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ARE THE MEMBERS OF A DEFECTIVELY ORGANIZED CORPORATION LIABLE AS PARTNERS?

By Charles E. Carpenter*

Are the members of a defectively organized corporation liable as partners? The decisions of the courts are in conflict. Where there is defectiveness of incorporation but the de facto requisites have been complied with, there is substantial agreement of the decisions that the members of the organization are not personally liable unlimitedly to the creditors of the corporation. If however the defect of incorporation goes beyond this and the requirements for a de facto corporation have not been met there is disagreement in the decisions. One group of cases, about half, holds that the members of such an organization are not liable individually as partners by reason of such defectiveness of organization, and the other group holds the members are individu-

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*Professor of Law, University of Oregon.

1 The de facto requisites have been stated by Professor Edward H. Warren in 20 Harv. L. Rev. 464 as follows: "1. That an attempt to incorporate has been made resulting in a colorable corporate organization; 2. That there was a law authorizing the formation of such a corporation as was attempted; 3. That there has been user of some of the powers which such a corporation would possess; and 4. That the persons seeking to prevent collateral attack acted in good faith."

Machen says, in 1 Modern Law of Corporations, sec. 285: "If there be a valid statute under which a company might be incorporated, a bona fide colorable attempt to comply with the law, and finally an organization and exercise of corporate functions all the authorities which recognize the doctrine of de facto corporations, would, probably, agree that a proper case has been made for holding that the company is a de facto, if not a de jure, corporation."

2 Professor Burdick in an article entitled Are Defectively Incorporated Associations Partnerships? 6 Col. L. Rev. 1, contends that the members should be held liable as partners and he would not draw the line where the de facto requisites have been met.

Professor Edward H. Warren thinks other considerations than the de facto requisites should be weighed in determining liability.


ally liable unlimitedly upon the ground that by virtue of such
defectiveness of organization they are partners.\(^4\)

In our restatement of the law, which of these views, if either,
shall we adopt? Shall we treat defectively incorporated associa-
tions as partnerships or not?

It is the contention of this article that because it is opposed
to a correct conception of the nature of the stockholders’ liability
on the contract of the corporation, the reasons given for it are un-
sound, and it is bad economic policy. The doctrine that members
of defectively organized corporations are partners should be
abandoned.

To treat those who take stock in a corporation as partners
where incorporation is defective is out of harmony with a correct
conception of the nature of the stockholders' liability on corporate
contracts. What is the nature of the stockholders' liability? The
usual mode of thinking and of speaking of the corporation is that
it is an entity distinct from the stockholders, and that this entity
is the party to the contracts and the owner of the property, while
the stockholder is a mere claimant against the corporation. But
in reality the corporation is simply a method by which natural
persons own property and manage business. The courts have
frequently recognized this.\(^5\) Professor Hohfeld has made a
graphic statement of this relation. Let me quote his words: 6

Richardson, (1879) 35 Ark. 144; Winfield v. Truitt, (1916) 71 Fla. 38,
70 S. 775; Duke v. Taylor, (1896) 37 Fla. 64, 19 S. 172, 53 A. S. R. 232, 31
I. R. A. 484; Flagg v. Stowe, (1877) 85 Ill. 164; Bigelow v. Gregory,
(1874) 73 Ill. 197; Pettis v. Atkins, (1871) 60 Ill. 454; Coleman v. Coleman
(1881) 78 Ind. 344; Kaiser v. Lawrence Sav. Bank, (1881) 56 Iowa 104
460, 121 Pac. 340; Sanders v. Herndon, (1908) 128 Ky. 437, 108 S. W. 908,
Bank v. Henderson, (1906) 116 La. 413, 40 S. 779; Provident Bank & Trust
Co. v. Saxon, (1906) 116 La. 408, 40 So. 778; Eaton v. Walker (1889) 76
382; Abbott v. Omaha Smelting Co., (1876) 4 Neb. 416; Hill v. Beach,
(1858) 12 N. J. Eq. 31; Bain v. Clinton, Loan Assoc., (1893) 112 N. C. 248,
17 S. E. 154; New York Nat. Exch. Bank v. Crowell, (1896) 177 Pa. 313,
Brunson, (1915) 104 S. C. 34, 38 S. E. 359; De Soto Bank v. Reed, (1908)
50 Tex. Civ. A. 102, 109 S. W. 256; Bergeron v. Hobbs, 96 Wis. 641, (1897)
71 N. W. 1056, 65 A. S. R. 85; Jennings v. Dark, (1910) 175 Ind. 332, 92
S. W. 948; Cincinnati Cooperage Co. v. Bate, (1894) 96 Ky. 356, 26 S. W.
496, 49 A. S. R. 394; Martin v. Fewell, (1883) 79 Mo. 401.

