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SOUTH  AUSTRALIA

SIXTY-SECOND REPORT

of the

LAW REFORM COMMITTEE

of

SOUTH AUSTRALIA

to

THE ATTORNEY-GENERAL

RELATING TO REFORM OF COMPANY LAW RELATING TO PRE-INCORPORATION CONTRACTS

1980

The Law Reform Committee of South Australia was established by Proclamation which appeared in the *South Australian Government Gazette* of 19th September, 1968. The Members are:

THE HONOURABLE MR. JUSTICE ZELLING, C.B.E., *Chairman.*
THE HONOURABLE MR. JUSTICE WHITE, *Deputy Chairman.*
THE HONOURABLE MR. JUSTICE LEGOE, *Deputy Chairman.*
D. W. BOLLEN, Q.C.
M. F. GRAY, S.-G.
J. F. KEELER.
D. F. WICKS.

The Secretary of the Committee is Miss J. L. Hill, c/o Supreme Court, Victoria Square, Adelaide, 5000.

The Honourable Mr. Justice White was on long service leave and the Honourable Mr. Justice Legoe was on circuit and accordingly neither of them signed this report.

SIXTY-SECOND REPORT OF THE LAW REFORM COMMITTEE OF SOUTH AUSTRALIA ON REFORM OF COMPANY LAW RELATING TO PRE-INCORPORATION CONTRACTS

To:

The Honourable K. T. Griffin, M.L.C.
Attorney-General for South Australia.

Sir,

In considering the new Companies Bill which you referred to us for consideration, it became evident that the law in relation to contracts entered into on behalf of a company about to be formed, required consideration by us.

We thought it simpler to set out our views on the topic in a short separate report which can be read along with and as supplementary to our Fifty-Seventh Report on the principal topic.

We make one general comment on the drafting of sections 35A and 35B of the new bill as they now stand, before dealing with the subject as a general topic of law.

It is this:—

These should not apply if the proper law of the contract is not that of a reciprocating Australian State or Territory. In Section 35B it is hard to see why it is necessary to take away the right of a person who enters into a contract before the formation of the company to enforce it personally, as he may do at present.

That general comment is however only useful if the sections stand in their present form. For the reasons given below, we think they should not do so.

Turning now to the consideration of the necessary reform of the law which should, in our opinion, be essayed in relation to this topic, we report as follows:—

The traditional starting point for a discussion of the problems of pre-incorporation contracts is *Kelner v. Baxter (1866) L.R. 2 C.P. 174.* In that case three persons who were to become the directors of a company signed a contract, while the company was not yet in existence, for the supply of goods that were to be used in the business of the company. The signatures were followed by the words "on behalf of the Gravesend Royal Alexandra Hotel Co. Ltd.". The company was subsequently registered but quickly became insolvent. The supplier therefore sued the signatories personally. The action succeeded. The Court held that the company could not acquire rights or incur obligations by reason of acts antecedent to its formation. Therefore one of two possible consequences had to follow: either the Court would attach personal liability to the signatories or the contract would fail altogether. In fact the Court, professing to apply the principle *ut res magis valeat quam pereat,* held that the signatories were personally bound by the written terms of the contract and refused to allow them to introduce extrinsic evidence to show that they had not intended to incur personal liability.

This case has always been accepted in subsequent authority as correctly decided, although implausible and unconvincing interpretations and distinctions have been adopted in order to avoid applying the principle for which it stands. But the assumption that the decision is correct seems to us disputable. In particular the refusal to admit

extrinsic evidence seems inconsistent with earlier authority and to have been made *per incuriam*. Counsel for the defendant sought to introduce "overwhelming evidence to show that it never was the intention of the parties that those who did the mere formal act of signing the agreement should be personally liable" [*(1866) 2 C.P. at 182*]. The Court declined to hear this evidence, presumably upon the basis of *Higgins v. Senior (1841) 8 M. & W. 834*, a case which decided that a person who signs a contract ostensibly as a principal cannot adduce extrinsic evidence to show that he intended to act merely as an agent. However, equity intervened to give relief against the rigours of this rule. In *Wake v. Harrop (1861) 6 H. & N. 786* (affirmed *(1862) 1 H. & C. 202)* the plaintiff sued the defendants personally for breach of a charter party that they had signed ostensibly as principals but with the intention of acting merely as agents. It was held by an overwhelming body of judicial opinion (Pollock C.B., Martin B., Bramwell B., Wilde B., Crompton J., Willes J., Byles B., Keating J. and Mellor J.) that although the defendants were liable at law, they nevertheless had a good equitable defence. The facts in *Kelner v. Baxter* are parallel in all material respects. Assuming the correctness of the Court's construction of the written contract, and that the defendants were therefore liable at law, they should nevertheless have been permitted, in accordance with the principle of *Wake v. Harrop,* to adduce extrinsic evidence with a view to establishing the equitable defence.

