THE IMPOSSIBILITY OF EFFECTING CONTRACTUAL INCOMPETENCE AND ITS CONSEQUENCES*

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The legislation of the majority of countries recognizes that the list of incompetent persons under disability is limited.[1] Numerous codes contain almost the same enumeration of incompetent persons as the French code, characterizing as incompetent the minor, the insane person who has been declared incompetent, occasionally the spendthrift placed under judicial guardianship, the person convicted of certain offences, and the married woman, for certain acts. Every other person is considered capable of validly contracting. This rule is accepted as a matter of public policy. It is not admitted that a person by his own voluntary or unilateral act may become incompetent. It is necessary to accord the protection resulting from incompetence to persons only who, by reason of their mental state (as the insane or the minor) or of their social status (as the convict), ought not to be able to contract with entire freedom.

There may, however, be certain exceptions to this principle. Thus, in French law it is quite generally admitted that the married woman who has adopted the dowry system is thereby rendered incapable of disposing of the dowry.[2]

Outside of these very limited cases which are of special interest to a few countries only, a person cannot effectively agree that he will thenceforth be incompetent or that his existing incapacity shall be augmented. Thus, in French law a married woman cannot enter into a contract in many cases without being authorized thereto by her husband or by the courts.[3] She cannot augment her incapacity by agreeing in her marriage contract that she shall not be capable, even with the consent

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[1] In this sense art. 1123 of the French Civil Code reads: "All persons are capable of contracting unless made incapable by law." Art. 1105 of the Italian, art. 1363 of the Dutch, art. 29 of the Chilean, and art. 1282 of the Mexican Civil Codes have reenacted this article textually. Art. 320 (2) of the Spanish Civil Code is inspired by the same idea, for it reads: "The adult is capable of performing every act of civil life, subject to the exceptions of this code." So the Portuguese code (art. 644): "All persons not excepted by law are capable of contracting." So the Swiss Civil Code: "Whoever can exercise civil rights is capable of acquiring and of obligating himself." (art. 12); "Every adult person capable of discretion (*discernement*) may exercise civil rights." (art. 13)

[2] 8 Aubry and Rau, *Droit Civil Français* (5th ed. 1916) 563.

[3] Civil Code, arts. 217, 219.

of her husband or of the court, of obligating herself toward third persons. That has been deemed by the courts as contrary to public policy.[4] Or a person cannot agree to render himself incapable of signing a certain class of contracts without the authorization of a third person. Conversely, a minor female who marries cannot by her marriage contract cause her capacity to be recognized as if she were an adult.[5]

This general principle being admitted, a question presents itself which does not seem to have been settled by legislation in the various countries, at least in any general way. At times, in order that a transaction concluded between two persons shall produce all the effects anticipated, it is necessary that one of the contracting parties estop or disable himself from undertaking certain other acts. Is an agreement of this kind valid, and if so, what is its legal operation?

I

We may begin by citing an example, namely, an insurance contract. The contracts of insurance against injury or damage to the insured or against liability of the insured have multiplied astonishingly during the last century. One of the dangers which they present, however, is that the insured, certain of being indemnified in case of injury or damage, is inclined to become less prudent and careful. To overcome this, it is agreed in certain insurance policies that the insurance company assumes liability to indemnify only for the greater part of the risk. For the rest, it is agreed that the insured will bear his own loss and he stipulates that he will not insure this fractional risk with any other company. For example, the insurance covers three quarters of the possible loss, and the insured remains his own insurer, so to speak, for the other quarter. This clause permits the company to reduce its risks arising from the insured's imprudence. The insured is no longer exposed to unlimited risk, yet he has an interest in preventing any loss. We believe that such an agreement not to contract must be deemed valid in France and in any other country where there is no express legislation to the contrary.

But what may be the practical effect of this stipulation against entering into certain contracts? If it produced genuine incompetence or incapacity, the system would be simple. A second insurance taken out in spite of the stipulation would be void. It would require merely fixing the nature of this nullity—whether it may be invoked by every interested person or merely by the disabled person himself. In any

[4] Court of Cassation, *Chambre Civile*, Dec. 22, 1879, Sirey, 1880, I, 125.

