THE AMERICAN LAW REGISTER

FOUNDED 1852.

UNIVERSITY OF PENNSYLVANIA

DEPARTMENT OF LAW

VOL. { 47 O. S. / 38 N. S. } MARCH, 1899. No. 3.

AN INQUIRY INTO THE NATURE AND LAW OF CORPORATIONS—PART III.

The Relations Between a Stock Corporation, its Directors, Stockholders and Third Persons.

Assuming the corporation to be properly organized and administered, these relations would seem to be very simple and completely determined by our previous discussion. A corporation we have found to consist of the persons authorized to act in its name, that is to say, in the case of a stock company, for almost all purposes, of the directors. It therefore follows, in the absence of special statutes, that in the directors are vested all the powers of the corporation, and that they exercise them, not as the agents of the stockholders as ordinarily assumed, but as principals, from which it further follows that, so long as the directors act in good faith for corporate purposes, they are subject to no control and need no special authority from stockholders or others. But since, like trustees, they are natural persons, exercising the powers and administering the assets of an artificial person for the benefit of third

persons (the stockholders), they, like trustees, may be enjoined from acting in fraud of the corporation or from otherwise wasting its assets. The stockholders, as contributors and ultimate owners of the corporate funds, contributed only to be used in good faith for corporate purposes, have the right to see that such funds are so applied, and to that end have standing in court. If the funds have already been wasted, the situation is a little more difficult; since, although the corporation plainly possesses the right to sue the directors on account of their fraudulent acts, yet as a corporation consists of the directors, such remedy would seem to be insufficient. The courts, however, to meet this difficulty, properly allow in such cases the stockholders to institute proceedings in the name of the corporation. Excepting, however, this right to proceed against the directors in cases of fraud or waste, the stockholders would seem logically to have no rights as regards the directors except those granted by the statute or reserved in the charter, such, for instance, as the right to elect or remove directors, to authorize mortgages, to amend the charter, to dissolve the corporation, etc., or any liability to third persons except such stockholders' liability as may be imposed by the statute. The relations between the corporation itself and third persons should be even more simple. A corporation existing in the law as an artificial person, the subject of the general property rights, the dealings of third persons with it, should be governed by the common law applicable to like dealings between natural persons, such third persons being in nowise concerned with the various relations between the corporation, its directors and stockholders. But, as a matter of fact, the law governing the dealings between third persons and corporations has been much perverted by the establishment of the doctrine known as "*ultra vires*," according to which a corporation possesses only those powers especially conferred by the charter or necessarily incident to the corporate purpose; any acts not founded on such powers being held *ultra vires* and void.

This doctrine cannot be said to be satisfactorily established, for so contrary is it both to the nature of a corporation and

the rights of third persons dealing therewith, that the courts have never been able to enforce it to its furthest extent. The courts have never gone to the logical length of holding a contract executed on both sides voidable on the part of the corporation, thus enabling the latter to recover any consideration it may have given on account thereof; but they have sometimes held contracts executed by third persons voidable by the corporation, thus enabling the corporation, while retaining the benefit, to withhold the consideration. To conceal this conflict between the justice and the supposed necessity of the case, the courts have created the fiction that all persons dealing with a corporation do so with full knowledge of the extent and limitation of its corporate powers, and that, therefore, there is no such thing as an innocent party to an *ultra vires* contract—a fiction founded on a recognized principle of public policy in a case of public corporations, but which cannot be maintained in the case of private corporations, in the face of the well-known fact that not one person out of a hundred dealing therewith has any knowledge of the corporate charter. Private corporations are innumerable, and they do business all over the commercial world without reference to the State of their creation, and it is in the nature of the case impossible that the public should be informed as to the provisions of their various charters. This extraordinary doctrine, having its origin in a total misconception of the true nature of a corporation, is bolstered up through the confusing by the courts of acts *ultra vires* with acts contrary to public policy, and the acts of private with the acts of public corporations. The law of corporations has no special concern with the doctrine of law declaring contracts contrary to public policy void, as this latter doctrine is but the general law of the land, applicable alike to artificial and natural persons; and yet the courts, and especially the Supreme Court of the United States, in passing upon cases in which corporations, and especially quasi-public corporations, such as railways, have entered into contracts contrary to public policy, have based their decisions, properly holding such contracts void, upon the lack of power of the corporations to make them, rather than upon the in-

