless, the case law is valuable in demonstrating that states have interpreted similar provisions differently. Oregon claims that the statute is ambiguous,[82] while Tennessee claims that it is clear and definite.[83] Arizona defines the unamended statute as applying the common law.[84] Consequently, Arizona courts must, in keeping with principles of statutory construction,[85] interpret the amendment as effecting a change in the statute.

RECOMMENDATION

The amended Arizona statute should not be interpreted as mere approval of common law principles. If a promoter purports to act on behalf of a contemplated corporation, absent authority, and the corporation subsequently adopts the contract, such adoption or ratification should constitute a novation and the promoter should be released from liability.[86] This is not a novel approach, considering that previous courts have held that corporate adoption releases promoters from liability. This approach is consistent with concepts of fairness because it eliminates the burden on the promoter and distributes it evenly among the remaining parties to the contract. The case in favor of abolishing promoter liability, upon the adoption or ratification of a

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75. 7 Wash. App. 759, 502 P.2d 486 (1972).
76. *Id. See* WASH. REV. CODE § 23A.44.100 (1965).
77. *Heintze*, 7 Wash. App. at 760, 502 P.2d at 487.
78. *Id.*
79. 197 A.2d 443, 447 (D.C. 1964).
80. 683 S.W.2d at 345.
81. The amendment reads, "[r]atification of preincorporation acts constitute authority to act in a corporate capacity as used herein." ARIZ. REV. STAT. ANN. § 10-146 (1977) (effective July 1, 1976).
82. *Sherwood*, 269 Or. at 395, 525 P.2d at 138.
83. *Thompson*, 683 S.W.2d at 345.
84. *Spence*, 15 Ariz. App. 99, 486 P.2d 211.
85. *See supra* notes 40-46 and accompanying text.
86. *See, e.g.*, Frazier v. Ash, 234 F.2d 320 (5th Cir. 1956); Buress v. Montgomery, 23 Ga. App. 590, 99 S.E. 143 (1919); Esper v. Miller, 131 Mich. 334, 91 N.W. 613 (1902); Carle v. Corhan, 127 Va. 223, 103 S.E. 699 (1920); Goodman v. Darden, Doman & Stafford Associates, 100 Wash. 2d 476, 670 P.2d 648 (1983). These courts held that when the contract on behalf of the unformed corporation is formed with a third party who agrees to look solely to the corporation for liability, the promoter incurs no personal liability. *See supra* notes 17-22 and accompanying text.

preincorporation agreement, rests not so much upon case law, however, as upon the criticism leveled at the common law rule.

One commentator suggests that the common law should be altered.[87] His arguments are rooted in fairness. The common law rule permits a third party unfettered choice about whom to hold liable—the corporation, the promoter, or both.[88] Moreover, the common law rule gives third parties unfair advantage in the business community.[89] Parties who contract with a corporation not fully organized assume less risk than parties who contract with individuals or fully organized corporations.[90]

There must, however, be a fraud exception. Where a promoter enters into an agreement without any disclosure that he is acting on behalf of a contemplated corporation or, when the promoter purports to be acting for a corporation that he knows does not exist, and will never exist, personal liability must attach.[91] Were this not so, perpetrators of fraud would be able to escape liability on a contract by assigning the contract to a shell corporation.

Other concepts of fairness should also be considered. Releasing the promoter from liability when the corporation adopts the agreement is fair. This idea need not be inconsistent with the intent analysis required in other contractual arrangements.[92] When the promoter enters into a contract with a third party, representing himself as an agent on behalf of a non-existent corporation, it is more likely that the third party intends to hold the corporation rather than the promoter liable.[93] The corporation, after all, is intended to perform the contract. It follows, therefore, that liability should attach to the party intended to perform.[94]

Moreover, promoter liability, subsequent to corporate adoption, violates the concept of contractual mutuality.[95] Upon the subsequent corporate adoption of a preincorporation agreement, the promoter retains no contractual rights.[96] Promoters cannot sue if the third party breaches.[97] Only the adopting corporation may sue.[98] The unfairness is clear. The promoter retains liability

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87. Kessler, *Promoters' Contracts: A Statutory Solution*, 15 RUTGERS L. REV. 566 (1961).

88. 1A W. FLETCHER, *supra* note 21, § 216. "Both the promoter and the corporation are liable for adopted services, unless it clearly appears that liability of the promoter was not intended, or the contract provides that adoption shall work a release or unless there is a novation." *Id.* at 474.

89. Kessler, *supra* note 87, at 582.

90. *Id.*

91. *Id.* at 583-84.

92. *See supra* note 28 and accompanying text.

93. This problem can be avoided where the promoter and third party spell out in the contract that the promoter is released from liability upon corporate adoption of the contract. *See* Weeks v. San Angelo Nat'l Bank, 65 S.W.2d 348, 349 (Tex. Civ. App. 1933). Many times, however, this is not the case. The third party may not want to relieve the promoter of liability, thus preserving its double security blanket.

94. "When performance of a duty under a contract is due any non-performance is a breach." RESTATEMENT (SECOND) OF CONTRACTS § 235(2) (1979).

95. *See* Speedway Realty Co. v. Grasshoff Realty Corp., 248 Ind. 6, 10, 216 N.E.2d 845, 847 (1966) ("A contract of a corporation, or a contract made by the promoters and subsequently adopted by the corporation, can be enforced only through an action brought by the corporation."). *See also* 18 C.J.S. *Corporations* § 133 (1939).

96. *Speedway*, 248 Ind. at 10, 216 N.E.2d at 847.

