

University of Pennsylvania Law Review

And American Law Register

FOUNDED 1852

Published Monthly, November to June, by the University of Pennsylvania Law School,
at 34th and Chestnut Streets, Philadelphia, Pa.

VOL. 79

JUNE, 1931

No. 8

MODERN DEVELOPMENT IN THE LAW OF PRE- INCORPORATION SUBSCRIPTIONS

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The persons primarily interested in the formation of a business corporation frequently desire to begin the process of financing the proposed enterprise before the formal steps resulting in the formation of the corporation are complete. One of the devices employed in this process of assembling funds is the pre-incorporation subscription.

The use of the term "subscription," as applied to transactions with an *existing* corporation, is not restricted by courts and text-writers to the description of one fact situation and one set of legal consequences.¹ This plural use of the term "subscription" is also to be found with reference to transactions concerning a corporation to be formed.² In this paper the term "pre-incorporation subscription" denotes a written or oral manifestation, made to a person engaged in the enterprise of forming an identifiable corporation, of the subscriber's consent to become a shareholder of shares of a designated class and number in the proposed corporation and to pay an ascertainable sum thereto.³

¹ Frey, *Post-Incorporation Subscriptions and Other Contracts to Create Shares at a Future Time* (1929) 77 U. OF PA. L. REV. 750, 751.

² *Ibid.* 750.

³ A pre-incorporation subscription may take an infinite variety of forms. It may be oral or written. It may be a distinctly individual transaction, or it may be specifically related to similar manifestations by other persons as where

Text-writers⁴ and other authorities,⁵ when dealing with the legal problems arising out of pre-incorporation subscriptions, customarily attempt to determine "the nature" of the transaction. Two theories are usually presented: (1) a pre-incorporation subscription is merely a continuing offer to the corporation to be formed, or (2) it is a contract between the subscribers, or between each subscriber and the promoters and that the subsequently formed corporation is either an assignee or a third-party beneficiary of this contract.⁶ There is a tendency to classify cases dealing with the legal aspects of pre-incorporation subscriptions approvingly or disapprovingly in accordance with their conformity to the theory favored. Rarely is any effort made to differentiate diverse types of actions and thus more sharply to define the purpose for which such classification is sought.

An adequate picture of what modern courts in this country are doing when confronted with problems arising out of pre-incorporation subscriptions must proceed from the standpoint of

a "subscription list" is signed. The word "subscribe" may not appear and such other language may be employed as "I hereby purchase, etc." The transaction may include definite provisions as to the time and manner of payment of the agreed amount, the time when the subscriber is to become entitled to a share certificate, the legal relations between the subscriber, the promoters, the other subscribers, the incorporators and other interested persons in the interim, etc. But usually the transaction presents a skeleton form which gives little or no indication of the intent of the parties with respect to such controversial matters.

⁴ BALLANTINE, PRIVATE CORPORATIONS (1927) § 33; 1 COOK, CORPORATIONS (1923) § 75; 2 FLETCHER, CYCLOPEDIA OF PRIVATE CORPORATIONS (1917) § 523; 1 MACHEN, CORPORATIONS (1908) § 249; 1 THOMPSON, CORPORATIONS (1927) § 587.

⁵ Lukens, *The Withdrawal and Acceptance of Pre-Incorporation Subscriptions to Stock* (1928) 76 U. OF PA. L. REV. 423, 424; Morris, *The Legal Effect of Pre-Incorporation Stock Subscriptions* (1928) 34 W. VA. L. Q. 219, 220.

⁶ Under the "contract" theory either of these conflicting results would seem analytically possible: (1) that by virtue of his subscription the subscriber at once becomes a member of an "association" and that when this association is transformed into the contemplated corporation, he automatically becomes a shareholder in such corporation of the shares designated in his subscription; (2) that the subscription is an offer which the subscriber has no power to revoke without the consent of the other parties to the contract; (3) that the subscription is an offer which the subscriber has the power to revoke without the consent of the other parties to the contract, but the subscriber is under a duty to such other parties not to exercise this power of revocation without their consent.