herent illegality of the contracts themselves. Take, for instance, the leading case of *The Central Transportation Company* v. *The Pullman Car Company*.[1] Here a *quasi*-public corporation, the Central Transportation Company of Pennsylvania, chartered for the transportation of passengers, etc., entered into a contract with the Pullman Palace Car Company of Illinois, agreeing, among other things, "not to engage in the business of manufacturing, using or hiring sleeping cars," thus in effect abandoning the duty which it owed the public. This contract, therefore, was void as contrary to public policy, and the Supreme Court, in deciding the case, so finds, but, nevertheless, rests its decision upon the general doctrine of *ultra vires* applicable to all corporations and all contracts, rather than upon the special circumstances of the case. It will be noted, in reading the opinion, that almost, if not all, the cases cited are either cases of like failure upon the part of quasi-public corporations to discharge their duty to the public, or are cases of *ultra vires* acts on the part of cities; yet all such cases are cited, as if the doctrine therein laid down was applicable to all corporations. But even in this case the court gives a proper definition of *ultra vires* contracts in the statement that they are such contracts as are "outside the object of its (the corporation's) creation as defined by the law of its organization," but, unfortunately, immediately draws the erroneous deduction that they are "therefore beyond the power conferred upon it by the legislature;" and then goes on to state that "the objection to the contract is not merely that the corporation ought not to have made it, but that it could not make it," although it is perfectly plain that the only objection to the contract in question in that case was that, for public reasons, the corporation ought not to have made it. This case, one of the leading cases in this country on the subject, shows very plainly the reason which has led the courts to establish this *ultra vires* doctrine upon an erroneous basis. The courts have entirely failed to distinguish between what corporations ought not to do and what they have not the

[1] 139 U. S. 24, 59.

power to do. There are evidently many things that a corporation should not do as being outside the purpose for which its capital was contributed by the stockholders, although entirely within the powers of the corporation as a person existing in the law. Of course, if the purpose of the contract be contrary to public policy, then, as in the case above cited, such contract is for such reason void, or if a municipal corporation enter into a contract outside the purpose of its organization, such contract is evidently voidable on the general ground that such corporations are not bound by the unauthorized acts of their agents. But such doctrine is not applicable to private corporation, and, therefore, plainly such corporations should be bound by all acts of the directors or corporate agents within the corporate powers, whether within the purpose of corporate organization or not. What these powers are, our previous inquiry has already determined. A corporation is an artificial person, existing in the law as the subject of the general property rights, and, therefore, subject, of course, to the right of the State to limit or enlarge them, is possessed of all the common law powers incident thereto. A corporation possesses the power to buy, to sell and to hold real and personal property, to borrow and repay money, to employ labor, to enter into contracts, etc., and, therefore, any act done or contract entered into by it in the exercise of any of such powers, is binding upon it, although such act or contract does not conduce to the purpose for which the corporation is organized. In such latter case we have found that the stockholders have a right to enjoin such action on the part of the corporation; but, nevertheless, if such act has been performed, or such contract entered into with an innocent third person without knowledge on his part of the improper purpose thereof, such corporation should evidently be bound thereby. The powers of persons at common law are simple and not complex (the right of purchase is a general abstract right and does not consist in the right to purchase one thing rather than another, or for one purpose rather than another), and of such nature also should the courts hold the powers of corporations.

The absurdity of treating the powers of a corporation as limited by its purposes is well illustrated by the case of *The Fort Worth City Co.* v. *The South Bridge Co.*[1] In this case a land company, although not vested by its charter with any special power to that end, contracted with a bridge company for the purchase of a bridge to be used on a public highway leading to the property which the land company was developing. At the suit of the bridge company for the contract price of the bridge, the land company, among other defences, alleged that the contract was beyond the special powers conferred on it by its charter and was, therefore, null and void. The court, Chief Justice Fuller, controlled it may be assumed by the requirements of justice, properly held the land company liable, but only upon the finding of fact that the construction of such bridge was one of the desirable means of developing the property held by it; leaving it to be inferred as, indeed, the doctrine of *ultra vires* would require, that if the construction of such bridge has not, as a matter of fact, been a proper means to that end, as to which fact the land company had full knowledge and the bridge company none at all, the bridge company and not the land company would have had to sustain the loss resulting from the building of a useless bridge. Plainly, in this case, the court should not have concerned itself with the question of the utility of the bridge, but should have held the land company liable upon the ground that the corporation possessing the power of purchase and having ordered the bridge, was liable to pay therefor, irrespective of the use to which it was put. Of course, however, should a corporation enter into an improper contract with a party having knowledge thereof, such contract should not be enforced, for in such case such party would be a party to the fraud on the corporation and fraud vitiates all contracts. But such knowledge, as in other cases of fraud, should be found as a fact and not presumed as a matter of law, although in many cases, as if, for instance, a charitable institution speculated through a broker, such knowledge might well be inferred

