Corporations: The Promoter's Dilemma

Robert L. Henry III
University of Kentucky

Follow this and additional works at: https://uknowledge.uky.edu/klj

Part of the Business Organizations Law Commons

Right click to open a feedback form in a new tab to let us know how this document benefits you.

Recommended Citation
Available at: https://uknowledge.uky.edu/klj/vol29/iss4/5
NOTES

CORPORATIONS: THE PROMOTER'S DILEMMA

ROBERT L. HENRY III

The scope of this note will be limited to the question of the liability of the corporation for the pre-incorporation services and expenses of the bona fide promoter and will not consider the question of subsequent adoption of the promoter's contracts or the subject of "secret profits." An attempt also will be made to show that the courts have recognized the difficulties inherent in the pre-incorporation period and that, in attempting to avoid them, they have perhaps unwittingly discriminated against the promoter in favor of others. Finally, a solution will be suggested as a cure for a situation which at present and for a long time past has existed as an unfair condition without an adequate remedy.

For the benefit of those who may have the fiction and screen conception of the promoter as one who serves no real economic purpose, but is instead a "slicker" trying to sell a "gold brick" or worthless stock and therefore not entitled to any compensation or consideration, it is felt necessary to define "promoter" and to quote from one of the classic cases on the subject, Bigelow v. Old Dominion Copper Co:

"The term 'promoter' is a term not of law but of business. A promoter is one who seeks opportunities for making advantageous purchases and profitable investments in industrial or other enterprises, who interests men of means in such a project, when found organizes them in a corporation for the purpose of taking over the project, and attends upon the newly formed company until it is fully launched in business. He may be a stockholder, director, officer or none of these. His services begin before the company is formed and ordinarily are not concluded until sometime after its formation."

Such a definition is, however, incomplete in that it fails to indicate that "the promoter is the creative force of the corporate enterprise, for corporations do not spring into being spontane-

* The writer of this note, a member of the Law Journal staff, is the son of the contributor of the leading article to be found on page 369.

1 Bigelow v. Old Dominion Copper Mining & Smelting Co., 74 N. J. Eq. 457, 71 Atl. 153, 171 (1908).
It must also be remembered in looking at successful organizations that often "behind the veil of outward effort and apparent achievement stand the initiative, resourcefulness, and driving force of a single man," the promoter.

There are many degrees of service which a promoter may perform for the benefit of the future corporation for which he should be compensated. These vary from the mere conception of the enterprise to pushing the project through to success as a going business. The promoter may go to some very real expense hiring engineers, accountants and lawyers and spending many months investigating the project himself. He may go to considerable labor and expense in acquiring property for the use of the future corporation and in supervising improvements on the property. In most cases, however, the promoter makes it clear to everyone with whom he deals that they must look to the future corporation and not to him for reimbursement and that any contracts the promoter makes for services or property are in the name of the future corporation. Ordinarily after the concern is fully organized and incorporated the promoter is voted a handsome reward for his services in the form of stock in the corporation, the customary amount being 10% of the total stock issue where his services were merely creative, although he might take as much as 51% where he combined the services of promoter, investor and banker. It is, however, with the cases where the corporation refuses to compensate the promoter or to adopt specifically his pre-incorporation contracts that the body of this paper deals.

The general weight of authority in the United States stands clearly for the proposition that a corporation is not liable for the pre-incorporation services and expenses of the promoter unless it expressly agrees to make such payment or unless the court can infer from the facts a new contract to reimburse him. This is

---

Id. at 264.

---
also the English rule, but the law in England goes a step further and provides emphatically that not only is the corporation not liable to the promoter, but that neither is it liable to strangers with whom a promoter may have contracted in the name of the corporation. The American courts, as will be shown, are considerably less emphatic in regard to this latter position, and the text writers, although they agree in principle with the majority view, often sympathize with the minority view without attempting to justify it. The main hurdle over which the majority of the courts refuse to jump in holding as they do, is comprised of three elements, two being of the law of contracts. The first is, that prior to the act of incorporation no such thing as the corporate entity existed and therefore at the time the services were performed or the contracts made, there was no principal and consequently no privity between the parties. Secondly, that in order to have a valid contract there must be an acceptance. Before its existence the corporation cannot accept and afterwards it cannot object to the rendition of services or avoid benefits which have already been performed without uncreating itself. The third element is perhaps fundamental, in that the courts feared that the interests of future stockholders would be prejudiced if the promoter were allowed to indebt the corporation before it came into existence. As to the first two elements there is no satisfactory answer. They are good law; although the result of the hurdle which they support may create an injustice. But as to the third element neither the corporation nor the stockholders would be substantially harmed or affected


by paying a reasonable amount, equivalent to the benefit actually received, for services and expenses rendered.⁹

