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INCIDENTS OF IRREGULAR INCORPORATION.

SECOND PAPER.

In the former paper an attempt was made to state the problems which grow out of irregularities in the organization of corporations and joint-stock companies. The various solutions worked out by the courts were set forth and some emphasis was laid upon the tendency (in the case of alleged corporations as distinguished from joint-stock companies) to confine a plaintiff in his recovery to the corporate fund instead of permitting him to recover against the associates as partners. Another phase of the same tendency was thought to be discernible in that class of cases in which, where the corporation is suing as a plaintiff, the courts preclude the defendant from taking refuge behind an irregularity in the plaintiff's corporate organization. It was suggested that if these results could be asserted without qualification, the law would have gained much—at least as far as simplicity of statement is concerned. It was observed, however, that suits by or against associates claiming to be incorporated are still likely to be complicated by a consideration of the degrees of compliance or non-compliance with statutory prescriptions and by a discussion of the amount of *user* necessary for the conception of a *de facto* corporation. The justification for the retention of these com-

plicating elements was found in the prevalent belief that the courts must in this way discourage the usurpation of corporate franchises by unauthorized individuals and discountenance the attempt to obtain the benefits of limited liability without a corresponding willingness to bear its burdens. While recognizing the paramount importance of regularity in corporate organization and the great dangers attendant upon the usurpation of corporate power, it was suggested that the true way in which to reach the desired result is to develop the machinery for checking and punishing irregularity and usurpation in proceedings instituted by the state for that purpose, as distinguished from the introduction into private litigation of a consideration of the relations between the corporation and the state. In the pages that follow it is proposed briefly to develop the thought which lies at the basis of this suggestion.

The suggested theory is this : Where associates hold themselves out as a corporation and engage in business as such, they shall be treated as a corporation in all private litigation between themselves and those who make contracts with them in the course of the business in which they are engaged. If the associates sue as a corporation upon such a contract, the defendant cannot set up the irregularity of the plaintiff's corporate organization as a defence. If they are sued as partners, they may defend on the ground that the plaintiff contracted with them when they were doing business as a corporation. If the contract is made pending an unexecuted intention to organize as a corporation, the associates are of course liable as individuals. If, however, the contract is made after the associates have assumed to organize as a corporation, there is no individual liability at law, even if the plaintiff did not in fact know of the organization. Not only, however, is a doing of business without compliance with the statute to be made punishable at the instance of the state, but wherever the assertion of a corporate organization amounts to a fraud upon creditors, relief may be had in equity by the aggrieved creditor against all those who used the corporate organization as a means of fraud.

The basis of the suggested theory is not in any sense

estoppel. The right of an irregular corporation to recover in contract cannot be worked out upon the theory that the defendant is *estopped* from denying the corporate existence any more than it can be said with accuracy that a creditor-plaintiff is *estopped* from treating the members of an irregular corporation as partners. It is difficult to find the elements of estoppel in these cases. The basis of the theory is *contract*. The individual and the associates acting as a corporation have given to the entity a legal existence at least for the purposes of the contract which they have made ; and it may be said of the individual that he either has a corporate contract or he has no contract at all. If the organization is inchoate : that is to say, if the associates themselves recognize that some steps are yet to be taken before they can attain corporate existence, it should seem to be a logical conclusion that no corporate contract can exist. Neither party, by supposition, intends to make a corporate contract. If, however, the contract is made after the associates have begun to do business as a corporation, then a contract entered into in the course of business must be treated as a corporate contract, for there is no intention upon their part to bind themselves individually. It is of the essence of the suggested theory, however, that the adoption of a corporate form of organization should be susceptible of treatment by a court of equity as being itself a fraud upon creditors, in cases in which the usual *indicia* of fraud are present and the creditors have in fact suffered damage. If a corporation is organized without paying into its treasury in cash the percentage of capital required by the act, the fact of non-compliance with the statutory provision will be of itself a ground for the withdrawal by the state of the corporate privilege which the associates have abused. As between the corporation and an individual, however, the non-payment of the required percentage will in no sense give to the individual a right to treat the contract which he has made as being other than a corporate contract. If he can show that the associates have acted in bad faith and that he has actually been prejudiced by their conduct, he can have recourse to an unlimited liability in equity by treating the corporate organization as a mere device put

forward to hinder and delay creditors. In other words, he will be in all cases confined to his contract rights unless the facts are such that he can show himself entitled to file a bill to obtain some recognized form of equitable relief. There will no longer be room for a discussion in private litigation of the extent of compliance or non-compliance with statutory requirements. There will no longer be a place for a consideration in private litigation of what does and what does not amount to *user* of corporate privileges. The only question for consideration will be the question whether the associates have or have not in good faith assumed to act as a corporation. If they have, no liability can be enforced except liability upon the corporate contract. If, on the other hand, what they have done has not been done in good faith, an injured plaintiff has all the rights which belong in equity to victims of a fraud upon creditors.