[5] Tribunal de la Seine, Jan. 11, 1911. Receuil de la Gazette des Tribunaux, 1911, First semester, 2. 217. and Cour de Paris, Dec. 27, 1911; Gazette du Palais, 1912, I, 206.

event, this incapacity might be invoked by the new insurer, even if he were ignorant of the first policy and of the stipulation against a second policy contained therein.

The idea of conventional incapacity being inadmissible, how can we support the prohibition of entering into contracts? The court must establish that the insured has violated his contract and if he has thereby contemplated the renunciation of the rights of the insured for failure to observe this clause in the policy, the court will declare that the company is under no duty to the insured. But if the policy is silent, what position can the insurance company take? It is certain that whoever violates an obligation of this sort may be obliged to pay damages equal to the injury which he has caused. But how shall we establish the injury resulting from the second insurance? The court cannot ordinarily establish that the loss would not have occurred if there had only been a partial insurance. The damages here will then bear no exact relation to the injury. It would accord with this idea that the prohibition embodied in the contract cannot be violated with impunity. We must then conclude that the court will fix the damages arbitrarily.[6]

Aside from this right, can the first insurer bring an action against the second insurer? If the latter had acted in bad faith, knowing that the second insurance was forbidden by the first, one might apply to him the principle enunciated by the courts in recent years, namely, whoever with knowledge aids a contractor in violating his contract is responsible towards the other contracting party for such violation. He may be sued as a tort feasor.[7] But if it may be said by virtue of this principle that the contract is void, the second insurer will profit thereby, if a loss occurs, by finding himself relieved from paying the indemnity which he promised. It might be declared that the second insurer is liable jointly with the insured for the damages which the latter owes to the first insurer. But this would hardly be useful, for the first insurer, who often has no knowledge of the second insurance until after a loss has occurred, will pay himself by retaining from the indemnity which he owes the insured the amount thus due him.

[6] [In the United States the legal consequences of such an insurance contract would seem to be as follows: the insured would owe a duty to the insurer not to make another contract of insurance; he would have the legal power, nevertheless, to make such a second contract (a power without the privilege of exercising it is not uncommon). Inasmuch as money damages for breach of this duty would not be adequate, exact performance thereof would be held to be a condition precedent to the duty of the insurer to pay (the plaintiff's breach of duty not to insure further would go to the essence). The final result would be that the second contract is valid, but the first insurer is no longer bound.—Ed.]

[7] See on this subject the monograph of M. Pierre Hugueney, *La Responsabilité du Tiers Complice de la Violation d'une Obligation Contractuelle (1910).*

[The doctrine of *Lumley v. Gye* (1853, Q. B.) 2 El. & Bl. 216, would not be extended so far as this in the United States, particularly if the first insurer is discharged.—Ed.]

If the second insurer acted in good faith, the first could under no circumstances bring an action against him. Thus the contractual capacity of the insured being unaffected by his private agreement, the second insurance taken out, notwithstanding the first, remains valid.

II

An analogous difficulty may present itself with respect to clauses in contracts by which the debtor promises not to contract like debts. A company issuing bonds may promise its subscribers not to issue a new loan by way of bonds until the first shall have been fully repaid. This promise may be of great importance to capitalists, for they may fear that if loans by the issue of bonds be multiplied, the liabilities of the company may not be fully paid in case the business goes badly. The promise not to issue new obligations is very valuable, but it does not render the company incompetent to issue new bonds. If the new holders had known of the promise made by their debtor their claims in case of the latter's bankruptcy could not be pressed so as to injure the old holders, for they are in effect responsible to the old bond holders for the wrong which they have committed. But if the new bond holders had acted in good faith, they could claim reimbursement on even terms in case of bankruptcy. The old bond holders could then merely sue the managers of the company who committed the wrong of issuing a new loan.