[1] 151 U. S. 294.

as a fact from the circumstances of the case. Even, indeed, if a corporation should be deprived by its charter of any general power, as, for instance, of the power to take or hold land, in the absence of any general law or public policy controlling the matter, persons dealing with such corporation should have the right to assume that it was not an exception to the rule, but that it was vested with the general property rights, and, therefore, in the absence of any special knowledge, such persons should be allowed to hold the corporation responsible for its *ultra vires* acts. On the contrary, however, it is equally true that if the powers of any special class of corporations, such as national banks for instance, are limited by general laws, such limitations, in accordance with the established doctrine of the common law, are binding on all persons. But the same considerations and the same corporate theory which should thus protect innocent persons against loss through the wrongful acts of persons composing a corporation, demand that such persons acting thus wrongfully should be held accountable to the corporation itself. It does not follow, however, that they should be held accountable for mere mistakes of judgment as to what acts do or do not serve the corporate purpose, but only when the corporate assets are wasted through their negligence or bad faith. This question of the responsibility of the directors of a corporation for their wrongful acts is often further complicated by the assent thereto of a number or all of the stockholders. It is clear that if every stockholder assented, they and through them the corporation, should be estopped from recovery, but it seems equally clear that any one innocent stockholder should have the right through the corporation to proceed against the directors, leaving the directors to whatever action they might have against their co-directors or assenting stockholders. To be sure, it would seem that the general doctrine that joint tort-feasors cannot enforce contribution against each other, would prevent such directors as were originally compelled to make good to the corporation the loss resulting from their wrongful acts, from recovering anything from their co-directors or from the stockholders participating therein, but the same public

policy which is the basis of the doctrine above mentioned, certainly sustains this application thereof. The knowledge on the part of the directors that, irrespective of the assent of even a majority of the stockholders, they will be held personally liable to the corporation for any loss it may sustain through their wrongful acts, will tend strongly to restrain them in the exercise of their trust.

All this proceeds on the assumption that a corporation is incorporated and organized in accordance with law; otherwise different questions arise. But such questions are easily determined if the proper nature of a corporation is born in mind. Take first the case of a body of men assuming to act as a corporation without authority of law. It is perfectly plain that if such persons so act without even a *bona fide* attempt to comply with the corporate law or for a purpose that is contrary to public policy, then their action is neither more nor less than a fraud upon the State, and they should not be permitted to screen themselves behind the corporate name, but should be held to their common law liability as individuals. But return to our definition, we see that the persons to whom the above statement applies are not the stockholders but the directors, since it is the latter, and not the former, who are empowered to assume to act under the corporate name; the stockholders, like the public, having been deceived, the latter into dealing with a fraudulent corporation, the former into subscribing for its stock. While the directors should, therefore, be held personally responsible to both the public and to the stockholders for any damages suffered by them through the fraudulent corporation, under no principle of law can innocent stockholders be held responsible therefor. As already found, in no sense are the directors the agents of either the corporation or of the stockholders, and therefore the stockholders, even of an illegal corporation, cannot be said to have authorized the directors to act as their agents. Nor can they be held liable as partners fraudulently doing business under the corporate name, for as already found it is the directors and not the stockholders who occupy such position. The stockholders are not partners in fact since such is not the contract

