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with a view to earning promotional profits." *Daly v. Jackson*, 226 Or 471, 478, 360 P2d 542, 545 (1961).

The term "promoter" is one broadly used to describe the person who brings the corporation into existence. It is a business term, not particularly a legal term. *King Features Syndicate v. Courier*, 241 Iowa 870, 43 NW2d 718, 722 (1950).

One court has described a "promoter" to be "one who undertakes to bring about the incorporation, procure for the corporation the rights and capital by which it is to carry out the purposes set forth in its charter, and establishes it as able to do business." (citations omitted) *Harry Rich Corp v. Feinberg*, 518 So2d 377 (Fla 3d DCA 1987). The Delaware courts have described a "promoter" as:

In a comprehensive sense "promoter" includes those 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, and may continue after the incorporation by attracting the investment of capital in its securities and providing it with the commercial breath of life. *Blish v. Thompson Automatic Arms Corp.*, 30 Del Ch 538, 64 A2d 581, 594-5 (1948)(quoting *Henderson v. Plymouth Oil Co.*, 15 Del Ch 40, 131 A 170).

See also: *Koppitz-Melchers, Inc. v. Koppitz*, 315 Mich 582, 24 NW2d 220, 226-7 (1946).

Although promoters are normally natural persons, a corporation can be a promoter for another corporation. *Molander v. Raugust-Mathwig, Inc.*, 44 Wash App 53, 722 P2d 103 (1986).

Promoter status attaches regardless of the term used by parties involved. Thus, even though a person may sign a contract as "treasurer" before the corporation is formed, a court may treat that person as a promoter for purposes of analyzing his/her liability on the contract. *Clinton Investors Co. v. Watkins*, 146 AD2d 861, 536 NYS 2d 270 (1989).

Whether or not a person is a promoter is a question of fact. *Id.*; *Arent v. Bray*, 371 F2d 571 (4th Cir 1967).

The term "promoter" in a corporate law context has some similarities to, but is not necessarily as broad as, the term "promoter" in the securities law context. See, for example the definition of promoter adopted by the Securities & Exchange Commission in 17 CFR § 230.405.

### **B. Incorporators distinguished.**

Although the terms "incorporator" and "promoter" may once have been used interchangeably, they are no longer synonymous. Today, the

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term "incorporator" is usually reserved for the person whose limited role it is to sign and file the articles of incorporation and, if no initial directors are set forth in the articles, to elect the first directors and organize the corporation. RCW 23B.02.010 and RCW 23B.02.050(1)(b). A more detailed discussion of incorporators appears in Section 3.02 of this book.

The same person may be both an incorporator and a promoter.

### **C. Multiple promoters.**

A corporation may have more than one promoter. Promoters may enter into a contract among themselves regarding the division of stock, compensation, and other lawful matters. *Swafford v. Levin*, 117 Wash 681, 202 P 254 (1921); *Kincaid v. Lazar*, 405 NE2d 615 (Ind App 1980); *In re Estate of Doelger*, 164 Misc 590, 299 NYS 565 (1937).

Some courts have held that prior to incorporation, promoters are to be treated as joint venturers or as partners. *Refrigeration Engineering Co. v. McKay*, 4 Wash App 963, 486 P2d 304 (1971); *Malisewski v. Singer*, 123 Ariz 195, 598 P2d 1014 (1979); *McRee v. Quitman Oil Co.*, 16, Ga App 12, 84 SE 487 (1915). One court has referred to promoters as "joint adventurers." *Abrams v. Puziss*, 235 Or 60, 62, 383 P2d 1012, 1013 (1963). Another court has held that the relationship among promoters is a complex factual issue not easily categorized:

The relationships among promoters are not such as can be readily classified or categorized, but their rights and duties as among themselves should be based on the particular contractual relationship entered into by them, their common goals, their specific function within the group of promoters, and their relative knowledge and contribution to the total scheme. Their rights and duties should then be determined according to the equities presented, taking into account whether they are all on equal footing as co-promoters, whether some are partners and some are agents, or whether some other actual relationship exists among them. Such a determination becomes basically a question of fact. (citations omitted) *Schuetz v. Winternitz*, 498 P2d 1183, 1185 (Colo App 1972).