III

A somewhat different question may present itself when the by-laws of an association forbid the directors to undertake certain operations.[8] Thus it may be provided in the by-laws that the company may not issue bonds except for a sum equal to three times the corporate capital; or it may be provided that the company shall not purchase immovables or realty except for cash. These clauses may be very useful, for they oblige the directors to exercise more prudence in the management of the corporate affairs. The question of the legal operation of these clauses deserves particular attention. It may be said, as in the preceding case, that the association was unable to render itself incompetent, for incapacity cannot be created by contract either for a corporation or for a physical person.

But a complication exists, involving the nature of the corporate entity. When a corporation is created it may be endowed for a certain purpose to the exclusion of all others; for example, the purchase of realty, the development of a certain industry, etc. We may likewise

[8] Here we use the word director, as well the word manager, in its widest sense. We have in mind a person who alone or with others directs or manages any commercial association, whether stock corporation or not. Impliedly we include a person who manages the property of an association or foundation.

limit the means by which a corporation may attain its objects; for example, it may be forbidden to undertake certain operations except for cash. Have these rules, established at the very inception of the corporation, thereby acquired such force that they are imposed absolutely upon third persons, even those acting in good faith? May one say that the corporation has been created only within the limits fixed by its by-laws, and for the acts contemplated therein, so that acts prohibited would be considered as concluded by a corporation having in reality no existence when it undertakes the forbidden act?

If the law itself forbids a corporation to undertake a certain act, the law thereby being violated, the act may be attacked as void. This the French courts have recognized.[9]

Would it be the same if the rule violated was merely a conventional rule—that by which the company was created?

A conflict arises here between the interests of the members of the association or third persons who have dealt with the association in the light of its known by-laws and, on the other hand, the interests of third persons who have concluded a contract with the company, which, according to its by-laws, was *ultra vires*. The legislation of certain countries has in this case favored the third persons. The German Commercial Code of 1897[10] provides that the clauses of by-laws designed to restrict the powers of the manager have no effect as against third persons, but only among the contracting members of the association.

"The stipulation which restricts the power of one of the members to represent an association has no effect as against third persons, especially the restriction by which the power of representing the association extends only to certain matters, or can be exercised only in certain circumstances for a certain time, or in certain places."

The Hungarian Commercial Code likewise provides:[11]

"Every restriction upon the power of a member of an association to represent the legal entity is void as against third persons."

This also is provided in article 216 (3) of the Venezuelan Commercial Code, in article 373 (1) of the Chilean Commercial Code, and in article 16 of the Swedish Law of June 28th, 1895, on commercial associations. Under these conditions third persons may deal with the association with entire safety. The German authors even admit that the limitations of power cannot be set up against third persons who knew of them.[12] Thus bad faith would seem to be rewarded. More-

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[9] Court of Cassation, *Chambre Civile*, May 26, 1894, Sirey, 1894, I, 265.

[10] Art. 126 (2), re-enacting art. 116 of the old code.

[11] Art. 92.

[12] 3 Cosack, *Droit Commercial* (French transl. 1907) 29; Lehmann, *Handelsrecht*, 308.

over, even without admitting this untoward solution, we compel the association to run serious risks if its managers should not be scrupulous men.

Other codes have found a means of reconciling within certain limits these conflicting interests. The Swiss Code of Obligations[13] says in effect:

"Every clause which would limit the powers of an associate is null and void with respect to third persons acting in good faith. There is excepted the case where, after inscription of the association in the commercial register, the association can be bound only by the collective signature of several associates."

The method of reconciliation, therefore, consists in taking account of the good faith of the contractor and, to a certain extent, of the publicity given the act of association. This is a system closely approaching the one arrived at in countries where legislation has not regulated this matter.