Both the "offer" theory and the "contract" theory are utterly inadequate to account for the modern development in the law of pre-incorporation subscriptions. This fact has been so clearly discussed by Lukens and by Morris in their respective articles (*supra* note 5) that it will be assumed, and referred to only *en passant* throughout the remainder of this paper.

the nature of the action, *e. g.*, was the nascent corporation suing the subscriber to enforce payment in full of the subscription amount; was it suing him for damages; was the suit being maintained on behalf of corporate creditors to compel the subscriber to pay the subscription amount in full; were the creditors seeking to enforce a statutory responsibility against the subscriber; was the subscriber suing the corporation for a share certificate, or for dividends or the right to vote or to examine the corporate records, or was he seeking to maintain a representative suit on behalf of the corporation? Obviously the effect of an attempted withdrawal of the subscription or of "non-acceptance" by the corporation will not necessarily be the same in one type of action as in another. This article is limited to a presentation of the prevailing rules with respect to two of these foregoing actions: (1) suits by the corporation against a pre-incorporation subscriber to compel payment of the amount designated in his subscription; and (2) actions by the pre-incorporation subscriber against the corporation to compel the corporation to accord to him one or more of the normal incidents of the shares designated in his subscription.

I

SUITS BY THE CORPORATION FOR THE SUBSCRIPTION AMOUNT

When a newly formed corporation sues a pre-incorporation subscriber for the subscription amount, one of the following defenses⁷ is frequently interposed by the subscriber:

- (1) the corporation has not "accepted" his subscription;
- (2) the subscription has been effectively withdrawn;
- (3) the corporation is not the corporation in which he agreed to become a shareholder.

⁷ Other defenses are (a) that the corporation has no power to create the shares subscribed for, or no power to create them as to the subscriber or for the agreed return, (b) that the subscription is conditional and the condition has not been fulfilled, and (c) that the subscription was induced by misrepresentation, fraud, duress, or illegal act. For a discussion of the power of a corporation to create shares, see Frey, *op. cit. supra* note 1, at 759. For a summary of modern judicial tendencies with respect to conditions in pre-incorporation subscription, see Comment (1927) 37 YALE L. J. 226, 231-237.

The Defense of Non-Acceptance by the Corporation

When a corporation sues on a pre-incorporation subscription most courts talk as if an "acceptance" were pre-requisite to the corporation's right to the subscription price. But if the subscriber urges as a defense to the action that the corporation has not "accepted" his subscription, this defense is never successful.⁸ The explanation of this is that the courts purporting to require corporations to "accept" pre-incorporation subscriptions as a condition precedent to a right to the subscription price say either (1) that the bringing of the suit is sufficient "acceptance,"⁹ or (2) that "acceptance" is to be inferred or implied from acts of the corporation after its formation.¹⁰ The courts maintaining the doctrine of "implied acceptance" are ready to extend it to any act of the corporation which can be described as in reliance on the pre-incorporation subscription, whether or not the performance of such act was required by the subscription or even communicated to the subscriber.

Both of these rules, while couched in the language of offer and acceptance, are unknown to orthodox contract law. Virtually any act which a corporation may do after its formation may be said to have been done in the expectation of receiving the amounts designated in pre-incorporation subscriptions. Hence, these courts, while talking the language of offer and acceptance, have

⁸ For a somewhat similar conclusion see *Morris, op. cit. supra* note 5, at 225.

⁹ *Utah Hotel Co. v. Madsen*, 43 Utah 285, 134 Pac. 577 (1913) at 300: "It is next contended that we failed to determine the question of whether the corporation after it was organized had accepted the agreement entered into by the appellant. We did not deem the question worthy of special consideration in view of the fact that it is generally held that the bringing of an action upon the agreement constitutes a sufficient acceptance." See also *Leelanau Transit Co. v. Hondek*, 239 Mich. 101, 214 N. W. 142 (1927).

¹⁰ *Richelieu Hotel Co. v. Military Encampment Co.*, 140 Ill. 248, 29 N. E. 1044 (1892) at 261: "But it is said that the evidence fails to show an acceptance of the subscription by the plaintiff after its incorporation. Whether such acceptance took place or not is a mere question of fact which is not open for consideration here. It may be said, however, that no formal acceptance was necessary, an acceptance being inferable from the conduct of the plaintiff in retaining the subscription in its possession and expending large sums of money on the faith of it, and these facts the evidence tends to prove." To the same effect see *Rutenbeck v. Hohn*, 143 Iowa 13, 121 N. W. 698 (1909); *Bullock v. Falmouth etc. Co.*, 85 Ky. 184, 3 S. W. 129 (1887); *McCormick v. Great Bend Co.*, 48 Kan. 614, 29 Pac. 1147 (1892).

