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Phone: (800) 668-6481 | Fax: (905) 479-3758 | John.Carson@lexisnexis.ca

Real Estate

Watch out when buying real estate with pre-incorporation contracts

By **Ray Mikkola**

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(October 18, 2018, 9:11 AM EDT) -- Many purchasers of commercial real estate will elect to execute purchase agreements on behalf of a corporation to be incorporated, for a number of reasons including income tax efficiency, liability avoidance and the need to tie up the property where time is of the essence.

The authority for entering into pre-incorporation contracts is found in s. 21 of the *Business Corporations Act (Ontario)* (OBCA). A similar though not identical provision is found in s. 14 of the *Canada Business Corporations Act*. The effect of the statute in both cases is to replace the common law: it allows a person (a "promoter") to execute a contract on behalf of a corporate purchaser which does not exist at the time of its execution and causes such purchaser to be liable for breaches of the contract, even those which occurred prior to incorporation and adoption. The promoter acts as a "functionary," taking steps to meet deadlines, undertake inspections, review title and avoid defaults.

If the purchase agreement expressly provides that the promoter is not in any event bound by the contract or entitled to the benefits thereof, then in that case, there exists a "nascent contract, its enforceability being suspended" pending the incorporation of the purchaser: (see *1394918 Ontario Ltd. v. 1310210 Ontario Inc.* 57 O.R. (3d) 607 para. 9 (ONCA)).

Plainly, a pre-incorporation contract constitutes an unusual legal arrangement, unknown to the common law. As it does not involve coexistent liabilities of the parties, it must be viewed entirely as a statutory construct. If properly drafted, the purchaser's ultimate business intention will be given effect, the newly created corporation will become the purchaser by adoption retroactively to the date of the purchase agreement, and the promoter will not have and will never have had any liability.

But care must be taken to ensure that the promoter does not inadvertently fall afoul of the statute. For example, s. 21 (4) of the OBCA sets out that if the promoter wishes to avoid any liability, the agreement must "expressly so [provide]".

Silence on this important point may mean that the promoter is in fact liable, as s. 21 (1) affixes liability to the promoter unless s. 21(4) expressly excludes it. But it seems that the required provision does not need to be overtly exculpatory. In *1394918 Ontario Ltd.*, the Court of Appeal held that the addition of the words "and not in his personal capacity" was sufficient to engage s. 21(4). There is also no need (and, indeed, it may be detrimental) to indicate that the promoter is executing the agreement "in trust" for the corporation to be incorporated. Where s. 21(4) applies, there is nothing to be held in trust because the promoter cannot benefit from the agreement and there is no beneficiary of the trust (see para. 12 of *1394918 Ontario Ltd.*).

Section 21 to of the OBCA requires the corporation to adopt the contract "within a reasonable time after it comes into existence". Presumably, the failure to do so may result in either the liability of the promoter under the agreement or the unavailability of the adoption process altogether. But note that the section is silent on the requirement to incorporate promptly.

In *1394918 Ontario Ltd*., the successful litigant was incorporated many months after the execution of the purchase agreement. Also, the adoption may be evidenced by "any action or conduct signifying its intention to be bound". Often, this involves merely a notification by the purchaser's lawyer as to the identity of the new corporation and indicating that the adoption has occurred. *In 1394918 Ontario Ltd.*, the initiation of the action to enforce the agreement was held to be a valid indication as to the adoption of the contract.

It is also important that the promoter should not conduct itself in such a fashion as to attract liability and thereby undo the protection of s. 21(4). In *1394918 Ontario Ltd.*, the promoter *assigned* the purchase agreement to the newly incorporated entity. The Court of Appeal overturned the motion judge's finding that the assignment was effective because, as s. 21(4) applied to the agreement, the court held that the promoter therefore "had nothing to assign" (see paragraph 15).

Promoters should therefore be careful not to use the assignment process as it is inconsistent with adoption. Worse, an assignment by the promoter may well indicate that the promoter actually had rights to assign, thereby potentially vitiating any subsequent right of the promoter to reject liability under the contract.

Finally, a vendor should consider carefully whether it wishes to accept a promoter as a purchaser. If it does, it should consider adding contractual provisions that give it comfort — for example, by requiring the promoter to incorporate promptly after the execution of the contract and to cause the newly incorporated corporation to adopt the contract promptly thereafter.

Ray Mikkola is a partner with the firm of Pallett Valo LLP*.*

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