The High Court of Australia has taken the view that *Kelner v. Baxter* does not establish any new principle under which an agent, professing to act for a non-existent principal, becomes personally liable upon the contract, but is rather merely an instance of a more general principle that in construing a contract the fundamental object must be to arrive at the intention of the parties. Fullagar J.'s statement in *Summergreene v. Parker (1950) 80 C.L.R. 304* that ". . . . the fundamental question in every case must be what the parties intended or must fairly be understood to have intended" is often cited with approval. To reconcile *Kelner v. Baxter* with that proposition is a somewhat Procrustean task. The High Court has attempted to do so by deducing that the defendants in *Kelner v. Baxter* did in fact intend to be personally bound, or at any rate that they gave no unequivocable indication that they did not intend to be bound. The argument rests upon two bases. First, there is an attempt to minimize the significance of the words "on behalf of the Gravesend Royal Alexandra Hotel Co. Ltd." appearing after the signatures of the defendants. Willes J. had suggested that these words did not necessarily import agency: "Putting the words 'on behalf of the Gravesend Royal Alexandra Hotel Co.' would operate no more than if a person should contract for a quantity of corn 'on behalf of my horses'" *(1866) 2 C.P. at 185.* This statement was cited with approval by all Judges of the High Court in *Black v. Smallwood 117 C.L.R. 52* but it entirely ignores the form of the contract. The words "on behalf of the Gravesend Royal Alexandra Hotel Co." followed the signatures of the defendants. A person who, in contracting for a quantity of corn, signed a contract and then added the words "on behalf of my horses", would be manifesting symptoms of an interesting and unusual form of hippomania that would fall more appropriately within the province of psychiatric rather than legal analysis. Willes J.'s suggestion should indeed be regarded as spurious. It forms only a very subsidiary aspect of his judgment, and on that point he was not supported by any other member of the Court. All the remaining Judges acknowledged that if the company had not been labouring under the disability of non-existence, it would have been unambiguously bound by the contract.

In *Black v. Smallwood* the High Court develops another argument with a view to establishing that the defendants in *Kelner v. Baxter* must have intended to incur personal liability. The Court attaches importance to the fact that, when the contract was made, all parties knew that the company had not yet been incorporated. From this the Court deduces that the parties must all have contemplated that the defendants would be personally liable. But that conclusion does not follow necessarily from the premises and a close examination of the facts of the case proves it to be false. The reporter records the following facts:

> "In pursuance of this agreement the goods were handed over to the company, and consumed by them in the business of the hotel; and on the 1st February a meeting of the directors took place at which the following resolution was passed: 'that the arrangement entered into by Messrs. Calisher, Dales and Baxter on behalf of the company for the purchase of the additional stock on the premises as per list taken by Mr. Bright the secretary and pointed out by Mr. Kelner, amounting to nine hundred pounds be, and the same is, hereby ratified'." [*(1866) 2 C.P. at 177*].

The order of events was as follows: the contract was executed on the 27th January; the above meeting of the proposed directors was held on 1st February; the company was incorporated on 20th February. The fact that this meeting of the proposed directors took place and purported to ratify the contract shows conclusively that the defendants mistakenly thought that they could validly act on behalf of the company before its incorporation. The High Court's argument that because the defendants knew that the company was unincorporated they must have intended to incur personal liability, is simply destroyed by the facts.