If there are two or more promoters and one of the promoters enters a contract within the scope of the promotion, all of the promoters are liable on that contract. *Refrigeration Engineering Co. v. McKay*, 4 Wash App 963, 486 P2d 304 (1971).

### **D. Modern trend.**

In its traditional sense is, the concept of a "promoter" has become outdated. At one time, a corporation could not begin doing business until it had received subscriptions for a certain amount of its capital stock. *Birge v. Browning*, 11 Wash 249, 39 P 643 (1895). One can infer from case law that a significant period would often elapse between the filing date of the articles of incorporation and the date the corporation started doing

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business. Most "promoter cases" involve legal disputes arising during this period.

Today, a corporation generally starts doing business almost immediately after its articles of incorporation are filed. In modern times, a promoter is usually already serving as a director and/or officer by the time he/she takes the action which is the basis for the legal dispute. In modern times, a "promoter case" is much more likely to be an action against a director or officer, rather than against the person known only as a "promoter."

### Section 2.02 Fiduciary Duty

A promoter has a fiduciary relationship to the corporation and to its subsequent shareholders. *Ennis v. New World Life Insurance Co.*, 97 Wash 122, 165 P 1091 (1917); *Smith v. Bitter*, 319 NW2d 196 (Iowa 1982); *Park City Corp. v. Watchie*, 249 Or 493, 439 P2d 587 (1968). A promoter owes a duty of utmost good faith to both. *Mangold v. Adrian Irr. Co.*, 60 Wash 286, 111 P 173 (1908).

Promoters who breach their fiduciary duty are liable for any gain or profit which they may realize from the breach. *Krause v. Mason*, 272 Or 351, 537 P2d 105 (1975); *Koppitz-Melchers, Inc. v. Koppitz*, 315 Mich 582, 24 NW2d 220 (1946). See: Section 2.05 of this book. The Washington Supreme Court has said:

From this fiduciary relation it follows that the promoters must deal with the persons who come into the organization as members or stockholders, in the utmost good faith. . . . Neither will they be permitted, either by fraud or silence, to use their position for the purpose of speculation. The general rule conceded and adopted by the authorities is that under such circumstances promoters [sic] cannot take advantage of their position to make secret profits out of their transactions with or on behalf of the proposed corporation or the incorporators. . . . "Justice demands that the promoters of the company should not abuse the confidence placed in them by the stockholders, or derive any unjust advantage through their control over the organization or management of the company." . . . If the promoters obtain secret profits out of any transactions, and either they themselves become members of the board of director, or persons under their control are elected as such directors, and the board thus composed adopts and ratifies the voidable transaction,--this, it has been held, will create no impediment to proceedings by stockholders for redress. *Ennis v. New World Life Insurance Co.*, 97 Wash 122, 135, 165 P 1091, 1095 (1917)(quoting Thompson on Corporations 2nd Ed).

#### A. Disclosure duty.

Promoters have a duty to disclose to the corporation and to its shareholders all material facts touching upon the promoter's relationship with the corporation. *Colville Valley Coal Co. v. Rogers*, 123 Wash 360, 212 P 732 (1923); *Mangold v. Adrian Irr. Co.*, 60 Wash 286, 111 P 173

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(1908). This duty includes a promoter's obligation to disclose any compensation, profits or advantages that are derived from the corporation or from persons dealing with the corporation. *Bowers v. Rio Grande Investment Co.*, 163 Colo 363, 431 P2d 478 (1967); *Killween v. Parent*, 23 Wis 2d 244, 127 NW2d 38 (1964); *Wills v. Nehalem Coal Co.*, 52 Or 70, 96 P 528 (1908).

The well-settled general rule is that promoters of a corporation must act in the utmost good faith in dealing on behalf of and with the corporation. If they undertake to sell property to the corporation, and in doing so obtain a secret profit, it is a breach of trust and a fraud on the corporation. For such conduct, promoters are liable to the corporation, either at law or equity according to the circumstances of the case. The corporation may recover damages at law for the fraud, or in a proper case may rescind the transaction and recover what it has parted with. *Ft. Myers Development Corp. v. J. W. McWilliams Co.*, 97 Fla 788, 122 So 264, 267 (1929).