\(^5\)Cincinnati Volksblatt Co. v. Hoffmeister, (1900) 62 Oh. St. 189, 200,
56 N. E. 1033, 48 L. R. A. 732; Upton v. Englehart, (1874) 3 Dill.

\(^6\)Col. L. Rev. 288-89.
"If for example we say that XYZ, a corporation, has entered into a certain contract with A, we mean that as to form and procedure the transaction has been carried out as if the XYZ association of individuals were a single person having XYZ as his name. Similarly, it is no doubt true, according to a number of decisions that a perfect legal title to land cannot be transferred merely by all the stockholders joining in a conveyance. This obviously does not indicate that the stockholders as such are not the exclusive holders of the legal rights, powers, liberties, etc., relating to that land; it shows merely that the form and method of transferring title to this particular land is different from that which would be sufficient if, e.g., the owners were ordinary joint tenants or tenants in common. The transfer must, in accordance with the forms prescribed by law, be made as if the corporation were itself a single person owning the land and acting through certain representatives."

If in a fundamental way and avoiding this descriptive formula of the corporate personality, we look at the question of the stockholders' liability on the contract made in the name of the corporate entity, we must say the stockholders' liability is contractual. There are many cases in which this liability has been described as contractual. Perhaps the strongest statement of this view is made by Justice Brewer in the well known case of *Whitman v. Oxford National Bank* where he said:

"The liability which by the constitution and statutes is thus declared to rest upon the stockholders, though statutory in origin, is contractual in its nature. It would not be doubted that if the stockholders in this corporation had formed a partnership the obligations of each partner to the others and to creditors would be contractual, and determined by the general common law in respect to partnerships. If Kansas had provided for partnerships with limited liability, and then parties complying with the provisions of the statute, had formed such a partnership, it would also be true that their obligations to one another and to creditors would be contractual, although only in the statute was to be found the authority for creation of such obligations, and it is none the less so when these same stockholders organized a corporation under a law of Kansas, which prescribed the nature of the obligations which each thereby assumed to the others and to

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the creditors. While this statute of Kansas permitted the forming of the corporation under certain conditions, the actions of these parties was purely voluntary. In other words they entered into a contract authorized by the statute."

There has been some dissent from this view that the nature of the liability is contractual and the contention made that the obligation is quasi-contractual rather than contractual.⁹

Professor Hohfeld champions this view. He says:¹⁰

"Over and over again, therefore, the obligation of X and the other stockholders may come into existence without this actual concurrence, and, in some cases, in spite of their express dissent and minority vote. Further, even if X expressly yields his assent to a contemplated corporate obligation and votes with the majority, the obligation thereafter fixed upon him and his fellows results not from his voluntary act alone or from exercise of his individual power alone; on the contrary, it results from the volitions and the concurrent exercise of rights and powers of a majority of the stockholders and the corporate officers and agents whose will may be involved. The obligation and liability of X, in other words, grows out of the relation which he has, by joining the corporation voluntarily constituted between himself and his fellow-stockholders. In view of the foregoing considerations, the obligation and liability in question may, perhaps be accurately described as quasi-contractual rather than contractual."

But does this not go too far in assuming that actual meeting of minds is a prerequisite to contract? Professor Williston has pointed out that the test of assent is objective rather than subjective, whether there is an expression that would normally indicate assent, not whether the minds of the parties met.¹¹ And Professor Costigan has shown that the objective test should be applied in the field of implied-in-fact contracts as well as in the express contracts.¹² The objective test of assent should be satisfied as well by conduct as by words. The instances are numerous where a contract arises without actual mental assent. There are the notorious instances of the transmission of words through an intermediary who makes a mistake in the words transmitted, and the mailing of acceptance before receipt of revocation, where a contract arises without actual mutual assent. Common instances are to be found in cases where custom forms a part of the contract. It is not essential in such cases that the parties knew of

¹⁰109 Col. L. Rev. 312-13.
¹¹14 Ill. L. Rev. 85-95.
¹²33 Harv. L. Rev. 376-400.
rules established by custom. Most indorsers undertake contract obligations they never had in mind.