If instead of a case of irregular organization it appears that the associates have regularly organized but have in reality used the corporation law as a device to enable a sole trader to obtain limited liability, it is sufficiently obvious that the suggested theory places no obstacle in the way of a solution of the problem. The theory deals with the relations between an individual and a corporation where the corporation is so irregularly organized that the state may proceed against the associates if it sees fit to do so. In the case now put, however, the state has by supposition no rights against the associates because the associates have complied with the requirements of the law. If the associates have satisfied the conditions imposed by the state, *a fortiori* they are exempt from attack at the suit of private individuals. This seems to be the true explanation of the case of *Broderip v. Salomon* (*Salomon v. Salomon & Co. Limited and Cross Appeal*)¹ recently decided by the House of Lords. Readers of the former paper will recollect that the decision of the Court of Appeal in this case was commended by the *New York Times*, while the decision of the House of

¹75 *Law Times*, 426, (1897). The decision in the Court of Appeal (which was reversed by the House of Lords) is reported in 72 *L. T. Rep.* 755, and in 2 *Ch. Div.* (1895) 323. The Court of Appeal had affirmed an order of Williams, J. reported in 72 *L. T. Rep.* 261.

Lords was criticised as conferring upon traders an "unlimited authority to cheat."¹ It is submitted, however, that there is no escape from the conclusion that the decision of the House of Lords was correct. The facts of the case are thus stated by Lord Herschell at page 432: "By an order of the High Court, which was affirmed by the Court of Appeal, it was declared that the respondent company, or the liquidator of that company, was entitled to be indemnified by the appellant against the sum of £7733 8s. 3d. and it was ordered that the respondent company should recover that sum against the appellant. On the 28th July 1892 the respondent company was incorporated with a capital of £40,000, divided into 40,000 shares of £1 each. One of the objects for which the company was incorporated was to carry out an agreement, with such modifications therein as might be agreed to, of the 20th July, 1892, which had been entered into between the appellant and a trustee for a company intended to be formed for the acquisition by the company of the business then carried on by the appellant. The company was in fact formed for the purpose of taking over the appellant's business of leather merchant and boot manufacturer, which he had carried on for many years. The business had been a prosperous one, and, as the learned judge who tried the action found, was solvent at the time when the company was incorporated. The memorandum of association of the company was subscribed by the appellant his wife and daughter, and his four sons, each subscribing for one share. The appellant afterwards had 20,000 shares allotted to him. For these he paid £1 per share out of the purchase money which, by agreement, he was to receive for the transfer of his business to the company. The company afterwards became insolvent and went into liquidation. In an action brought by a debenture-holder on behalf of himself and all the other debenture-holders, including the appellant, the respondent company set up by way of counter-claim that the company was formed by Aaron Salomon, and the debentures were issued in order that he might carry on the said business and take all the profits without risk to himself, that

¹36 American Law Register and Review (N. S.) p. 19.

the company was the mere nominee and agent of Aaron Salomon, and that the company or the liquidator thereof was entitled to be indemnified by Aaron Salomon against all the debts owing by the company to creditors other than Aaron Salomon. This counter-claim was not in the pleading as originally delivered: it was inserted by way of amendment at the suggestion of Williams, J., before whom the action came on for trial. The learned judge thought the liquidator entitled to the relief asked for and made the order complained of. He was of opinion that the company was only an alias for Salomon: that the intention being that he should take the profits without running the risk of the debts, the company was merely an agent for him, having incurred liabilities at his instance, was, like any other agent under such circumstances, entitled to be indemnified by him against them. On appeal the judgment of Williams, J., was affirmed by the Court of Appeal, that court 'being of opinion that the formation of the company, the agreement of Aug. 1892, and the issue of debentures to Aaron Salomon pursuant to such agreement were a mere scheme to enable him to carry on business in the name of the company with limited liability contrary to the true intent and meaning of the Companies Act 1862, and further, to enable him to obtain a preference over other creditors of the company by procuring a first charge on the assets of the company by means of such debentures.' The learned judges in the Court of Appeal dissented from the view taken by Williams, J., that the company was to be regarded as the agent of the appellant. They considered the relation between them to be that of trustee and *cestui que trust*, but this difference of view, of course, did not affect the conclusion that the right to the indemnity claimed had been established. It is to be observed that both courts treated the company as a legal entity distinct from Salomon and the then members who composed it, and therefore as a validly constituted corporation. This is, indeed, necessarily involved in the judgment which declared that the company was entitled to certain rights as against Salomon." (Now either the organization formed by Salomon and the members of his family was or was not a corpora-