In another decision, the court said:

It is now established without exception that a promoter stands in a fiduciary relation to the corporation in which he is interested, and that he is charged with all the duties of good faith which attach to other trusts. In this respect he is held to the high standards which bind directors and other persons occupying fiduciary relations. *Koppitz-Melchers, Inc. v. Koppitz*, 315 Mich 582, 24 NW2d 220, 227 (1946)(quoting *Old Dominion Copper Mining & Smelting Co. v. Bigelow*, 203 Mass 159, 89 NE 193, 201).

Thus, a promoter who purchases land for \$5 per acre and then immediately resells it at a profit to the promoter's corporation, without disclosing such fact, has breached the promoter's duty to that corporation. *Mangold v. Adrian Irr. Co.*, 60 Wash 286, 111 P 173 (1908).

### **B. Transactions between promoter and corporation.**

A promoter's fiduciary duty to the corporation does not prohibit business dealing between the promoter and the corporation. Promoters are permitted to sell property to the corporation, as long as the promoters are "open" about their profits and all other aspects of the transaction. *Colville Valley Coal Co. v. Rogers*, 123 Wash 360, 212 P 732 (1923). Promoters can, and usually do, purchase stock in the corporation. Such a purchase is permitted as long as the purchase price is fair and the purchase price (or value) exchanged for the stock is disclosed. *State ex rel Carriger v. Campbell Food Markets, Inc.*, 60 Wash 2d 478, 374 P2d 435 (1962).

Transactions between a promoter and the corporation are more likely to be upheld if approved or ratified by an independent board of directors and/or by the shareholders. *Downey v. Byrd*, 171 Ga 532, 156 SE 259 (1930); *Dickerman v. Northern Trust Co.*, 176 US 181 (1900).

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### C. **Secret profits.**

Promoters are not prohibited from earning profits out of their dealings with or on behalf of the corporation. *Colville Valley Coal Co. v. Rogers*, 123 Wash 360, 212 P 732 (1923). In fact, one court has described a "promoter" to be a person motivated by a desire "to earning promotional profits." *Daly v. Jackson*, 226 Or 471, 478, 360 P2d 542, 545 (1961). Rather, promoters are only prohibited from earning *secret* profits.

Fraud to be actionable must result in injury, and it nowhere appears that injury has resulted to any one because of such exchange. It does not appear but that subsequent stockholders purchased with full opportunity for investigation into the condition and assets of the company, and that the stock they purchased was fully worth the sum paid therefor. If, therefore, subsequent stockholders obtained full value, there can be no element of injury or fraud as to them. *Inland Nursery and Floral Co. v. Rice*, 57 Wash 67, 69, 106 P 499, 499 (1910).

A promoter "is bound to disclose to [the shareholders] fully all material facts touching his relation to them, including the amount which he is to get for his services as promoter." *Wills v. Nehalem Coal Co.*, 52 Or 70, 76-7, 96 P 528, 531 (1908). For example, in *Park City Corp. v. Watchie*, 249 Or 493, 439 P2d 587 (1968), a promoter was held liable to the corporation for failing to disclose that the promoter had received a commission in connection with the sale of property where the purchaser turned around and resold the property to the corporation.

See: Comment, *Accountability of Promoters to the Corporation for Profits*, 12 WASH L REV 30 (1937).

### D. **Multiple promoters.**

If there are two or more promoters, generally each promoter will have a fiduciary duty to the other. *Pollard v. Pollard's L. L. & L., Inc.*, 279 Or 467, 568 P2d 1387 (1977); *Wilson v. McClenny*, 262 NC 121, 136 SE2d 569 (1964); *Morris v. Whittier Amusement Co.*, 123 Cal App 121, 10 P2d 1017 (1932).

## Section 2.03 Breach of Duty

Promoters who breach their fiduciary duty are liable for any gain or profit which they may realize from the breach. *Krause v. Mason*, 272 Or 351, 537 P2d 105 (1975); *Koppitz-Melchers, Inc. v. Koppitz*, 315 Mich 582, 24 NW2d 220 (1946). See also: Section 2.05 of this book.