in fact been developing a rule of the law of corporations, namely, that immediately upon its formation the corporation has a right to the subscription price.¹¹

Some courts, recognizing that the law of offer and acceptance is not an adequate explanation of the right of the corporation to the subscription price, assert that the subscriber is obligated to pay the subscription price, because immediately upon the formation of the corporation he becomes a shareholder.¹² While this reason is unsound¹³ (if the issue were the right of the subscriber to dividends, to vote, etc., instead of the right of the corporation to the subscription price, there is nothing to indicate that these same courts would hold that the subscriber automatically became a shareholder upon the formation of the corporation), the important fact remains that here, too, as in the cases referred to above, the courts are according to the corporation, immediately upon its formation, a right to the subscription price.

It will be noted that the foregoing right arises "upon the formation of the corporation." The determination of when a corporation is formed depends in large measure upon one's conception of what a corporation is. The term "corporation" might

¹¹ If this right of the corporation to the subscription price arises only after it has made a demand therefor upon the subscriber, it might be more accurate to describe the corporation's relationship to the subscriber as a power, by such demand, to create in itself a right to the subscription price. There are several other questions which are reciprocally related to this problem of whether demand of the subscription price is prerequisite to a right thereto: (1) if the corporation brings an action against the subscriber for the subscription price without having made any previous demand therefor, and the subscriber pays without judicial compulsion, will the costs of the proceedings be assessed against the plaintiff or defendant; if the corporation gets a judgment for the subscription price, is it entitled to interest from the time of its formation; does the statute of limitations begin to run from the time of the formation of the corporation?

¹² *Cartwright v. Dickinson*, 88 Tenn. 476, 12 S. W. 1030 (1890) at 482: "But at the moment when the conditions required by law as preliminary to the granting of the charter were complied with, the subscribers became shareholders, entitled to a voice as shareholders in all subsequent proceedings, and to compel specific performance of the contract of memberships. At the same time all the obligations of a shareholder were assumed, and the liability to pay the amount of the shares became fixed and absolute." See *Twin Creek etc. Co. v. Lancaster*, 79 Ky. 552 (1881); *Phoenix Warehousing Co. v. Badger*, 67 N. Y. 204 (1876); *Bole v. Fulton*, 233 Pa. 609, 82 Atl. 947 (1912); *Jeannette Bottle Works v. Schall*, 13 Pa. Super. 96 (1900).

¹³ Except in the situation set forth *infra* note 35.

be defined factually, *e. g.*, the issuance of a certificate of incorporation by a designated state official might be said to result in the formation of a corporation regardless of the legal consequences of that act. On the other hand, the term "corporation" might be restricted to apply to an aggregate of legal incidents regardless of the facts out of which they arise. For the purpose of explaining the right under discussion, this paper adopts the latter conception of a corporation.

The legal incidents most commonly embraced by the term "corporation" are: (1) the power of the associates to sue and be sued and to hold and convey property in a common name; (2) the freedom of the associates from personal responsibility for obligations incurred by the group; and (3) the exclusive management of the enterprise by persons selected by the associates, or a class of associates. Throughout this paper a corporation is said to exist when, and only when, this totality of incidents occurs;¹⁴ hence the "formation of the corporation" takes place when all the acts have happened which are pre-requisite to the existence of these incidents. Normally, these acts are a sufficient compliance with the general statutory requirements for "incorporation" to entitle the incorporators to a "certificate of incorporation" from the state officials (if any) designated to issue such certificates. But in many jurisdictions further acts, sometimes described as acts of "organization" (election of officers, allotment of shares, etc.), are required as conditions precedent to the existence of one or more of these incidents, *e. g.*, limited responsibility of the associates.¹⁵ Under such circumstances the formation of the corporation does not occur until the acts of "organization" as well as the acts of "incorporation" have taken place.

¹⁴ Compare the definition of "corporation for profit" set forth in the Definitive Section, RESTATEMENT OF BUSINESS ASSOCIATIONS (Am. L. Inst., Tentative Draft No. 1, 1928) 9. See also definitions of "incorporation" and of "legal personality" set forth in CONFLICT OF LAWS RESTATEMENT (Am. L. Inst., Proposed Final Draft No. 1, 1930) 196, Comments *a* and *b*.