Commercial associations are in the majority of countries subjected by legislation to certain forms of publicity. In France the important law of July 24th, 1867,[14] requires of associations an extensive publicity either by the registration of their articles of association and by-laws with the clerks of certain courts, or by the publication in the newspapers of extracts from their by-laws. A similar system is provided for by several foreign codes.[15] In other states publicity is provided for by means of inscription in the commercial register.[16]

When the publicity given to the by-laws of the association easily permits third persons to obtain knowledge that a certain act cannot be undertaken in the name of the association by its managers, if legislation, as in France, has not provided for acts *ultra vires* committed by the managers, we may posit the following principle: third persons who deal with the association know, or ought to know, that the by-laws forbid a certain act. If they are ignorant, it is their own fault. Consequently when a clause has been duly published limiting the powers of the managers, it may be invoked against third persons. This solution, which by a middle course reconciles the security of the association with that of third persons, appears to us possible of adoption in all countries where the question has not been settled by legislation.[17]

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[13] Art. 561.

[14] Art. 55, 56, *et seq.*

[15] E. g., the Roumanian Commercial Code, art. 92; the Italian Commercial Code, art. 90, *et seq.;* the Dutch Commercial Code, art. 23, *et seq.;* the Chilean Commercial Code, art. 354; and the Belgian Law of May 18, 1873, art. 6.

[16] This is the case with the Spanish Commercial Code, art. 16, *et seq.;* the Argentine Commercial Code, art. 36, *et seq.;* and the Mexican Commercial Code, art. 19.

[17] 1 Thaller and Pic, *Sociétés* (1908) sec. 479; 1 Vidari, *Diritto Commerciale* (5th ed. 1900) sec. 1062; 4 Navarrini, *Diritto Commerciale* (1908) sec. 1643; 1 Lacour, *Droit Commercial,* sec. 302.

This is the solution adopted in France by the Court of Cassation in a case where the corporate by-laws forbade the associates to issue notes or to sign any drafts obligating the association, even with the concurrence of other associates and under penalty of being null and void as against third parties. The court said:[18]

"It is within the power of the contracting parties to limit in their collective or individual interest the powers of the managers of the association by forbidding them to undertake certain predètermined acts. This obligatory prohibition laid upon the associates may likewise be set up against third persons by reason of the publicity which the articles of association have received."

If, on the contrary, publicity has not taken place, the clause cannot be set up against third persons. This also the Court of Cassation has decided when confronted with a formal provision of articles of association according to which the associates could not sign notes for the purchase of merchandise "when it was not duly established that this clause was included in the publication which alone could render it possible to set it up against third persons."[19]

In all these cases in which the mere examination of the contract proposed to third persons makes it possible in the light of the by-laws to determine whether the contract is valid, it is the fact of publicity, or non-publicity, of the articles that determines the issue against or in favor of third persons.

Moreover, even when the clause was not published, if it is established in fact that the third person knew the provisions of articles and by-laws, the third person in bad faith cannot be protected and his claim against the association cannot be recognized.[20] If the third person cannot enforce his contract because there was publication of the clause violated or because he acts in bad faith, he can only sue the association for enrichment to the extent still enjoyed by the latter by reason of the contract when the action is brought.

The question is complicated when we are unable to determine whether the contract offered to a third person conforms with the articles of association except by means of an examination of facts. This would be the case if the articles indicate that the manager of the association can borrow in the name of the association only if he acts in corporate matters. Does such a clause render void an act concluded with a third person in good faith, by the mere fact that it was published? If the affirmative is admitted, we require from third persons a very minute

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[18] *Chambre Civile,* Dec. 22, 1874, Dalloz, 1875, I, 255.

[19] *Chambre des Requètes,* August 16, 1875, Dalloz, 1876, I, 422. So in Belgium, Bruxelles, March 17, 1881, Pasicrisie, 1881, II, 349.

[20] *Chambre des Requètes,* Oct. 31, 1887, Dalloz, 1888, I, 472; Douai, March 7, 1899, Dalloz, 1902, I, 6; 1 Thaller and Pic, *Sociétés* (1908) sec. 479.

examination of facts. Certain authors also declare that the clause cannot be invoked against third persons in good faith.[21] The Court of Cassation appears, however, to adopt a contrary solution,[22] and to consider as effective the "intention of the contracting parties to remove from the liabilities of the association every obligation or debt which one of the associates might incur for causes foreign to the association even when the associate had made use of the corporate signature." This solution seems to us dangerous for third persons. It seems to us that the latter—if in good faith and if they could not by reading the by-laws determine whether the act they were about to conclude was regular—must be protected against any action for the nullity of the contract.