### A. **Claims against promoter are usually claims of corporation, not shareholders.**

Generally, a claim against a promoter for breach of fiduciary duty to the corporation is a corporate claim, not a claim belonging to individual shareholders. *Fletcher v. Stapleton*, 123 Cal App 133, 10 P2d 1019

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(1932); *Masberg v. Granville*, 201 Ala 5, 75 So 154 (1917); *Wills v. Nehalem Coal Co.*, 52 Or 70, 96 P 528 (1908). As with lawsuits against officers and directors alleging a breach of fiduciary duty, a shareholder must bring such lawsuit derivatively, with damages payable to the corporation. *Huffman v. Ellen Mining Co.*, 118 Wash 546, 204 P 197 (1922); *Krause v. Mason*, 272 Or 351, 537 P2d 105 (1975); *Koppitz-Melchers, Inc. v. Koppitz*, 315 Mich 582, 24 NW2d 220 (1946); *Cassidy v. Rose*, 108 Okla 282, 236 P 591 (1925). As with other derivative lawsuits, attorney fees may be recoverable by the shareholder if the lawsuit results in a gain or benefit to the corporation. *Krause v. Mason*, 272 Or 351, 537 P2d 105 (1975).

A more detailed discussion of derivative lawsuits appears in Section 8.02 of this book.

### **B. Exception - shareholder claims against promoter.**

There are exceptions to the general rule that only the corporation, not a shareholder, has a claim against the promoter.

At one time, statutes required a corporation to raise a minimum amount of money before it could begin operations. Under these statutes, courts held that shareholders had an individual, not a derivative, claim against the promoter if the promoter permitted the corporation-to-be-formed to use subscriber funds before all subscriptions were sold, *Miller v. Denman*, 49 Wash 217, 95 P 67 (1908), or if the promoter permitted the corporation-to-be-formed to enter into a contract and subsequently failed to obtain the required number of subscriptions. *Stern v. Fletcher American Co.*, 204 Ind 35, 181 NE 37 (1932). While statutes today generally do not contain such a requirement, sometimes by contract, a promoter promises to escrow all subscribers' funds until a minimum amount is raised. If a promoter jumps the gun and releases funds early, a subscriber likely would have an individual claim against the promoter for breach of contract.

A shareholder generally has an individual common law claim directly against the promoter when the promoter uses fraud to induce the purchase of stock. *Killeen v. Parent*, 23 Wis 2d 244, 127 NW2d 38 (1964); *Downey v. Byrd*, 171 Ga 532, 156 SE 259 (1930); *Grover v. Cavanagh*, 40 Ind App 340, 82 NE 104 (1907).

A promoter's breach of fiduciary duty may also form the basis for an individual claim by a shareholder under the securities laws, particularly if the promoter was involved in the stock sale to the complaining shareholder. See, for example: RCW 21.20.430; 15 USC § 77I; and 15

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USC § 78j(b).

### **C. Remedy.**

Generally, if a promoter breaches his/her fiduciary duty to the corporation, the corporation has available the same remedies it would have against an agent, officer or director for breach of fiduciary duty. Such remedies may include damages and/or disgorgement.

A corporation may not have a remedy, however, if its promoter was the only shareholder at the time of the promoter breached that duty. For instance, one case holds that a corporation does not have a direct claim against a promoter who transfers over-valued property to the corporation in exchange for 100% of the corporation's stock. *Hamilton v. Hamilton Mammoth Mines*, 110 Or 546, 223 P 926 (1924). However, a person who later purchases the stock from the promoter may have a direct claim against the promoter for common law fraud and/or violations of the securities laws.

## **Section 2.04 Promoter Compensation**

A corporation clearly has the right to enter into a contract with its promoter to compensate the promoter for his/her pre-incorporation services. *Parrott v. Collins*, 87 Ga App 533, 74 SE 485 (1953); *Annotation*, 8 ALR 2d 723. Such compensation may be in the form of cash, stock or other property. Stock is the most common compensation.

Absent a contract, most courts have held that a promoter has no right to compensation for services during the pre-incorporation period. *Kincaid v. Lazar*, 405 NE2d 615 (Ind App 1980); *Lindsey v. Pasco Power & Water Co.*, 203 F 251 (9th Cir 1913).