¹⁵ See, for example, *Wechselberg v. Flour City National Bank*, 64 Fed. 90 (C. C. A. 7th, 1894); *Walton v. Oliver*, 49 Kan. 107, 30 Pac. 172 (1892); *Rau v. Union Paper Mill Co.*, 95 Ga. 208, 22 S. E. 146 (1894).

The Defense of Withdrawal of the Subscription

Although the rule is not universally followed,¹⁶ by the vast weight of authority the subscriber may preclude the possibility of incurring any obligation to pay the subscription price by a withdrawal¹⁷ of his subscription prior to the incorporation¹⁸ of the proposed corporation.¹⁹ This power he may exercise even though his subscription was contained in a subscription list signed by other pre-incorporation subscribers after he had subscribed thereto.²⁰ There is no clear indication in the decided cases as to

¹⁶ Except where influenced by statutory requirements, the cases which hold that the subscription cannot be withdrawn even prior to the formation of the corporation proceed on the theory that the subscription list constitutes a contract between the subscribers and hence cannot be revoked. This is a *non sequitur*. Assuming that there is a "contract" between the subscribers (which the vast majority of courts deny), the legal consequences of such contract may be either (1) no power to withdraw the subscription, or (2) power to withdraw but a duty to each of the other subscribers not to exercise this power. The first interpretation is no more "inevitable" than the second. See Corbin, *Offer and Acceptance, and Some of the Resulting Legal Relations* (1917) 26 YALE L. J. 169, 185-197.

¹⁷ In this paper the term "withdrawal" is used factually to denote a manifestation by the subscriber that he no longer consents to become a shareholder of the shares designated in his subscription. So varied are the circumstances attending the formation of the proposed corporation that no useful general rule can be stated as to the persons to whom this manifestation must be made in order to be operative. Notification of withdrawal to the promoters or to the person in charge of the subscription list, or possibly to any other subscriber, would appear to be adequate.

¹⁸ It should be noted that the point in the development of the proposed enterprise at which the pre-incorporation subscriber incurs a disability to withdraw his subscription is not in every instance the same as that at which the right of the corporation to the subscription price accrues. As heretofore set forth, the right of the corporation to the subscription price arises when all acts have occurred prerequisite to the existence of the incidents of a corporation as previously defined; this point is described herein as "formation" of the corporation. The disability of the subscriber to withdraw his subscription arises when the articles of association have been duly filed or recorded pursuant to statutory requirements; this point is described herein as "incorporation" of the corporation. Usually formation and incorporation coincide, but occasionally incorporation precedes formation.

¹⁹ Lukens, *op. cit. supra* note 5, at 424 and 425; BALLANTINE, *op. cit. supra* note 4, at §§ 114-117; 2 FLETCHER, *op. cit. supra* note 4, at § 563; 1 Machem, *op. cit. supra* note 4, at § 249; 1 THOMPSON, *op. cit. supra* note 4, at § 592.

²⁰ In many of the cases upholding the power of the subscriber effectively to withdraw his subscription prior to the formation of the corporation, the subscriber had signed a subscription list. See, for example, *Bryant's Pond Steam-Mill Co. v. Felt*, 87 Me. 234, 32 Atl. 888 (1895) in which the subscription began as follows: "We, the undersigned, hereby agree to pay for the number of shares set opposite our names." The power to withdraw similar subscriptions was upheld in *National Bank v. Amoss*, 144 Ga. 425, 87 S. E. 406 (1915); *Muncy Traction Co. v. Dela Green*, 143 Pa. 269, 13 Atl. 747 (1888); *Lewis*

whether or not by such withdrawal the subscriber would incur a duty to other subscribers who had relied on his subscription, or to the corporate promoters, to compensate them for such damage as they might have suffered therefrom.²¹

Cases of attempted withdrawal of pre-incorporation subscriptions after the incorporation of the corporation are less numerous than those involving withdrawals prior thereto, but the results are more uniform. However much the courts may differ as to the effect of withdrawals prior to incorporation, they are quite agreed that after incorporation of the corporation the subscriber cannot by an attempted withdrawal avoid whatever obligations would otherwise result from his subscription.²²