97. *Id.*

98. 18 C.J.S. *Corporations* § 133 (1939).

for the corporation's breach but may not enforce the corporation's contractual rights.[99]

The promoter is subject to this unequal arrangement until such time as the corporation and the third party mutually agree to release him from liability.[100] To hold that a promoter can never be discharged from liability, absent a novation, is too strict and disregards the intent of the parties.[101] One commentator has suggested other arrangements.[102] A corporation, by agreeing to the promoter's contract, takes the place of the promoter, thereby assuming all responsibility for any liabilities that may arise under the preincorporation agreement.[103]

Such an interpretation can and should be given to the Arizona statute. Obviously, if the corporation subsequently ratifies the contract, it is receiving the benefits of the promoter's actions, whether or not the promoter had previous authority to act.[104] Likewise, the promoter is held liable if he acts without authority and the corporation fails to ratify the preincorporation agreement.[105]

A new test should be applied to determine a promoter's liability on preincorporation contracts. This test should include four steps. First, has the promoter entered into a contract on behalf of a non-existent corporation? Second, has the corporation adopted or ratified the contract? Third, have the corporation and the third party contractor entered into a novation to release the promoter from liability, or, has the third party agreed to look solely to the corporation for liability? Finally, is the corporation genuine or has it been established to defeat promoter liability in connection with a fraudulent scheme?

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99. The rights of the corporation are deemed to be those of the corporation and not the promoter even though the promoter may be liable on the contract. *Id.*

100. *See supra* notes 17 & 22.

101. 1 H. OLECK, *supra* note 28, § 39, at 208.

102. 2 S. WILLISTON, A TREATISE ON THE LAW OF CONTRACTS § 306 (3d ed. 1959).

103. If the assent of the corporation to the bargain is merely an adoption of it, the promoter apparently must still remain liable.

> But it seems more nearly to correspond to the intention of the parties to suggest that when the corporation assents to the contract, it assents to take the place of the promoter—a change of parties to which the other side of the contract assented in advance. There would then be a novation which would discharge the promoter at the same time the corporation assumed the obligation.

Id. at 431.

104. Whether or not the promoter had previous authority to act has no bearing if the corporation accepts and ratifies the agreement. The corporation would still receive the benefits of the promoter's actions and the promoter could still be held liable. This follows logically from the idea that, absent a novation, a promoter cannot be released from his or her obligations. *See supra* notes 17 & 22.

105. If the promoter enters into a contract with a third party and the corporation does not ratify the agreement, the promoter is deemed to have entered into the contract with the third party and will subsequently be liable. This is true because it is neither desirable to hold a corporation liable for a contract that it does not wish to adopt nor to hold it liable for an unauthorized contract, assuming, of course, that it does not adopt the contract. This proceeds from the notion that corporate liability will not attach unless the corporation adopts or ratifies the preincorporation agreement. 1A W. FLETCHER, *supra* note 21, § 205. *See also* Ong Hing v. Arizona Harness Raceway, Inc. 10 Ariz. App. 380, 387, 459 P.2d 107, 114 (1969). Moreover, the promoter is liable even if the corporation ratifies the agreement but fails to enter into a novation with the third party. *See supra* notes 17, 22-28 and accompanying text.

If the promoter entered into a contract on behalf of an unformed corporation and the corporation adopts or ratifies the agreement, the promoter should be released from liability. Similarly, if the corporation and third party enter into a novation to release the promoter from liability, or the third party agrees to look solely to the corporation for liability,[106] the promoter should be relieved of liability. If, on the other hand, the corporation adopts or ratifies an agreement which is designed to defraud the third party, the promoter should not be released from liability. This will protect innocent third parties from fraudulent individuals who enter into contracts and use the corporation to avoid liability.

This interpretation fairly addresses the conflicting interests of the parties to a preincorporation agreement. The third party contractor is protected from fraudulent individuals who use corporate status as a shield from liability. The corporation can establish business relationships while attaining its corporate status. And, promoters are effectively relieved of liability upon the subsequent formation of the corporation and its adoption of the preincorporation agreement.

CONCLUSION

This Note focused on the interpretation of the 1976 amendment to Arizona's promoter liability statute. Although the Arizona statute is not a promoter liability statute per se, its effect is the same.[107] Indeed, the 1969 Model Act provision upon which Arizona's statute was modeled has subsequently been titled "Liability for Preincorporation Transactions."[108]

This Note illustrates the unfairness of the continued common law application of the statute in light of its subsequent amendment. In adding an amendment to an already clear and unambiguous statute, the legislature signaled the need for a change. It is no longer necessary to apply the common law rule interpretation to the statute.

The statute should be interpreted consistent with principles of fairness as expressed by commentators on the subject.[109] These commentators suggest that, absent fraud, corporations adopting preincorporation contracts relieve the promoters of liability. This interpretation is consistent with concepts of fairness and justifiably replaces the outmoded common law rule.

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106. *See, e.g., Carle*, 127 Va. 223, 103 S.E. 699.

> [Generally,] persons dealing with promoters of a corporation to be thereafter formed are allowed the double security of the promoters and the corporation when it comes into being; but where . . . the contract was made solely on behalf of, and that the credit was extended solely to, a corporation which was then in process of formation, and which shortly thereafter procured its charter, the rule does not apply.

Id. at 234, 103 S.E. at 702-03.

107. The Arizona statute is titled "Unauthorized assumption of corporate powers." ARIZ. REV. STAT. ANN. § 10-146 (1977) (effective July 1, 1976). Its use, however, is focused on the liability of those persons who act as a corporation without authority, i.e., before the entity has achieved corporate status.

108. MODEL BUSINESS CORP. ACT § 2.04 (1985).

109. *See supra* notes 87 & 102.