The High Court's exposition of *Kelner v. Baxter,* involving as it does the proposition that any presumption of personal liability must yield to the actual intention of the parties which constitutes the "fundamental question", severely emasculates the principle of the case. The fact is that in the usual case, where prospective directors of a company act in good faith, but prematurely, in the name or on behalf of the proposed company, the human signatories *never* intended to incur personal liability. The state of debility in which the High Court's decision has left the law may be illustrated by *Hawke's Bay Milk Corporation v. Watson (1974) 1 N.Z.L.R. 236.* A manufacturer of yoghurt entered into a contract with the defendants who professed to be agents of a company that would act as a wholesale distributor of yoghurt in Auckland. The company had not been formed when the contract was made. It was subsequently registered but had only a brief and inglorious existence. It went into liquidation some ten months after its formation and was in liquidation at the time of the proceedings. The manufacturer sued the defendants personally for the value of yoghurt supplied. Wild C. J. found that the defendants honestly believed on the date of the contract that the company was already in existence. The Chief Justice adopted the rationalization of *Kelner v. Baxter* suggested by the High Court in *Black v. Smallwood.* He therefore exonerated the defendants from liability on the ground that they had not intended to become personally liable. Such a result must flow, almost inevitably, from applying *Black v. Smallwood.* The pendulum did swing back to some extent in New Zealand in *Marblestone Industries v. Fairchild (1975) 1 N.Z.L.R. 529.* That case has, however, a number of unsatisfactory aspects, and we need not pause to consider it now.

The principle enunciated in *Kelner v. Baxter* has suffered further attrition by the adoption of the distinction propounded in *Newborne v. Sensolid [1954] 1 Q.B. 45* and followed in *Black v. Smallwood* "between a case where the execution of a document if effected by the subscription of the company's name followed by the signature of a director or directors as such and the case where the document is executed by an agent on behalf of the company" *(117 C.L.R. at 60).* It was held in *Black v. Smallwood* that because the former method of execution was chosen, and the signatories signed not as agents but as the human intermediaries of a non-existent metaphysical creature, there could be no contract, and the question of applying *Kelner v. Baxter* simply did not arise. This distinction has, in our opinion, absolutely nothing to commend it. If we are to approach a contract that purports to be binding upon a non-existent company with the intention of upholding the contract then either we must jettison our ontological objections to the idea of binding a company by contracts made before it comes into existence, or we must, as *Kelner v. Baxter* decides, attach liability to the human signatories. The reasons for taking the latter course must surely be equally good or bad, as the case may be, whether the signatories profess to act as the agents or as the human intermediaries of the company.

We turn now to Sections 35A and 35B of the Companies Bill. We think that one might make the following observations:—

(a) The provisions seem to be directed at a non-existent problem. Their object seems to be to provide a procedure by which a person, acting with full knowledge of the law, may make a contract for the benefit of a company yet to be formed. They provide that the agent will be bound on a collateral warranty unless the contract contains a clause exempting him from liability and a statement setting out the terms of Section 35B. But there never was a problem in this regard. There is not the slightest difficulty in contracting with a view to acquiring a benefit for a future company provided that the contracting parties are prepared to assume personal liability. Nor is there any real difficulty if the party acting for the future company wants to avoid personal liability. In such a case, one would merely include a condition subsequent in the contract entitling either party to rescind should the company fail to come into existence within a reasonable time, or decline to take an assignment of the contract.

There may be some slight value in empowering a company to ratify a contract made by a professed agent prior to its incorporation. The inability of a company to ratify such a contract is, at present, a minor problem which the Bill, in its present form, would overcome.

However, the real problem in this area of the law arises when prospective directors of a company that has not yet been formed act prematurely in the mistaken belief either that the company does already exist, or that action taken by them before the incorporation of the company will bind it when it comes into existence. The proposed new provisions will not reach these cases because there will be, in all probability, no indication in the contract that the company does not yet exist—a condition that must clearly be satisfied if Section 35A(3) is to operate and that is also presupposed (although not so clearly) by Section 35A(1).

(b) The amendments do not make clear what status the contract has prior to ratification. The contract may well be a nullity at common law. Are we to conclude that the party who contracts with the purported agent may withdraw, with impunity, from the contract at any time prior to ratification? The problem has already been encountered in the "cooling-off" provisions of such Acts as the Business Agents Act. The position should be made clear.

(c) The new provisions do not make it clear whether they are intended to provide an *exclusive* means of entering into contracts with a view to benefiting future companies. We are inclined to think that must have been the intention. But then what effect will the new provisions have upon a contract that does not in fact conform with the new provisions? That question should surely be dealt with.