Even if it be feasible to describe a pre-incorporation subscription as an "offer" or as a "contract" for other purposes, such terminology is clearly inapplicable for the purpose of presenting the law as to withdrawal, in view of the fact that the subscription may be effectively withdrawn up to the time of incorporation of the corporation but not thereafter. Perhaps an explanation of the readiness of courts to uphold withdrawal of pre-incorporation subscription, at least until after the corporation is incorporated is to be found in the judicial consciousness or belief that promoters of new enterprises are frequently glib and persuasive individuals, and investors gullible and credulous persons; hence the courts are ready to give the subscriber a chance to amend an ill-considered

v. Hillsboro Roller Mill Co., 23 S. W. 338 (Texas 1893). Cf. Collins v. Morgan Grain Co., 16 F. (2d) 253 (C. C. A. 9th, 1926).

An attempted withdrawal, which otherwise would be effective, may be rendered inoperative by statutes prescribing or relating to the formal requisites of an enforceable pre-incorporation subscription.

²¹ See Morris, *op. cit. supra* note 5, at 222: "The writer has found no case (short of an underwriting agreement) in which individual subscribers were successful in a suit against a defaulting co-subscriber for damages for failure to take and pay for stock. And it is interesting to note that in such a suit in Montana a recovery was denied" (citing Deschamps v. Loiselle, 50 Mont. 565, 148 Pac. 344 (1915)).

²² Ryder v. Alton & Sangaman Ry., 13 Ill. 516 (1851); Bullock v. Falmouth *etc.* Co., 85 Ky. 185, 3 S. W. 129 (1887); Glass Coating Co. v. Clark, 118 Ohio 10, 160 N. E. 460 (1928); Balfour v. Baker City Gas Co., 27 Ore. 300, 41 Pac. 164 (1895); Myrtle Point Mill *etc.* Co. v. Clarke, 102 Ore. 533, 203 Pac. 588 (1922); Auburn Bolt Works v. Shultz, 143 Pa. 256, 22 Atl. 904 (1891); Berwick Hotel Co. v. Vaughn, 300 Pa. 389, 150 Atl. 613 (1930); Gleaves v. Brick Church Turnpike Co., 1 Sneed 491 (Tenn. 1853).

decision, provided he manifests his change of intention before the process of forming the enterprise has gone too far, and the point of incorporation of the corporation has been adopted as a more or less arbitrary "dead line."

The Defense That the Corporation Is Not the Corporation in Which the Subscriber Agreed to Become a Shareholder

Obviously a pre-incorporation subscription for shares in a proposed corporation imposes upon the subscriber no obligation to any corporation other than the one in which by his subscription he manifested his consent to become a shareholder. Whether the corporation formed is that corporation is a matter of degree. The answer depends in large measure upon the extent to which the objects, the authorized share capital, the incidents of the shares to be created, *etc.*, of the proposed corporation are indicated by the terms of the subscription, or operative attendant circumstances, and the extent to which the objects, *etc.*, of the corporation formed vary from those of this proposed corporation. Only one phase of this subject will be dealt with in this article, namely, the defense that the corporation formed is not the contemplated corporation if it is "de facto."

If, in the attempt to form a corporation the statutory requirements have been so far complied with as to produce all the incidents of a corporation as heretofore defined, but there has nevertheless been sufficient non-compliance to entitle the state successfully to maintain *quo warranto* proceedings to terminate this corporate existence, the association is usually called a "de facto" corporation. Many text writers assert that a "de facto" corporation has no right against a pre-incorporation subscriber to the subscription price.²³ The cases cited in support of this conclusion do not substantiate the proposition. These cases are of four types:

(1) those where there was not sufficient conformity with the statutory requirements even to produce the normal

²³ BALLANTINE, *op. cit. supra* note 4, at § 36, page 124; 1 COOK, *op. cit. supra* note 4, at § 186; 1 MACHEN, *op. cit. supra* note 4, at § 260.

incidents of a corporation, *i. e.*, where the association is not even a corporation *de facto*; ²⁴

(2) those where the plaintiff corporation was found by the court to be *de jure* and not *de facto*, and any statement that a *de facto* corporation cannot enforce a pre-incorporation subscription is therefore only *dictum*; ²⁵

(3) those where the corporation formed was held to be materially different in object or structure from that contemplated in the pre-incorporation subscription and this fact is held to be a defense to the payment of the subscription price; ²⁶