tion as between themselves and the sovereign.) If the court had decided that it was not a corporation, then the questions heretofore discussed would have demanded consideration—how far, namely, creditors could take advantage of this circumstance in private litigation. But the judges of the Court of Appeal admitted that all things had been done in the matter of organization which the statute required and it seems fair to say that they conceded that a valid corporation had come into being even as against the sovereign. If, then, the organization was a corporation as between itself and the sovereign, certain important consequences followed. In the first place, the title to its property was vested in it and, in point of law, its business was to be regarded as carried on by it. In the second place, its debentures were perfect obligations and enforceable against it unless they could be impeached for fraud. Thirdly, the relation between the corporation and its stockholders was not that of trust—for as the corporation had the legal title, the stockholders could not be treated as trustees; and that the interest of a stockholder in a corporation is not an equitable interest is the well settled modern doctrine. It follows that to say that under such circumstances the business and property were “substantially Salomon’s” means nothing. (Either the business and property were Salomon’s or they were not.) If it be assumed that they were, the assumption is inconsistent with the finding of the Court of Appeal that a corporation came regularly into being. If they were not, then they were the property of the corporation, and must be dealt with as having the ordinary incidents of other corporate property. Of fraud there was no evidence. The only suggestion was that the property had been sold by Salomon to the company at an over-valuation and that the sale should therefore be rescinded. In support of this suggestion reference was made to *Erlanger v. New Sombrero Phosphate Co.*¹ In the Salomon case, however as the House of Lords pointed out, the only persons who could have a standing to allege fraud were the stockholders other than Salomon, and it appeared affirmatively that they knew all the facts and had not been deceived. As the

¹ 39 L. T. Rep. 269; 3 App. Cas. 1218.

corporation could not under this view of the case be treated as the agent or trustee for Salomon, it acquired no right as against him to be indemnified and the reversal of the decision of the Court of Appeal seemed to follow by an inevitable necessity.

It is submitted, therefore, that the suggested theory leads to sound conclusions as between the corporation and the individuals with whom it contracts and that it is in no sense inconsistent with the result worked out by the House of Lords in *Broderip v. Salomon*.

It may be urged, however, that the theory practically involves the conception of a corporation created without the intervention of the sovereign power, inasmuch as under this theory a creditor would be confined to the corporate fund even in a case where the associates had failed to file a certificate or charter under their act or had omitted to comply with some one or all of the most important statutory prescriptions. The answer is that as between the associates and the state there can be no valid exercise of corporate privileges without the consent of the sovereign power. It does not follow from this admission, however, that there may not be such a thing as a quasi-corporation resulting from contract as between a group of associates and those with whom they have business. "Some, again," say Pollock and Maitland,¹ "may feel inclined to say that a corporation must have its origin in a special act of the State, for example, in England, a royal charter; but they again will be in danger of begging a question about ancient history, while they will have the utmost difficulty in squaring their opinion with the modern history of joint-stock companies. Modern legislation enables a small group of private men to engender a corporation by registration, and to urge that this is the effect of 'statute' and not of 'common law' is to insist upon a distinction which we hardly dare carry beyond the four seas."