If a promoter fails to contract for compensation, however, he/she may have no right to compensation. *Lindsey v. Pasco Power & Water Co.*, 203 F 251 (9th Cir 1913). At least one case implies that a promoter has no quantum meruit claim for compensation. *Abrams v. Puziss*, 235 Or 60, 383 P2d 1012 (1963). *But see: Labor Investment Corp. v. Russell*, 405 P2d 1008 (Okla 1965) (equity permitted promoter to recover under quantum meruit theory for services he performed for corporation under contract which later turned out to be unenforceable due to technicality).

A more detailed discussion of the area of promoter compensation appears in Brockelbank, *The Compensation of Promoters*, 13 OR L REV 195 (1934).

## **Section 2.05 Liability of Promoter to Third Parties**

A promoter who executes a contract before the corporation is

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formed is usually be personally liable on the contract, even though the contract was executed on behalf of the corporation. RCW 23B.02.040; *Equipto Division Aurora Equipment Co. v. Yarmouth*, 134 Wash 2d 356, 950 P2d 451 (1997); *Royal Development and Management Corp. v. Guardian 50/50 Fund V, Ltd.*, 583 So2d 403 (Fla 3d DCA 1991); *Jones v. Burlington Industries, Inc.*, 196 Ga App 834, 397 SE2d 174 (1990).

The liability of the promoter for a contract will depend upon the terms of the contract and the intent of the parties. There is a strong inference that a person intends to make a contract with an existing entity, rather than the to-be-formed corporation. (citations omitted) *Molander v. Raugust-Mathwig, Inc.*, 44 Wash App 53, 58, 722 P2d 103, 107 (1986).

Thus as a general rule, a promoter will be liable unless the other party to the contract agrees to look only to the corporation-to-be-formed for performance.

The Washington Court of Appeals has said:

The rules governing promoter liability are well settled. Ordinarily, a corporate promoter is personally liable on any contracts he or she makes for the benefit of a corporation not yet in existence. The subsequent organization of the corporation does not discharge the promoter from liability, unless the parties agree that his or her liability should cease at that time. Similarly, absent agreement of the parties, a promoter will not be discharged from contractual liability if the corporation subsequently adopts or ratifies his contract. A plaintiff can ordinarily, therefore, look to both the promoter and the corporation for compensation for a breach of the preincorporation contract. (footnote & citations omitted) *American Seamount Corp. v. Science and Engineering Associate, Inc.*, 61 Wash App 793, 798, 812 P2d 505, 508-9 (1991).

See also: *Goodman v. Darden, Doman & Stafford Associates*, 100 Wash 2d 476, 670 P2d 648 (1983).

If after its formation either the corporation expressly assumes the contract or the corporation ratifies the promoter's act and accepts the full benefits of the contract, both the corporation and its promoter will become liable on the contract. *Crown Controls, Inc. v. Smiley*, 110 Wash 2d 695, 756 P2d 717 (1988).

### **A. General rules of agency apply.**

General rules of agency apply to promoters. Under such rules, an agent for a non-existent principal is personal liable for acts undertaken on behalf of that nonentity. *Maxwell's Electric, Inc. v. Hegeman-Harris Company of Canada, Ltd.*, 18 Wash App 358, 567 P2d 1149 (1977); *White & Bollard, Inc. v. Goodenow*, 58 Wash 2d 180, 361 P2d 571 (1961); *Vinye v. American Automobile Co.*, 165 Wash 161, 4 P2d 851 (1931). Prior to incorporation, a promoter is an agent for a nonexistent entity.

If one contracts as agent, when in fact he has no principal, he will be personally liable. A promoter though he may assume to act on the behalf of the projected corporation and not for himself, can not be treated as an

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agent of the corporation, for it is not yet in existence; and he will be personally liable on his contract, unless the other party agreed to look to some other person or fund for payment. (citations omitted) *Wiggins v. Darrah*, 135 Ga App 509, 218 SE2d 106, 107-8 (1975).

See also: *Illinois Controls, Inc. v. Langham*, 70 Ohio St 3d 512, 639 NE2d 771, 781 (1994); *Kelley v. RS & H of North Carolina, Inc.*, 197 Ga App 236, 398 SE2d 213 (1990); *Coopers & Lybrand v. Fox*, 758 P2d 683 (Colo App 1988); *C. & H. Contractors, Inc. v. McKee*, 177 So2d 851 (Fla 2d DCA 1965); RESTATEMENT OF AGENCY (SECOND) §§ 320 & 322.