between them, nor should they be presumed to be such in law in the absence of any authority or right, apparent or real, on the part of any one of them to act on their joint behalf. As already said, it is the directors who hold themselves out to the public as authorized to act in the corporate name, and it is therefore they and not the stockholders who, if the corporation be non-existent, should be presumed in law to be partners. Yet the above considerations do not seem to go to the extent of relieving the stockholder from liability upon their stock subscriptions, for, although they have not in anywise constituted the directors their agents to conduct a commercial enterprise for them as principals, nevertheless they certainly have entrusted them with funds to be applied to such purpose, and their rights, therefore, should be subordinate to those of the creditors to whom such funds have been equitable pledged by way of carrying on such enterprise. As against the corporation and its directors, the stockholders should be permitted to disaffirm a contract of subscription entered into under a mistake of fact provided such disaffirmance is made promptly upon the discovery of such mistake; but as regards the public, who have dealt with such alleged corporation, relying upon the funds contributed or subscribed to it by the stockholders, the latter should be estopped from setting up the illegality of such stock subscriptions in defence of any action that might be brought against them or the corporation for or on behalf of innocent creditors. As regards the status of such pretended corporation itself, having no legal existence, no proceedings in the nature of *quo warranto* by the State are necessary to dissolve it, but its affairs will be wound up by a court of equity at the instance of any person interested in its affairs, or its non-existence may be set up by any third person in defence of any action brought in its name. But it does not follow from this that persons who, in their dealings with such pretended corporation have obtained possession of moneys or other properties properly belonging to the persons acting under such corporate name, should be permitted to maintain possession thereof as against these latter persons. On the contrary, under the general legal principle which holds all persons responsible for all moneys or

other properties coming into their possession which properly belong to another, they should be held liable therefor at the suit of such pretended incorporators as individuals.

So much for the case where the corporators cannot be said to be acting in good faith, but evidently where such corporators are acting in good faith and for a proper purpose, although having failed to comply with some provision of the statute authorizing the formation of the corporation, then other considerations apply, and in the absence of any special damage to any persons there would seem to be no reason why the courts, in order to maintain the rights of all persons concerned, should not hold all persons except the State estopped from denying the legal existence of the corporation. Although corporations were and are, as already seen, illegal at common law, yet the State having, through its legislation, recognized the policy of permitting persons to carry on certain commercial enterprises as an artificial person under an assumed name, the courts, certainly, in furtherance of such policy, may, when public convenience, equity and justice alike require it, recognize persons as a corporation who are in good faith acting as such for a legal purpose; and so the courts have done, and treat such pretended corporations as corporations *de facto* although not *de jure*. A corporation *de facto* may, therefore, be defined as the artificial person existing in contemplation of law by virtue of the *bona fide* undertaking by various persons to act as a corporation in accordance with the law and policy of the State.

A still different condition of affairs results when a corporation, although properly incorporated, undertakes to transact business without the capital required by its charter. The State, in creating a stock corporation, but confers upon various individuals the power to carry on a commercial enterprise under an assumed name by means of a fixed capital divided into transferable shares. The amount of capital is set forth in the charter that persons dealing with the corporation may have knowledge of its financial standing, that irresponsible companies may not masquerade as responsible concerns, that corporations should not be mere frauds and shams by which

individuals should be enabled to avoid their common law responsibilities and defraud the public. If, however, the legal requirement expends itself when the corporation declares a nominal capital, not demanding that such capital should actually exist as a condition precedent to the prosecution of the business, then it becomes but an additional snare and trap for the public deceived by such statement. Better that the corporation should not declare its capital, that the public should have no information with regard thereto and should knowingly deal therewith at its peril, than that it should be misinformed, that it should be lead to believe that a corporation possessed a large capital, when in reality it might possess little or none. The State, in fixing the capital or in requiring it to be publicly fixed, plainly makes the acquirement of such capital a condition precedent to the transaction of business, if not, indeed, to the very existence of the corporation itself. The State but authorizes the corporators to carry on a certain commercial enterprise under the corporate name by means of the capital stated; unless therefore provided with such capital, the corporators act at their own risk and without authority, and should not be permitted to screen themselves behind a charter with the most important provision of which they have failed to comply, but should be held to their individual common law liability.

