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# THE LIABILITY OF THE ASSOCIATES IN A DEFECTIVE CORPORATION.

To say that it is the present day tendency to conduct business and commercial enterprises through the medium of corporations in order to secure the resulting limitations of liability to those engaged therein, is to state an obvious fact. Partnerships are fast falling into disuse; individuals are organizing "one man corporations," that is to say, corporations in which all the stock is owned or controlled by one individual; and in direct proportion to the hazard of the proposed enterprise, intending incorporators are seeking the advantage of those states in which the requirements for publicity and official supervision are lax and in which subscription for any considerable proportion of the shares of the capital stock prior to organization, is not a necessity, to the end that they may risk but little in their quest for gain. It goes without saying that the vast majority of the companies organized in the United States are incorporated in good faith, but it is unfortunate that it is possible to evade the laws of the state of the residence of the incorporators, when its policy towards corporations as declared by its legislative enactments, imposes too many irksome restrictions and guarantees to the public a protection which the incorporators would seek to avoid. And so, too, it is unfortunate that frequently those who have extended credit to a corporation, relying on the published statement of its authorized capital stock, find when it is too late that but a modicum of the authorized shares have been subscribed for and issued, and that the assets of the corporation are practically nil.

But the very facility with which corporations may be organized in many of our states and territories frequently breeds a certain carelessness on the part of those who would shelter themselves behind the outward form and show of a corporation. Though the require-

ments are but few, often some of the most essential are not complied with, and the important questions arise: Can such defects render the incorporation invalid and impose upon those associated by virtue thereof the liability of co-partners? And if so, what are those defects?

Partnerships and stock corporations are both associations of individuals, united in a common business venture, under an agreement to divide among themselves the profits thereof. In a partnership each associate assumes the liability of the entire partnership indebtedness. In a corporation the liability of the associates is limited.

At common law every association engaged in a commercial venture under an agreement among the associates to divide profits was a partnership and each associate had imposed upon him the liability of a partner.[1] A grant of authority from the sovereign was necessary to enable the associates to limit their liability. This grant was termed a charter. It was a franchise to associate as a corporation, to limit the liability of each associate to the amount by him subscribed as capital, for the prosecution of the joint venture, and to relieve him from all liability when his subscription was fully paid.

In the United States, the right to incorporate was rarely conferred by executive grant; it was most commonly granted by the legislature by special act. By reason of abuses which crept into this practice and hindrance of general and public legislation, incorporation by special act has very generally fallen into disuse or is forbidden by constitution. General incorporation acts obtain in most states and a substantial compliance with their provisions is the only method of obtaining the right to associate as a corporation and to limit the personal liability of the associates. These acts are in effect general charters to all who qualify according to their provisions.

Such acts usually provide that a specified number of persons desiring to incorporate, shall file with the clerk of the county where the principal place of business is proposed to be situated, a written instrument, usually called the Articles of Incorporation, by them subscribed and acknowledged, stating the name of the proposed corporation, its place of business, the purposes of the incorporation, the amount of the capital stock and the number of shares into which it shall be divided. A certified copy of these articles is usually required to be filed with the secretary of state, who thereupon is usually required to issue under the great seal a certificate of incorporation.

1. Story on Partnership, Sec. 2; *Berthold v. Goldsmith*, 24 How. (U. S. 536; *Hunt v. Oliver*, 118 U. S. 221; *Karrick v. Hannaman*, 168 U. S. 328, 334.

The articles of incorporation, when prepared, executed and filed in conformity with the enabling act, constitute the special charter from the state to the associates. In other words, the articles particularize and limit the powers authorized by the general charter or general incorporation act, to the needs and purposes of the incorporators; thereby there is conferred upon them *the mere right to organize a corporation* and to limit the liability of each to the amount proposed to be contributed by him to the joint venture. A corporation *in posse* exists, which, after organization, will become a corporation *in esse*.[2] It follows that no association of individuals organized to engage in a business enterprise by any act or declaration not in pursuance of the enabling statute can divest itself of the character of a partnership and clothe itself with that of a corporation.[3]

It frequently happens, however, that such an association in good faith attempts to comply with an enabling statute, but the proceedings taken by it are defective and the questions then arise, whether the corporate character has been attained and what is the measure of the liabiity of the associates to the creditors of the association.

The authorities on these questions are numerous and somewhat inharmonious. The most recent and conservative authorities recognize the hardship of holding the associates liable as partners when they have in good faith attempted to limit their liability and lay down the rule that where the defect is formal rather than essential, the incorporation cannot be questioned collaterally and the associates are liable only as shareholders. If the proceedings have been such that a *de facto,* but not a *de jure* corporation has been organized, the associates will be considered as shareholders and the incorporation can be questioned only by the state in *quo warranto* proceedings.[4]

However, the statement of this rule is easier than its application. The question at once arises, what is formal and what is essential. So far as I have been able to discover, the authorities have laid down

2. *Miller v. Ewer*, 27 Me. 509; *Wechselberg v. Flour City Nat. Bank*, 64 Fed. 90, 95.

3. Helliwell on Stock and Stockholders, Sec. 438; *Mokelumne Hill Mining Co. v. Woodbury*, 14 Cal. 424; *Finnegan v. Nocrenberg*, 52 Minn. 239; *Kaiser v. Lawrence Savings Bank*, 56 Ia. 104; *Guckert v. Hacke*, 159 Pa. 303; *Abbott v. Omaha Smelting Co.*, 4 Neb. 416; *Jones v. Aspen Hardware Co.*, 21 Col. 263; *Bigelow v. Gregory*, 73 Ill. 197.