We will add that in the absence of any clause it is admitted that the managing associate obligates the association even if he borrows for personal purposes when the third person with whom he deals acts in good faith.[23] The Court of Cassation has said in this sense that a third person in good faith, when all the circumstances justify him in believing that the associate used the corporate signature only with the consent of his associates and in the concerted interest of the association, was a valid creditor.[24] Conversely, it admits that if the third person was in ignorance of the unlawful conditions under which the associate used the corporate signature, he cannot be considered a creditor of the association.[25] It does not seem to us that this system protecting third persons acting in good faith can be abandoned merely because a clause in the articles of association imposed on the manager of the association the duty not to obligate the latter except in corporate matters.

From these particular observations we may deduce a conclusion. The law recognizes that certain persons are incompetent or without legal capacity. In that case, this result being based upon public policy, which requires that incompetents shall not be victimized by reason of their social status or their mental state, the incapacity reacts against third persons. The latter are exposed to having rendered void at the

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[21] Thaller, *Droit Commercial* (5th ed. 1916) sec. 412; 2 Lyon-Caen and Renault, *Traité de Droit Commercial* (12th ed. 1918) sec. 293; Percerou, *Des Abus de la Raison Sociale* (1898) 12 ANNALES DE DROIT COMMERCIAL, 118, 132 *et seq.*

[22] *Chambre des Requètes,* June 22, 1881, Sirey, 1883, I, 158, and Nov. 5, 1900, *ibid.* 1901, I, 127; 1 Arthuys, *Droit Commercial,* sec. 250; 1 Thaller and Pic, *Sociétés* (1908) sec. 563.

[23] In our opinion it would be the same if the member or partner borrowed for another member or partner personally and did so in the name of the association, even when the lender knew the situation, if he believed or had reason to believe that the association had an interest in thus coming to the aid of a member or partner.

[24] *Chambre de Requètes,* Feb. 21, 1860, Sirey, 1860, I, 415.

[25] *Chambre Civile,* July 11, 1899, Sirey, 1900, I, 5; cf. 1 Thaller and Pic, *Sociétés* (1908) secs. 461-462.

request of the incompetent an act concluded with him, whether or not they knew of the existing incapacity. But parallel with this system there is another which involves a different technical conception. In a private interest, in order to permit a contract to be carried out more completely, one may stipulate that a person shall not in the future conclude a certain class of contracts. There will not result therefrom a conventional incapacity, but an obligation upon the promisor with respect to the promisee and this obligation will react upon third persons acting in bad faith. But the system is completed by the idea of publicity. When the law has provided for publication of the clauses in question, by the mere fact of such publication third persons who might thereby discover the existence of the clauses are considered as having knowledge thereof and this presumption is conclusive.[26]

Thus we have two somewhat related theories which are both systematized by their inspiration in practical utility. But the first pursues an aim of public policy, namely, protecting incompetents. The second merely looks toward a private purpose, whence its less vigorous character. But both tend to constitute themselves rationally, by forming a body of coherent solutions. The solutions which they present also have a certain universal validity. They may be proposed in those rather numerous countries where there is no legislation to the contrary.[27] Thus we may on this point, as on many others, construct a certain unity of law among the various peoples.

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[26] [In the language of the common law, we may say that there are persons (e. g., lunatics in care of a judicially appointed guardian) who wholly lack legal power and whose agreements are void; there are others (e. g., infants) who have power to contract, with the accompanying power of avoidance; still others (e. g., general agents with private limiting instructions) who have power to bind their principals only by contracts made with third persons who act in good faith without notice, actual or constructive.—Ed.]

[27] It might even be adopted to clarify certain legislative texts which leave the question obscure, e. g., art. 316 (3) of the Commercial Code of Brazil, according to which: "If the member or partner abuses the association purpose, an action lies against him for damages, both on the part of the other associates and of third persons."