But, as has already been found in the case of persons assuming to act as a corporation without authority of law, it is the directors not the stockholders who so act, and who, therefore, should be held responsible personally as partners therefor. The stockholders, like the public, may be assumed to be deceived by the directors, and there would seem to be no equity in holding them personally liable, not for their own, but for the directors' acts, except, as already found, to the extent to which they may have agreed to contribute to the corporate capital. And, indeed, this is recognized by the court, and in some States such limitations are even imposed by statute, while at the same time the courts have gone very far in holding such stockholders liable to the full par value of the stock taken by them, properly holding that the amount payable therefor is in

the nature of a trust fund, pledged for payment of the corporate obligations. Evidently, however, the creditors are entitled to something more than this limited right of redress against the stockholders, when they have been injured by the action of the *directors* in conducting the business of the corporation before the legal requirements as to capital have been by them complied with. If all the stock has not been subscribed, the full payment of all the subscriptions will not furnish the corporation with as large a fund applicable to the payment of its debts as the law requires, and which the creditors, therefore, have the right to demand; while if some of the stock has been subscribed for by irresponsible persons, the creditors should evidently not be put to the expense, delay and difficulty of pursuing the individual stockholders, nor be compelled to take the risk of any failure to collect from any such the par value of his stock.

But the matter needs no further discussion, since plainly the directors having, without complying with a condition precedent thereto, undertaken the prosecution of the business of the corporation to the resulting loss and injury of third persons, are and should be held, legally and equitably, personally responsible to them for such unauthorized act. It would not, indeed, seem extreme, under such circumstances, to deny the directors the right to set up their corporate capacity in defence of any action brought against them personally, and thus hold them responsible for all the debts of the corporation; but the demands of justice would seem to be met if they were compelled to make good to the corporation and its creditors the fund without which they had no right to transact business in a corporate capacity. The same reasoning applies to the case where the stock of the corporation has been all subscribed for and issued as full paid, when in fact the consideration therefor was not cash, but either of a nominal character or consisted of rights and properties of less than such par value. In such case, unless such issue for other than cash is authorized by law, the same is illegal and must be held to be at the risk of the directors who so issue, and of the stockholders who so pay their subscriptions; and, therefore, unless said

property realizes to the corporation in cash the full par value of the stock issued therefor, such directors should be held liable for the entire deficit, and each stockholder for the balance of his subscription, at the suit of the corporation or of any creditor. If, however, such issue for other than cash is authorized by statute, and such statute has been in all respects complied with, and such property has been in good faith given and accepted as of the full par value of and in full payment for the stock issued, no liability would arise on the part of anyone, even though such property is subsequently found to be inadequate in value; while on the contrary, if the statute has been evaded or the property knowingly overvalued, this constitutes a fraud invalidating the entire transaction, wherefore the directors, as before, should be held personally responsible to the creditors to the extent of the authorized capital, and such stockholders who have received their stock for less than its par value should be held responsible for the unpaid portion of their subscription. The authorities properly hold that the question in such case is one of good faith.

The law as stated above, and especially the doctrine of the primary liability of directors, would seem to be the necessary consequence of the nature of corporations as disclosed. The courts, however, do not recognize such personal liability on the part of the directors, and it is not law. Both the Bench and Bar have been misled by the assumption that the persons authorized to act as a corporation are thereby constituted not the corporation but its agents, and by the further assumption that if any persons could be said to be the corporation, they were the stockholders and not the directors. Having put the directors in the possession of mere agents, the courts have been unable to hold them to that primary and personal responsibility which is properly theirs, and which equity and justice demand should be imposed upon them. Yet, although released at law, it is the directors and not the stockholders who at the bar of public opinion are held responsible for corporate frauds, and it is to the character and position of the directors, and not that of the stockholders, that the public look for its estimate of corporate responsibility. The feeling of the

public, indeed, with reference to the nature of a corporation, is much nearer the truth than the accepted theory of law. So contrary, indeed, to the real nature of corporations is the legal assumption that it is the directors and not the stockholders who are responsible for improper corporate acts, that the courts have usually been compelled, upon one plea or another, to release the stockholders from such liability, with the unfortunate result that innocent third persons, defrauded by persons pretendlng to act as the corporation, have often had no redress except against the empty corporate treasury. If, however, the courts but held the directors to that responsibility which is properly theirs, full justice would be done and third persons and stockholders alike protected—as in such case the public would be justified in relying upon the character of the directors, instead of being ensnared thereby to its loss.

It is now probably too late to expect the courts to reverse the unfortunate position assumed by them, but it is to be hoped that the present evil may be cured by statute. Let the legislature but once impose upon corporate directors the responsibility which in justice and in law should be theirs, and fraudulent corporations would surely become things of the past, since being known by their directors, they would be incapable of injury.

Henry Winslow Williams.

Baltimore, October, 1898.