Denial of liability on the part of the corporation might be assumed to be the limit to which the courts have gone in discouraging the promoter; yet a number of courts have declared that it is more reasonable to hold that any services performed by the promoter who thereafter became a director are gratuitous.¹⁰ This could be taken as actual encouragement to the new corporation to refuse compensation to the person primarily responsible for its creation; at any rate it is unreasonable to expect anyone under such decisions to do any promoting.¹¹

It is well to keep in mind the difficulties which the majority of courts cannot overcome when one considers the minority cases; for in them it can be seen that in the courts’ attempt to provide reasonable compensation for the promoter it ignored the hurdle entirely by finding an implied contract to pay for the benefits received and for services performed with the expectation of being paid therefore.¹² The minority view is well expressed in the Kentucky case of the Farmers Bank (of Vine Grove) v. Smith which says:

“A corporation is, by an implied contract, liable for such or any services rendered for the use of the corporation as are necessary to its formation. . . . It seems to us that any other rule would render it difficult to organize any corporation, however necessary. No person would render the services or pay another to do so, however essential it be to organization if there was no obligation to pay by the corporation after it is brought into existence.”³³


¹²"It is clear that no business man will undertake the risks incident to organization and early financial sponsorship of an industrial enterprise without at least a promise of a liberal return in case of the successful outcome of the venture. To deny this by law is to force the business man to adopt secret methods of securing profits which because they are circuitous and indirect are far more socially harmful than the open acknowledgment by law that the promoter is entitled to pay for his services." Dewing, Op. Cit. Supra note 3, at 262, footnote J.


Although there is no so-called minority English rule which could be cited in support of the above view, there is an unexplained inconsistency in decisions of both the British and American Courts in regard to the reasonable amount of compensation for pre-incorporation services and expenses which the promoter is allowed, in the form of a recoupment, when he has been sued by the corporation for the return of "secret profits."¹⁴ The courts are silent as to the grounds on which the promoter is permitted to retain this back door compensation. Such silence might well be taken as apparent encouragement to the wily promoter to attempt to make large "secret profits" on the assumption that if he is eventually made to return them he will at least get a reasonable compensation for his services and expenses in the form of a recoupment, which is more than the honest straightforward promoter could expect.

Between the majority and minority views there are a considerable number of courts that seek to avoid the harsh effects of the technicalities of the hurdle, yet cannot shut their eyes entirely to the legal principles which prevent them from agreeing with the minority view. They seek, therefore, to find various distinctions whereby they can allow a recovery in quasi-contract or by estoppel, where the corporation has accepted the benefits. In none of these cases, however, do the courts allow the promoter acting alone to recover for his services, but insist on finding an implied contract between the promoter or corporators and a stranger,¹⁵ and in order to bind the corporation the pre-incorporation services must have been found necessary and reasonable; the contract must have been made in the name of the company with the understanding that it was for the benefit of the future corporation and that the parties looked to it alone for pay.¹⁶

¹⁴ Mason v. Carrothers, 105 Me. 392, 74 Atl. 1030, 1037 (1909); Hayward v. Leason, 176 Mass. 310, 57 N. E. 656, 662 (1900); Lydney, etc. v. Bird, 33 Ch. D. 85, 96 (1886); Emma Silver Mining Co. v. Grant, 11 Ch. D. 918, 941 (1879); Bagnall v. Carlton, 6 Ch. D. 371, 400 (1877).


The principal distinction made by the courts has arisen where the company acquired property by reason of the promoter's pre-incorporation contract with the stranger and by having accepted the benefits of the contract the corporation was thereafter held to be estopped from denying liability. The grounds for recovery here might, however, be considerably complicated where labor was done on the property which was thereafter acquired by the corporation, for if the labor were already performed and the company then took the property it would have no choice but to take the labor also. However, this difficulty apparently has not worried the courts very much.