(4) those where the subscriber by his subsequent conduct is said to have "waived" the "implied condition" that a corporation *de jure* be formed, or to have become estopped to deny that the association is a corporation *de jure*, and hence the alleged defense that the corporation is "de facto" is not allowed. ²⁷

No case has been found which, on its facts and decision, actually holds that a "de facto" corporation cannot enforce a pre-incorporation subscription. In every case examined, if sufficient acts had occurred to result in the incidents of a corporation as heretofore defined, the right of the corporation to the subscription

²⁴ See, for example, *Capps v. Hastings Prospecting Co.*, 40 Neb. 470, 58 N. W. 956 (1894) (failure to comply with the statute requiring articles of association to be filed in county where principal office was to be located was held to have precluded the formation of a corporation; the court said, at 478, 58 N. W. at 959: "If the plaintiffs in error are to pay for the stock subscribed, it of course follows they become entitled to the stock. This would make them stockholders in a *de facto* corporation, and liable as copartners (italics the author's), where their contract was to become liable as stockholders"); *Indianapolis Furnace etc. Co. v. Herkimer*, 46 Ind. 142 (1874) (no certificate of incorporation was shown to have been filed or recorded); *Williams v. Citizens' Enterprise Co.*, 25 Ind. App. 351, 57 N. E. 581 (1900) (the court said, at 357, 57 N. E. 583: "As there is no statute authorizing the organization of a corporation for the purposes named, it follows that the articles of association are void."); *Richmond Factory Ass'n v. Clark and Alexander*, 61 M. E. 351 (1873) (the Secretary of State rejected the certificate of incorporation; the court said, at 357: "The doings under such attempted organization became void and of no effect."); *Clark v. Barnes*, 58 Mo. App. 677 (1894) (the Missouri Court declared that the organization formed was in contravention of the laws of Arkansas).

²⁵ See, for example, *Schloss and Kahn v. Montgomery Trade Co.*, 87 Ala. 411, 6 So. 360 (1888).

²⁶ See, for example, *Doris v. Sweeney*, 60 N. Y. 463 (1875).

²⁷ See, for example, *Clay Co. v. Harvey*, 9 Utah 497, 35 Pac. 510 (1894); *Owenton etc. Co. v. Smith*, 13 S. W. 426 (Ky. 1890).

price was upheld unless the subscriber had some other defense than that the corporation was subject to *quo warranto* proceedings to terminate its existence. Moreover several cases²⁸ expressly hold that a *de facto* corporation can compel payment of a pre-incorporation subscription.²⁹

There is no sound reason for implying that a corporation must prove *de jure* existence as a condition precedent to enforcing a pre-incorporation subscription. If the subscriber becomes a shareholder in a *de facto* corporation, he acquires shares in an association virtually indistinguishable from a *de jure* corporation, for the existence of a *de facto* corporation is subject only to direct attack by the state of its incorporation, and this threat is far more theoretical than real. In some jurisdictions *quo warranto* proceedings against a private corporation may be brought only by the Attorney-General *ex-officio*, and he practically never acts against a *de facto* corporation unless it has so conducted itself after formation as to make the termination of its existence desirable. When the relator is a private individual, the writ or information issues only in the discretion of the court. Furthermore if the relator is not an "interested" party, if the injury is of a "private" nature and generally if there is another "adequate" remedy, *quo warranto* will not be permitted.³⁰

For these reasons, *quo warranto* proceedings to terminate the existence of a *de facto* corporation are so scarce as to be negligible. For the eleven-year period from April, 1916, to April, 1927, the *American Digest* reports but twenty-seven cases throughout the entire United States of *quo warranto* proceedings to ter-

²⁸ *McCarter v. Ketcham*, 74 N. J. L. 825, 67 Atl. 610 (1907) (the court said, at 827, 67 Atl. at 611: ". . . the liability to pay for the stock subscribed was fully proved when the certificate of incorporation was proved, and the corporation became a corporation *de facto*. . . . The theory of the plaintiff in error that the subscription to pay is conditioned upon the formation and organization of a corporation *de jure* is utterly without substance."); *Cayuga Lake R. R. v. Kyle*, 64 N. Y. 185 (1876); *Wadesboro etc. Co. v. Burns*, 114 N. C. 353, 19 S. E. 238 (1894)

²⁹ All the authorities agree that the fact that a corporation is "de facto" and not "de jure" is no defense to the payment of a post-incorporation subscription. BALLANTINE, *op. cit. supra* note 4, at § 36, pp. 123-4; 1 COOK, *op. cit. supra* note 4, at § 185.