4. Cook on Corporations, Sec. 234; Helliwell on Stock and Stockholders, Sec. 438; *Mokelumne Hill Mining Co. v. Woodbury*, 14 Cal. 424; *Finnegan v. Nocrenberg*, 52 Minn. 239; *Kaiser v. Lawrence Savings Bank*, 56 Ia. 104; *Guckbert v. Hacke*, 159 Pa. 303; *Abbott v. Omaha Smelting Co.*, 4 Neb. 416; *Jones v. Aspen Hardware Co.*, 21 Col. 263; *Bigelow v. Gregory*, 73 Ill. 197,

no general rule by which this question may be solved, each case seeming to have been decided on its own merits.

To arrive at such a rule we must consider the reason underlying the enabling laws. As we have already seen, these laws usually provide that the articles of incorporation shall be made a public record. It is self-evident that the reason for this provision is publicity. It is designed to give notice to those intending to deal with the company that it is a corporation, the liability of the members of which is limited, and not a partnership. The required contents of the notice usually are only matters of which the public should be advised for its protection in dealing with the company.

I think that a rule which will come within the reason of the law, is that all acts which the legislature has provided, shall be done for the purpose of protecting the public in its dealings with the future corporation, must be substantially done before a corporation can be organized, either *de jure* or *de facto*. Any other rule would tend to encourage secrecy and fraud. Certainly, associates secretly adopting articles of incorporation and failing to give them the required publicity, as they might adopt articles of co-partnership, cannot be said to have advised the public of their intention to limit their individual liability, and until such notice is given, the law very justly provides that the public may hold them liable as partners; that no corporation, either *de jure* or *de facto*, has been created.[5]

A *de facto* corporation may be defined as an association of individuals who may have made a *bona fide* and colorable attempt to secure a charter and organize a corporation under an enabling act, and who actually assume the use of corporate powers. That is to say, there must be on the face of the record the appearance of having substantially complied with the essentials of the act. If such be the fact, the state alone can question the corporate existence; if such be not the fact, at least so far as limitation of liability is concerned, no corporation has been formed.[6]

The wisdom of the law is in the legislature, not the courts, and the courts cannot say that it is non-essential which the law either in letter or in spirit makes essential.[7]

If the associates file their articles of incorporation in a foreign state and substantially comply with the requirements of its enabling

5. *Bigelow v. Gregory*, 73 Ill. 197; *Finnegan v. Noerenberg*, 52 Minn. 239; *Abbott v. Omaha Smelting Co.*, 4 Neb. 416.

6. *Finnegan v. Noerenberg*, 52 Minn. 239; *Montgomery v. Forbes*, 148 Mass. 249; *Martin v. Deetz*, 102 Cal. 55; *Johnson v. Corser*, 34 Minn. 355; *Walton v. Oliver*, 49 Kan. 107.

7. *People v. Montecito Water Co.*, 97 Cal. 276.

act, as we have already seen they receive in effect a charter from that state; and that state for that enabling act, within the limitation prescribed by the articles, confers upon them the right and authority to organize a corporation. This organization must be effected pursuant to such authority before the incorporation is complete. Where then must the corporation be organized? Obviously the enabling act can have no extra-territorial operation; the authority is derived only from that act and cannot be conferred without the state. Accordingly it follows that the corporation must be organized within the boundaries of the state which authorizes its organization.[8] In order to hold an organization within the state of the residence of the associates valid, it must be also held that the enabling or incorporation acts of every state, territory and foreign country are operative in every other state and that any foreign jurisdiction by legislative enactment or executive decree can enable citizens of another state to associate as a corporation in that state and make the public record of their incorporation in a distant and foreign state. To so hold is to defeat the very policy of all incorporation laws, which, as we have seen, is to give publicity to the fact of incorporation. There is no rule of comity which permits a foreign sovereign to legislate within the confines of the domestic state. To permit foreign laws so to operate is to surrender sovereignty itself. "There is no rule of comity which requires one state to be made the birthplace of corporations chartered by another."[9]

The associates can organize a corporation in the state of their residence only under the enabling act of that state. If they attempt to organize within that state under a grant of authority from a foreign state, the company which they organize is not a corporation. The authority by virtue of which they attempt to organize has no force, effect or existence in the state of their residences, and so far as they are concerned, while acting in that state, the enabling act is as though it had no existence whatsoever. The company which they have organized is not even a *de facto* corporation, for, as has already been seen, such a corporation is premised upon the existence of an enabling act and an attempt to comply therewith, but they have complied with an act which has no existence in the place of the company's organization.

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8. *Miller v. Ewer*, 27 Me. 509; *Smith v. Silver Valley Smelting Co.*, 64 Md. 85; *Bank of Augusta v. Earle.* 13 Pet. 519; *Tioga R. R. v. Blossberg, etc. R. R.*, 20 Wall. 137; *Insurance Co. v. Francis*, 11 Wall. 210; *Ohio, etc., R. R. Co. v. Wheeler*, 1 Black 286; *Paul v. Virginia*, 8 Wall. 169. *Contra, Heath v. Silverthorn Lead Mining and Smelting Co.*, 39 Wis. 146.

9. *Smith v. Silver Valley Smelting Co.*, 64 Md. 85.