An economic objection may be made to the theory on the ground that one consequence of it will be the removal of the present sanction of regular organization and the substitution

¹ History of English Law, Vol. I., p. 470.

of state control in a department in which it is most unwise that the state should have control? It may be contended that since corporations represent vast accumulations of wealth and influence, the executive and judicial officers of the state will be subjected to great temptations to stay their hands and to take no steps in the direction of restraining the exercise of corporate privileges by unauthorized persons. In support of this argument, attention is called to the alleged inefficiency of the common law remedy by *quo warranto* as practically administered in our Commonwealths. These are important considerations, but it is submitted that they are by no means as weighty as at first appears. As an answer to the objection it may be said that, from the economic point of view, the wisdom or unwisdom of the suggested development is scarcely open for consideration, because an examination of the reports shows that the stream of tendency has actually carried the courts to the point at which the theory here insisted upon is necessary to give a legal explanation of their position. The theory is not made "out of the whole cloth," but represents an attempt to explain the observed phenomena of judicial decision and to facilitate the extinction of a few anachronisms which mar the uniformity of the law. In the second place, attention is called to the fact that the questions of irregular incorporation with which the courts have had to deal do not appear to have arisen in the case of corporations of great wealth and influence. In other words, it has been true in the past, and it will continue to be true in the future, that strict compliance with statutory provisions is the best policy to be pursued by those who propose to stake large interests in the corporate enterprise. The questions, as a rule, have arisen in connection with trading corporations doing business in a way that is small when compared with the class of great corporations of which one thinks when a reference is made to corporate wealth and influence. Partnership liability has been sought to be enforced by the creditors of these smaller concerns as a sort of "forlorn hope"—an attempt to obtain recourse to a source of payment to which the creditor did not look when the debt was originally contracted. In many cases,

the questions have arisen as the result of the promotion of wild-cat enterprises and schemes of adventurers who have sought to obtain a share of the profits of some legitimate corporate business established by the enterprise and integrity of large and solvent organizations. In such cases frauds are perpetrated upon creditors, and accordingly the theory recognizes that the elastic decree of a court of chancery is best adapted to meet the exigencies of the situation. The point insisted upon, however, is that the class of corporations which are, in fact, irregularly organized are not in a position to exercise corrupt influence upon administrative officials. In so far as great and powerful corporations are interested in the matter of regular organization at all, their interest is identical with that of the state, for experience shows (in the domain of insurance, for example) that the substantial and solvent insurance companies are the most active in setting in motion the legal machinery for punishing their unscrupulous and fraudulent competitors. Finally, it may be suggested that from the administrative point of view, a system which divides the responsibility of corporate supervision between the judiciary and the executive department is fundamentally unsound. It is believed that if reform is needed in the direction of greater activity upon the part of the state in keeping corporate enterprise within bounds, the way to secure the reform is to emphasize the responsibility of the state and not to shrink from a recognition of it. It must not be forgotten, moreover, that an acceptance of the suggested theory leads naturally to the adoption of stringent legislative enactments imposing fine or imprisonment or both upon those who usurp corporate privileges without complying with the conditions imposed by the state.

Again, it may be objected that, however desirable the results of the suggested theory may be, the acceptance of it is inexpedient as being in effect "judicial legislation" and, therefore, to be condemned as dangerous. It may be said in reply that the modern decisions in regard to *de facto* corporations which have proceeded upon no coherent legal theory are indeed open to criticism as being instances of judicial legisla-

tion, but that no such objection can properly be directed against a theory which is, after all, nothing more than a generalization from observed facts in social and economic development. The growth of corporate activity amongst us has been a rapid growth, and it has necessitated a rapid development of our legal ideas. It used to take centuries for legal doctrines to attain maturity, but in these days each decade makes a definite contribution to our jurisprudence. When the judges move faster than society, they are justly criticised for legislating from the bench. It is an open question whether or not they are acting judicially when they merely keep abreast of the march of social progress. The suggested theory, it will be observed, does not require them to do more than keep a respectful distance behind the front of the column.

A study of the English Reports seems to indicate that in England the problems of irregular organization have heretofore been dealt with in a different way. There has been no gradual growth of decisions of the class summarized in the former paper and drawn upon as the source of the suggested theory. The English solution of the problem of irregular incorporation must, therefore, be a legislative solution. Indeed, this fact has been recognized by our English brethren, and a Committee recently appointed by the Board of Trade to inquire into the matter of the formation and management of companies have made a most elaborate and interesting report in favor of an amendment of the Companies Act and have annexed to their report a draft of a bill to accomplish the needed reform. This report and the draft of the bill have come into the hands of the present writer since the publication in this magazine of the first paper on irregular incorporation, and after the present paper was mapped out. It is interesting to note that the draft of the bill reported by the Committee (so far as it deals with the question of irregular incorporation), in effect puts the suggested theory into actual operation. Section 1 provides that a certificate of incorporation given by the registrar in respect of any association, shall be conclusive evidence that all the requisitions of the Companies Acts, in respect of registration and all matters precedent and incidental