³⁰ See Comment, *Quo Warranto and Private Corporations* (1927) 37 YALE L. J. 237, 240.

minate the existence of a corporation, and of these only twelve were successful. These twenty-seven cases embraced seventeen jurisdictions, no one of which reveals more than two cases.

II

ACTIONS BY THE SUBSCRIBER FOR RECOGNITION AS A SHAREHOLDER

Although the corporation has a right against the subscriber to the subscription price immediately upon its formation³¹ (subject to the defenses noted),³² the subscriber does not automatically become a shareholder, *i. e.*, entitled to any of the incidents normally pertaining to shares,³³ upon either the incorporation or the formation of the corporation. For the creation as to the pre-incorporation subscriber of the incidents of the shares designated in his subscription an act by the corporation after its incorporation, recognizing him as the holder of such shares, is necessary.³⁴ Among the acts which constitute such recognition are a resolution of the board of directors allotting to him shares of the class and number designated in his subscription, the tender to him of an appropriate share certificate, the entry of his name on the corporate records as a holder of the designated shares, notifying him

³¹ *Supra*, page 1009.

³² *Supra*, pages 1007-16 and note 7.

³³ For the sense in which the term "share" is used herein, see Frey, *op. cit. supra* note 1, at 754.

³⁴ Very few cases have arisen in which a pre-incorporation subscriber is seeking to compel a reluctant corporation to recognize him as a shareholder. Normally the corporation is only too glad to receive the subscriber as a shareholder of the shares designated in his subscription. The leading case on this subject is *Starret v. Rockland Fire Insurance Co.*, 65 Me. 374 (1876). In that case the plaintiff by the terms of his written subscription agreed "to take and secure" the amount set opposite his name. He failed, however, to accompany the subscription with stipulated collateral, and evidence tended to show that he refused to pay the subscription after the corporation was formed. His name was entered on the stock ledger and filed with the Secretary of State; seventeen years later he brought an action for dividends. The court found for the defendant on two grounds: (1) that the plaintiff had not fulfilled the conditions of his subscription by securing it with collateral, and (2) that the corporation had not "accepted" the subscription. The court also found that plaintiff's name had been entered on the stock ledger under a "mistake of fact". See also *Clapp v. Gilt Edge Mines Co.*, 33 S. D. 123, 144 N. W. 721 (1913) and *Wallace v. Eclipse Coal Co.*, 83 W. Va. 321, 98 S. E. 293 (1919).

of shareholders' meetings, and holding him out as a shareholder to prospective corporate creditors.³⁵

Demand by the corporation of payment of the subscription price may or may not be an exercise by the corporation of its power to cause the subscriber to become a shareholder. The effect of such demand depends on whether or not the circumstances indicate that it is recognition of the subscriber as a shareholder. If the demand is an unconditional recognition of the subscriber as a shareholder, he at once becomes a shareholder of the shares designated in the subscription, unless he has one of the defenses, heretofore noted, to the payment of the subscription price; neither payment to the corporation of the agreed return nor tender to the subscriber of a share certificate is essential to the creation of shares. Normally, however, such demand is only an offer to recognize the subscriber as a shareholder upon compliance therewith, and the corporation withholds recognition of the subscriber as a shareholder until it has received the payment demanded.

But even a demand unaccompanied by such recognition is not devoid of legal consequences. It has the effect of creating as to the subscriber a power to make himself a shareholder of the designated shares by paying the portion of the subscription price demanded. This power, it should be noted, he did not have prior to the corporation's demand; it results from the demand, and is revocable at any time prior to its exercise. Furthermore, the power is subject to the terms of the subscription, which may stipulate that the subscription price is to be paid in instalments or upon call by the directors, and that the shares are not to be created until the final instalment or call has been paid, or until a designated date thereafter.

It would seem that an involuntary payment of the price, pursuant to a judgment obtained by the corporation and a successful levy of execution thereon, would similarly cause the subscriber to become the holder of the shares designated in the subscription and subject to the benefits and burdens thereof.