### **B. Exception - third party agrees to look only to corporation.**

There is an exception to the general rule that promoters are liable for pre-incorporation contracts. A promoter is not liable if the other party to the contract knew that the corporation was not yet in existence, but nevertheless agreed to look only to the corporation for payment. *Betchard-Clayton, Inc. v. King*, 41 Wash App 887, 707 P2d 1361 (1985); *Heintze Corporation, Inc. v. Northwest Tech-Manuals, Inc.*, 7 Wash App 759, 502 P2d 486 (1972); *Tin Cup Pass Limited Partnership v. Daniels*, 195 Ill App 3d 847, 553 NE2d 82 (1990); *Sherwood & Roberts-Oregon, Inc. v. Alexander*, 269 Or 389, 525 P2d 135 (1974).

The third party's intent to look only to the corporation may be proven by language in the contract or by circumstantial evidence. *Goodman v. Darden, Doman & Stafford Associates*, 100 Wash 2d 476, 670 P2d 648 (1983).

### **C. Promoter remains liable even if corporation assumes contract.**

Absent novation, however, a promoter remains liable on a pre-incorporation contract, even though the contract is assumed or ratified by the corporation after incorporation. *Clinton Investors Co. v. Watkins*, 146 AD2d 861, 536 NYS 2d 270 (1989). "This view is founded upon the well-settled principle of the law of contracts that a party to a contract cannot relieve himself from its obligations by the substitution of another person, without the consent of the other person." *Illinois Controls, Inc. v. Langham*, 70 Ohio St 3d 512, 639 NE2d 771, 781 (1994). Absent novation, if a corporation ratifies the contract, both the corporation and its promoter will be liable on the contract to the third party.

The rules governing promoter liability are well settled. Ordinarily, a corporate promoter is personally liable on any contracts he or she makes for the benefit of a corporation not yet in existence. The subsequent organization of the corporation does not discharge the promoter from liability, unless the parties agree that his or her liability should cease at

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that time. Similarly, absent agreement of the parties, a promoter will not be discharged from contractual liability if the corporation subsequently adopts or ratifies his contract. A plaintiff can ordinarily, therefore, look to both the promoter and the corporation for compensation for a breach of the preincorporation contract. (footnote & citations omitted) *American Seamount Corp. v. Science and Engineering Associate, Inc.*, 61 Wash App 793, 798, 812 P2d 505, 508-9 (1991).

If after its formation either the corporation expressly assumes the contract or the corporation ratifies the promoter's act and accepts the full benefits of the contract, both the corporation and its promoter will become liable on the contract. *Crown Controls, Inc. v. Smiley*, 110 Wash 2d 695, 756 P2d 717 (1988). In such case, the promoter would likely have a claim against the corporation for indemnity.

### **D. Miscellaneous.**

If there are two or more promoters and one of the promoters enters a contract within the scope of the promotion, all of the promoters are liable. *Refrigeration Engineering Co. v. McKay*, 4 Wash App 963, 486 P2d 304 (1971).

Because a promoter who enters into a contract in the name of a nonexistence corporation become a party to the contract, the promoter may enforce the contract in the promoter's individual capacity. *White v. Dvorak*, 78 Wash App 105, 896 P2d 85 (1995).

Generally, promoters are not personally liable for post-incorporation acts of the corporation. *Anders v. Metropolitan Life Ins. Co.*, 314 Ill App 196, 40 NE2d 739 (1942). *But see: Georgia Portland Cement Corp. v. Harris*, 178 Ga 301, 173 SE 105 (1934)(promoter continues to be liable for post-incorporation acts when the promoter so dominates the corporation that the corporation may be deemed to be the mere puppet of the promoter).

A discussion of promoter liability appears in Flores, *The Case for Eliminating Promoter Liability on Preincorporation Agreements*, 32 ARIZ L REV 405 (1990); Miller, *Liability of Organizers, Members and Officers of Private Corporation under the Indiana Law*, 4 Ind L J 183 (1928).

A discussion of a corporation's liability for acts of its promoter appears in Section 11.01 of this book.