thereto, have been complied with, and that the association is a company authorized to be registered and duly registered under the Companies Acts. Section 36 provides that the company may be wound up (*inter alia*): "Where the court is satisfied that a certificate of incorporation has been obtained by fraud, misrepresentation or mistake or by a wilful violation of any provision of the Companies Acts; or where the court is satisfied that the Company was formed or that its business has been carried on with the intent or in such manner as to defraud, defeat or delay the creditors of the company, or of any other company, or for any fraudulent or illegal purpose." The learned Committee (which included Lord Davey, Sir Joseph William Chitty, Sir Roland Vaughan Williams, and a number of other distinguished men), formulated their report at a time when the appeal in *Broderip v. Salomon* was still pending in the House of Lords. The Committee annexed the opinions of the judges in the Court of Appeal to their report and after summarizing the decision of that tribunal, used the following language: "If this view be correct, it appears to your Committee unnecessary to suggest any amendment to the existing law; but they think that some addition to the grounds upon which a winding-up order may be made, would be desirable in order to meet such cases as that of Aron Salomon, and possibly also cases of the kind to which the Pharmaceutical Society and the Medical Associations have called attention.¹ They have accordingly suggested a clause making it a cause of winding-up (a) where a certificate of incorporation has been obtained by fraud, misrepresentation, or mistake, or by a wilful violation of any provision of the Companies Acts, or (b) where the Court is satisfied that the company was formed or that its business has been carried on with the intent or in such manner as to defraud, defeat, or delay the creditors of the company or of any other company or person, or for any fraudulent or illegal purpose; and in such cases giving the court power

¹ These were cases in which persons sought to evade the provisions of the Pharmaceutical and Medical Acts by becoming incorporated and thus putting themselves beyond the terms of those statutes. The Committee were of opinion that this evil could best be dealt with by amending the Pharmaceutical and Medical Acts.

to declare the liability of any one or more of the members for all or some of the debts to be unlimited. They also propose that in such cases the Attorney-General may petition. But your Committee cannot recommend any general enactment rendering the members liable without limit where there are seven members, but some of those members do not hold what may be called a substantial interest, or are trustees only for other persons. . . . It is not usually the creditors of the original owner of the business who suffer, but the creditors of the company. Now, so long as the company is a going concern, and pays its way, no harm is done to anybody. But when the company fails to pay its creditors it may be wound up, and in that event the power proposed to be given to the court in aid of the existing law would come in and enable the court if one or a few individuals have been carrying on business under the cloak of a company in abuse of the Acts to make them liable. It is further suggested that persons conspiring to defraud by means of such devices as described in Aaron Salomon's case are amenable to the criminal law." What amendments will be suggested in view of the decision of the House of Lords is, of course, only a matter of conjecture. The point upon which it is desired to insist is that our English brethren recognize (1) the importance of treating the certificate as conclusive, (2) the wisdom of enlarging the remedy by compulsory winding up and by petition of the Attorney-General and (3) the expediency of imposing criminal penalty for abusing the privileges conferred by corporation laws. It may be remarked incidentally that the volume containing the report will amply repay careful study, for it evidences a most thorough and satisfactory investigation of the whole subject by the learned Committee, and a determination upon their part to familiarize themselves with the practical operation of corporation laws and companies' acts in Germany, France and in the United States. The report is in itself a lesson upon the right way in which to prepare an act of legislature.

It is submitted, in conclusion, that there is reason for believing that both the English experience and our own tend

to establish the soundness of the result which can be reached by applying the suggested theory. In England the state of legal development is such that the result can be attained only by an Act of Parliament. With us, such progress has been made by the courts in the direction of a solution satisfactory to the world of industry and commerce, that no obstacle stands in the way of the acceptance by the judges of a theory which provides the necessary safe-guards for the purchasers of shares, which makes ample provision for the supervision and control of corporate activity and to a great extent banishes that anachronism the *de facto* corporation from the realm of private litigation.

George Wharton Pepper.

Philadelphia, March 1, 1897.