³⁵ The existence of a statute requiring all incorporators to be subscribers, or all subscribers to be incorporators, and all subscriptions to be contained in the articles of association may result in the subscribers becoming shareholders immediately upon the *incorporation* of the corporation.

Occasionally a pre-incorporation subscriber pays money or transfers property to the promoters of the proposed corporation on account of his subscription, which money or property they turn over to the corporation upon its incorporation. While such receipt of the money or property by the nascent corporation is not of itself a recognition of the subscriber as a shareholder of the shares designated in his subscription, its retention beyond a reasonable time obligates the corporation to create such shares as to him unless accompanied by a disclaimer of its right to the subscription price.³⁶ If the corporation disclaims this right,³⁷ it subjects itself to a duty to repay or retransfer this money or property to the subscriber with interest or rental value from the time of its formation.

Summary

The law of corporations for profit is of such comparatively recent and rapid development that heretofore its exponents have almost inevitably looked to other subjects of the law, and not within the economic structure of the corporate device, for guidance in the solution of wholly novel problems. Pre-incorporation subscriptions are in fact *sui generis* transactions developing a law unto themselves out of the needs and customs of the business community. The following rules are offered as a summary of this development, a summary not of a portion of the law of contracts or of agency but of a fragment of the law of corporations, frankly self-sufficient and requiring no dogmatic support from other topics of legal study.

1. Immediately upon the formation, within a reasonable time,³⁸ of the corporation contemplated in a pre-incorporation subscription, the corporation has a right against the subscriber to that portion of the subscription price the payment of which is not postponed by the terms of the subscription, unless

(a) the subscriber effectively withdrew his subscription *prior* to the incorporation of the corporation, or

³⁶ Wallace v. Eclipse Coal Co., *supra* note 34.

³⁷ Martin v. Cushwas, 86 W. Va. 615, 104 S. E. 97 (1920).

³⁸ Cf. Francis Hotel v. Chicco, 131 S. C. 344, 127 S. E. 436 (1925).

(b) the subscription is conditional, and the condition has not been fulfilled, or

(c) the corporation has no power to create the shares subscribed for, or no power to create them as to the subscriber or for the agreed return, or

(d) the subscription was induced by fraud, misrepresentation, duress or illegal act.

2. This right of the corporation ceases to exist, if, within a reasonable time after its formation, it does not either demand payment from the subscriber of the subscription price or recognize him as a shareholder of the shares designated in his subscription.

3. This right exists even though the corporation is a corporation "de facto."

4. This right does not exist until all acts have occurred prerequisite to the existence of all the incidents of a corporation, *e. g.*, limited responsibility of the members.

5. The subscriber can preclude this right from coming into existence by withdrawing his subscription before the articles of association have been filed or recorded pursuant to statute.

6. The subscriber does not become a shareholder of the shares designated in his subscription until the corporation recognizes him as the holder thereof.

The development of this apparent lack of mutuality between the legal position of the corporation and that of the subscriber is an adjustment to a need of the corporate world.³⁹ One may speculate plausibly that the economic reasons for the rule that the corporation upon its formation at once has a right to the subscription price are (1) that capital is the most desperate need of a newly formed corporation, and technicalities of "acceptance," etc., must not be permitted to hinder its acquisition, and (2) that when

³⁹ There is nothing to indicate an imminent abandonment of any of the rules above set forth; the prolonged survival of any rule of law is some indication that it works tolerably well or at least that society is able to adjust its practices so as to nullify otherwise onerous results.

a new enterprise has progressed to the point of formation of the corporation, so many persons might be adversely affected in such various ways by the failure of a subscriber to make his agreed contribution to the common fund that the most feasible procedure is to accord the corporation a right to the subscription price.

On the other hand, owing primarily to the fact that pre-incorporation subscriptions to more shares than the amount of the corporation's authorized share capital may have been obtained, and that some of the subscribers may be or have become financially irresponsible persons, unable to pay the designated subscription amounts, it is desirable that the subscribers should not become shareholders automatically upon the formation of the corporation, but that those in charge of the enterprise should have some power of selecting the future members. The subscriber is amply protected by the requirements that the corporation must enforce its right to the subscription price by demand within a reasonable time or forfeit the right, and that if it elects to enforce this right it must recognize him as a shareholder upon his payment of the subscription in accordance with its terms.