## **Section 2.06 Promoter Liability for Acts of Defective Corporations**

At one time in an action by a creditor, a promoter could assert as a defense that a defective corporation was a *de facto* corporation. This defense is no longer available in Washington.

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A *de facto* corporation was a corporation in which (i) a promoter had made a good faith effort to organize the corporation, (ii) the corporation had made a colorable or apparent attempt to comply with the law, and (iii) the corporation had exercised corporate powers. *Mootz v. Spokane Racing & Fair Ass'n., Inc.*, 189 Wash 225, 64 P2d 516 (1937). If the court found that a *de facto* corporation existed, the corporation's existence could not be attacked by a third party (other than the state) and the promoters and shareholders were not personal liable for contracts executed on behalf of the *de facto* corporation.

With the adoption on the present Act, the Legislature abolished the *de facto* corporation defense. *Equipto Division Aurora Equipment Co. v. Yarmouth*, 134 Wash 2d 356, 950 P2d 451 (1997).

Under current Washington law, all persons purporting to act on behalf of a corporation, knowing that no corporation exists, are jointly and severally liable for all liabilities created while so acting. RCW 23B.02.040. Such liability requires actual knowledge; constructive knowledge is not enough. *Equipto Division Aurora Equipment Co. v. Yarmouth*, 134 Wash 2d 356, 950 P2d 451 (1997); *Silvers v. R&F Capital Corp.*, 123 Or App 35, 858 P2d 895 (1993), *review denied*, 318 Or 351, 870 P2d 220 (1994). Theoretically, a promoter may lack actual knowledge that the articles of incorporation have not been filed.

The filing of the articles of incorporation with the Secretary of State's office is conclusive proof that the incorporators have satisfied all conditions precedent to incorporation (except in certain proceedings initiated by the state). RCW 23B.02.030. *See also*: Section 6.04 of this book.

A more detailed discussion of *de facto* corporations appears in Section 3.04 of this book.

### **Section 2.07 Watered Stock**

#### **A. Rule today.**

At one time, shareholders were liable to the corporation, and ultimately to corporate creditors, for the par value of each share of stock purchased, less the amount the shareholder actually paid for the share. *See*: Section 10.11 of this book.

In early times, promoters often received a disproportionate number of shares for their pre-incorporation services to the corporation. Such shares were sometimes referred to as "watered stock." As a result of abuses, many states, including Washington, included provisions in their

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constitutions prohibiting the issuance of watered stock and the courts either held such transactions to be void or held the promoters liable for the par value of their "watered stock." *Fox v. Seattle Contract Copper Co.*, 98 Wash 557, 168 P 185 (1917); *McAllister v. American Hospital Ass'n.*, 62 Or 530, 125 P 286 (1912).

Under the 1990 Act, the concept of par value has been abandoned. Shareholders are now liable to the corporation "to pay the consideration" promised for such shares. RCW 23B.06.220. See also: Sections 3.09 and 10.11 of this book. Not only is cash an acceptable form of consideration for shares, pre-incorporation services and contracts for future services are also acceptable as consideration for shares. RCW 23B.06.210(2).

RCW 23B.06.210(3) provides that the board's determination as to the adequacy of the consideration received for shares is conclusive, provided the determination is made in good faith. The business judgment rule applies to that determination. *In the Matter of Delk Road Associates, Ltd.*, 37 BR 354 (ND Ga 1984); *Garbe v. Excel Mold, Inc.*, 397 NE2d 296 (Ind App 1979); *Smith v. Schmitt*, 112 Or 687, 699, 231 P 176 (1924). When the corporation's directors are also its promoters, however, their judgment as to the adequacy of the consideration is subject to scrutiny.

The judgment of the directors of a corporation upon the value of property or stock to be taken and accepted by the corporation in exchange for its own stock in payment of a subscription contract, the exercise of which, when acted upon, is made conclusive by statute, refers to an honest attempt to determine the value of the property or stock by a board of directors representing the corporation alone and jealous of its right and interests and anxious to secure for the corporation all that it is justly entitled to. Anything less than that is dishonest and fraudulent. The directors may be honestly mistaken. They may exercise a very poor judgment and make a very poor bargain, but this is wholly immaterial so long as they have no personal interests of their own to further and act fairly and honestly by the corporation they profess to represent. *Atwell v. Schmitt*, 111 Or 96, 106, 225 P 325, 328 (1924).