(d) The requirement imposed by Section 35A (2) that a copy of the contract and of the resolution ratifying the contract should be lodged with the Commission seems unnecessary and officious. We cannot see what conceivable interest the Commission would have in the matter. If the subsection remains, it should be made clear whether non-compliance with the requirement has any civil consequences.

(e) The reference to "Subsection (1)" in Section 35B (3) should be a reference to "Subsections (1) and (2)".

(f) Section 35B (4) seems misconceived. If the company does not ratify, then there will be no contract, or at least no contract to which the company is a party and under which it may receive a benefit. We might observe, in passing, that Section 35B (4) *(d)* seems to empower the Court to order a company to indemnify a purported agent for damages awarded against him in an action for breach of warranty irrespective of whether the company has received any benefit.

(g) We are perplexed by Section 35B (5). It seems to negate the earlier provision enabling an "agent" to contract out of personal liability. In any event we cannot see why a prospective director of a future company should be expected to guarantee that the company will fully perform the contract. That may well be a salutary requirement, but if it is to be introduced, it should apply to company contracts generally.

In our opinion, an entirely new approach is needed to the problem of the pre-incorporation contract. The problem normally arises where a prospective director acts in good faith, but prematurely, in the business of the company. No solution that has been hitherto proposed is entirely satisfactory. The solution suggested by *Kelner v. Baxter* that the directors should be personally liable does too much violence to the intentions and expectations of contracting parties who act in good faith without intending to incur personal liability. On the other hand, it is equally unsatisfactory to follow *Black v. Smallwood* and find the contract void in every case. The most satisfactory solution would be, in our opinion, to modify the ontological prejudices which prevent us from believing that a company can be bound by an act occurring before its incorporation. If a person contracts in the name or on behalf of a non-existent company and when the company comes subsequently into existence that person has actual, usual or ostensible authority to contract in the name or on behalf of the company, the contract should,

in our opinion, be regarded as a valid contract binding that company. A provision to this effect would cover the vast majority of cases. In order to make the provision logically complete, a provision along the lines of Section 9 (2) of the United Kingdom European Communities Act 1972 could be included but with modifications limiting its operation to cases not covered by the principal provision. The section as a whole might then take the following form:—

(1) Where—

(a) a person purports to contract in the name or on behalf of a company;

(b) the company is not then in existence but comes into existence within a reasonable time after the contract is purportedly made;

and

(c) either—

(i) the person contracting in the name or on behalf of the company has, upon the incorporation of the company, actual, usual or ostensible authority to enter into contracts in the name or on behalf of the company of the same kind as the contract in question;

or

(ii) the persons who become the first directors of the company, or a majority of them, authorise, ratify or acquiesce in the making of the contract (either before or after the incorporation of the company),

the contract is binding upon the company.

(2) Where—

(a) a person purports to contract in the name or on behalf of a company when the company is not in existence;

and

(b) the contract is not binding upon the company under subsection (1),

the contract binds the person who purported to contract in the name or on behalf of the company as a principal.

(3) Where a contract that binds, as a principal, a person who purported to contract in the name or on behalf of a company subsequently becomes binding upon the company in accordance with subsection (1), the company shall, in the absence of any contrary intention expressed in the contract, be substituted for that person as a party to the contract and shall be subrogated to the rights and obligations of that person under the contract.

We think that the last few words of the proposed subsection (3) might better be phrased "and the rights and obligations of that person under the contract shall be deemed to be assigned to the Company who may sue and be sued thereon".

If this suggestion is adopted, it would in our view deal in a rational and reasonable way with this difficult problem. The solution propounded by us has the additional merit of being in consonance with the commercial expectations of those who enter into this type of contract. As Lord Mansfield rightly pointed out long ago, the law falls into discredit if it does not mirror accurately the modes of thought and

the needs, even if they are not always articulate, of the commercial community which uses the law in its daily transactions.

We should perhaps add, as we have done in the Sixtieth Report, that if it is impracticable at this stage to make so considerable a reform of the projected Sections 35A and 35B of the new Companies Bill, you may think it proper to request the National Commission to refer this topic to the Committee for further study and report.

We have the honour to be

HOWARD ZELLING
D. W. BOLLEN
M. F. GRAY
J. F. KEELER
D. F. WICKS

Law Reform Committee of South Australia.

18th June, 1980.

D. J. WOOLMAN, GOVERNMENT PRINTER, SOUTH AUSTRALIA

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