In a Kentucky case where the subscribers to stock in the future corporation contracted for improvements on the land, all of which were intended thereafter to be taken over by the corporation, the company was in fact held liable for the amount of a mechanic's lien or for the pre-incorporation services of a stranger which it could refuse only by failing to take the land upon which the assets of the corporation were based. However, in an Indiana case the court says that the corporation is not bound by the contract indebtedness because "the lien is not the creature of the contract, but of the law. It is the law and not the contract which gives the lien."

(1889); Perry v. Little Rock, etc., Ry. Co., 37 Ark. 164, 191 (1881): "It should appear that the view of the future organization was mutual between the contracting parties, and that the labor, material, etc., were furnished at the time, on behalf of the future company, with the view, authorized by the assurances of the projectors, that the company, when chartered, would assume the debt, as created in its behalf. In such case only would the acceptances of the benefits of the contract amount to a ratification, and implied promise at law. . . ."


18 Grand River Bridge Co. v. Rollins, 13 Colo. 4, 21 Pac. 897 (1889); Chicago Building & Mfg. Co. v. Talbottton Creamery Co., 106 Ga. 84, 31 S. E. 809 (1898); Koeppler v. Redfield Creamery Co., 12 S. E. 483, 81 N. W. 907 (1900).

19 Waddy Blue Grass Creamery Co. v. Davis-Rankin Co., 103 Ky. 579, 45 S. W. 895 (1898).

20 Davis-Rankin Co. v. Vice et al., 43 N. E. 889 (Ind. 1896).
The basis upon which the courts find a further distinction on which to allow a recovery, is not as firm as that where the corporation could accept or reject property received under contract with strangers, for in the following cases it is difficult to see how the corporation could object to the benefits received.\footnote{Chicago Building & Mfg. Co. v. Talbotton Creamery Co., 106 Ga. 84, 31 S. E. 809 (1898); Maryland Apartment House Co. v. Glenn, 49 Md. 395 (1877).} For instance, in the Kentucky case of \textit{Morton v. Hamilton College}\footnote{Morton v. Hamilton College, 18 Ky. L. R. 765, 38 S. W. 1 (1896).}, the plaintiff advanced money to the promoters with the agreement and understanding that it was to be repaid to him by the corporation when it was brought to life. The court says in this case that the corporation will be estopped from denying that the promoters had power to bind it when the very payment of the money gave the corporation life. In an Ohio case also we find the court saying “that where promoters of a corporation go forward in good faith and contract debts which are necessary to the creation and advancement of the corporation, and the corporation afterwards avails itself of the benefits of those acts, the corporation is liable, and upon the plainest principles of justice and right it should be held.”\footnote{City Building Assn. v. Zahner, 6 Ohio Dec. Reprint 1068 (1891).} It is contended herein that the latter court is quite right that the corporation should be liable upon the principles of justice and right, but it is impossible to see the liability in terms of contract or agency.

Another reason for distinction even weaker than the preceding one has been found in the proposition that where a majority of the subscribers or promoters contract for services, the corporation when formed will be liable therefor.\footnote{Morton v. Hamilton College, 18 Ky. L. R. 765, 38 S. W. 1 (1896); Clarke v. O. & S. W. R. R., 5 Nebr. 314 (1877); Low v. Railroad, 45 N. H. 370 (1864); Merchants Nat'l. Bk. of Carlisle v. Eckels, 191 Pa. 372, 43 Atl. 245 (1899); Bell's Gap R. R. v. Christy, 19 Pa. St. 54, 21 Am. Rep. 39 (1889).} Why a number of agents without a principal is better than one is not explained; and even if the corporation existed, what, it is asked, would be the result if a majority of the stockholders contracted in the name of the corporation? The answer is obvious, for it is a well established principle that stockholders \textit{per se} are not the corporation which can only contract through its officers or agents.
The final distinction attempted by some courts, if in truth it can be called a distinction at all, is one found in the fact that the one performing the pre-incorporation services is an attorney. The courts have permitted attorneys to be compensated for such services and expenses in a number of cases. All the objections that the majority view both in the United States and England found to making the corporation liable for the promoter's services and expenses can be equally well found in regard to the attorney. Perhaps, however, the court feels a closer kinship to the attorney than to the promoter; at any rate it describes his relation to the corporation in City Building Assn. v. Zahner as being that "of 'accoucher' to this infant corporation. When it becomes able to stand and act for itself it availed itself of his labor."