A more detailed discussion of the conflicts faced by directors in such circumstances appears in Section 5.16 of this book.

### **B. Constitutional prohibition against watered stock.**

Article 12, Section 6 of the Washington Constitution restricts the authority of a Washington corporation to issue watered stock. It provides:

Corporations shall not issue stock, except to *bona fide* subscribers therefor, or their assignees; nor shall any corporation issue any bond, or other obligation, for the payment of money, except for money or property received or labor done. . . . All fictitious increase of stock or indebtedness shall be void.

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Article 12, Section 6 was included in the Washington constitution in response to the Credit Mobilier scandal of 1872-3. *Spokane Concrete Products, Inc. v. U. S. Bank of Washington*, 126 Wash 2d 269, 892 P2d 98 (1995). This scandal arose from transactions between the Union Pacific Railroad and Credit Mobilier, a construction company primarily owned by shareholders of Union Pacific. Congress authorized Union Pacific to build a railway and provided that Union Pacific's shares were to be sold at par. Instead, Union Pacific shares were sold to Credit Mobilier at about one-third of par value in exchange for construction services on the railway. In 1868, Credit Mobilier issued dividends consisting of watered Union Pacific stock, so that for every \$1,000 invested, \$3,500 worth of Union Pacific stock was allocated. The bubble burst, resulting in the Panic of 1873 and the ruin of thousands of shareholders. *H. J. Cohn Furniture (No. 2) Co. v. Texas Western Financial Corp.*, 544 F2d 886, 888 n 2 (5th Cir 1977).

Debate at the constitutional convention over Article 12, Section 6 centered on three concerns:

(1) preventing "watering" of stock, especially by railroads; (2) controlling railroads' charges for services, which were based on the amount of stock issued, fictitious as well as actual; (3) whether, by requiring full value for capital stock, this section would cripple new or struggling corporations attempting to raise capital. *Spokane Concrete Products, Inc. v. U. S. Bank of Washington*, 126 Wash 2d 269, 276, 892 P2d 98, 102-3 (1995).

For the most part, Article 12, Section 6 has not played a large role in determining appropriate consideration for shares. Dolliver, "*Condemnation, Credit, and Corporations in Washington: 100 Years of Judicial Decisions - Have the Framers' Views Been Followed?*" 12 U PUGET SOUND L REV 163, 194 (1989). There have been few cases interpreting this provision.

A transaction in which \$1 par value stock was issued for \$0.07 was declared unconstitutional and void under Article 12, Section 6, of the Washington Constitution. *Fox v. Seattle Contract Copper Co.*, 98 Wash 557, 168 P 185 (1917).

More recently, in *Spokane Concrete Products, Inc. v. U. S. Bank of Washington*, 126 Wash 2d 269, 892 P2d 98 (1995), the Washington Supreme Court assumed, without deciding, that a corporation's borrowings from a bank and its repeated issuances of notes to the bank constituted an *ultra vires* act in violation of the Article 12, Section 6 of the Washington Constitution.

Since a corporation is no longer required to assign a par value to its

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stock under the current Washington Business Corporation Act, Article 12, Section 6 likely only applies were a corporation issues for nominal or no value.

### **C. Miscellaneous.**

Proof of the consideration paid for shares may be through the minutes of a board of directors' meeting, but proof may also be by testimony or other evidence. *Frisch v. Victor Industries, Inc.*, 51 Wash App 377, 753 P2d 1000 (1988). Once issued, there is a presumption that a share was issued for consideration. *Id.*; *Murphy v. Panton*, 96 Wash 637, 165 P 1074 (1917).

A corporation itself cannot sue its promoters over an inadequate purchase price if the promoters received 100% of the initial shares, even though the promoters later sold these shares to others. *Lake Mabel Development Corp. v. Bird*, 99 Fla 253, 126 So 356 (1930); *Hamilton v. Hamilton Mammoth Mines*, 110 Or 546, 223 P 926 (1924). Under some circumstances, however, a new purchaser of such shares may have a claim against the promoter/seller for violations of the securities laws.