One of the reasons for defining the promoter in detail in the beginning was to point out that he served a real economic purpose and that he was therefore entitled to a reasonable compensation; but it can be seen that with the exception of the minority opinion and the cases of recoupment in an action for the return of "secret profits" the promoter sole has found it next to impossible to collect for his services, in bringing the corporation into the world, if it should prove recalcitrant. On the other hand the courts have apparently gone to extreme lengths in attempting to compensate the stranger with whom the promoter or corporator has found it necessary to deal in creating the corporation and has done so on an obviously unsubstantial basis. It is submitted that there is a real discrimination in favor of the stranger at the expense of the promoter, whom the courts categorically hold to be in a fiduciary relationship to the corporation even prior to its creation, when they hold that the stranger may deal at arm's length with the corporation through a pre-incorporation contract with the promoter.


The promoter is therefore in a dilemma. He may be in a position by his efforts to increase substantially the wealth of society yet hesitate because of the problematical quality of his compensation. Particularly would this be true where, as in most cases, the bankers take over control. It is, therefore, suggested as a way out of the dilemma that, before any promotional expenses are incurred or services performed, and before the banker has been approached at all, the project created and as it exists in the mind of the promoter be incorporated into what might be called a promoter's corporation. This corporation would contain all the elements and features of the final project or corporation towards which the promoter is directing all his energies. Its articles of incorporation would contain everything that the promoter is able to foresee as being necessary to the corporation in its final state except its final capitalization. If, however, there were features that needed revising and enlarging this could be done at a future date by simply amending the articles of incorporation of what at the beginning was called the promoter's corporation so that finally this preliminary corporation would grow to its full statute. When such a procedure is followed, it is then possible for the promoter to contract with the corporation for his compensation and the corporation will thereafter be estopped from denying that it was a corporation at the time of the contract and will be held liable. To incorporate in this manner it is, however, necessary to have a statute similar to that of Kentucky which gives the corporation an inchoate or formative existence pending completion of organization allowing it during this period a limited corporate power to contract for reasonable and necessary promotional services as was done in the Kentucky case of


28 Kentucky Statutes (Carroll's 1936 ed.) Sec. 541, "Until the directors are elected the signers of the articles of incorporation shall have the direction of the affairs of the organization of the corporation, and may take such steps as are proper to obtain the necessary subscriptions to stock and to perfect the organization of the corporation."
Standard Drilling Co. v. State.\textsuperscript{29} The possible joker in this particular Kentucky statute is a provision in sec. 4225 which levies a stiff organization tax on the basis of the capital stock to be issued, and as stated in the articles of incorporation. This tax is payable at the moment of incorporation and might make the cost too great if the final amount of stock contemplated were stated in the articles of incorporation of the promoter's corporation. But as a practical matter at this stage of the promotion and under the plan suggested here it will usually be impossible to determine what capitalization will be necessary in the future, because this preliminary corporation should be merely the first step in promotion after the project has been conceived in the mind of the promoter. Therefore, in these articles of incorporation the capitalization should be stated at a purely nominal amount, thus avoiding the burden of the organization tax. Then, when the promoter has performed his function as previously described, even to getting subscriptions for the necessary amount of stock which by that time would have been ascertained, the original articles of incorporation would merely be amended to show the real or final capitalization of the completed project or corporation. In other words the promoter's corporation at that time would agree to enlarge itself to its full stature and pay all the necessary expenses of such growth including the organization tax on the increased capitalization.

To complete the picture, the statute providing for a corporation's formative existence should be enlarged so as to make it liable for reasonable attorneys' fees and expenses in drawing up and filing its preliminary articles of incorporation. This slight change in the Kentucky statute would not affect what has been suggested and can already be done under it at present in regard to the formation of an inchoate preliminary corporation, here called the promoter's corporation.

By the above procedure it is possible for the corporation to bear the expenses necessary in creating itself which is only just and equitable. The promoter would get his just dues and the hurdle by which the majority of the courts have been balked would be obviated.

\textsuperscript{29}Standard Drilling Co. v. State et al., 205 Ky. 714, 266 S. W. 377 (1924).