In the field of obligations where one is bound by the acts or expressions of another, there are many instances when the law imposes contractual liability without actual mental assent. It is difficult to spell out actual mental assent on the part of the principal to all contracts made by his agent, when the agent has been given a large measure of discretion, and it is clearly impossible to do so where the agent makes a contract within the general scope of the business but in violation of an express limitation on his authority by the principal. Yet no case has been found which questions that the liability of the principal is contractual in such cases. In the case of unincorporated associations not partnerships, and in partnerships, the basis of liability of members who did not contract directly rests upon the principles of the law of agency, and frequently members are held liable who do not actually mentally assent to the contract. Thus members of a college class who attend a class meeting and who assent to a vote being taken for a class publication are bound in contract, though they voted against the proposal.3

The members of a voluntary unincorporated association, such as a class, committee, club or society, are not by virtue of membership in such association liable on contracts made in behalf of such association, where such associations were not formed for the purpose of making such contracts. There is lacking in such cases the necessary objective assent. But where it is part of the scheme or purpose of the organization to undertake certain contracts, contracts made on the credit of the association may be entered into by a majority vote, or at the discretion of a committee or an officer whose duty is to enter into such transactions for the association, even against the express dissent of members, who are no less bound by the contract than the assenting members. By becoming a member of the association a person assents in advance to be bound by its proper contracts. It seems wiser to say the assent in such cases is sufficient for contract, and to treat these as contractual obligations of the parties as the courts have done, than to throw them over into the class of quasi-contract obligations. So long as principals, members of unincorporated associations, and partnerships are bound by contracts in spite of their specific non-assent to the contract, there seems to be no ground, at least

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so far as the element of assent is concerned, for distinguishing the liability of stockholders on the contract of the corporation and treating them as quasi-contractual.  

Does defectiveness of incorporation change the nature of the stockholders' liability on corporate contracts? Where the stockholder has nothing to do with the insufficiency of incorporation, is in no way responsible for it and has no knowledge of it, we cannot say the consensual elements of the contract are changed. The objection to treating the stockholders' contract as a corporate one, no matter how defective the incorporation, it is submitted, is not to be found in principles peculiar to the law of contracts. The objections, if any, rest in public policy. Apart from public policy, stockholders in a corporation, no matter how defectively organized, should be able to sue or be held liable on contracts as if they were a corporation.

What are the considerations of public policy which are opposed to giving validity to the corporate contract? Is it that the associates in a defective corporation should not be allowed to sue or be sued or to do business in the corporate name? This is hardly more than a technical objection. It has been ably shown that associates who have never even attempted to incorporate should not be denied the privilege of suing or being sued, or doing business, in the corporate name.

The only substantial objection to treating an insufficiently incorporated association as a corporation is the possibility of fraud and imposition upon persons who have dealt with it, for such persons would have lost their recourse against the individual members without being assured of that substituted security which legal incorporation would have given them. Subject to safeguard against abuse of immunity from individual liability, persons should be as free to associate themselves into corporations by contract as to form partnerships or other voluntary associations.

But even if the obligation is treated as quasi-contractual because arising from the relation, still the nature of the obligation should be determined by the nature of the relation the parties intended to establish. The non-partnership, non-corporation association would be a relationship giving rise to a different type of obligation from that of the partnership and the partnership a different obligation from that of the corporation.

See able article on Unincorporated Associations as Parties to Actions by Professor Wesley A. Sturges, in 33 Yale L. Jour. 383.

In a free commercial country, individuals should have the power by mere private contract or agreement to associate themselves together as a corporation for any merely private lawful object. They should enjoy the same freedom in the formation of corporations that Anglo-Saxon jurisprudence has always accorded in the formation of partnerships or
Since the basis of the doctrine of de facto corporations is that compliance with the de facto requisites furnishes the necessary safeguard against abuse of the immunity from individual liability, it would be well if the de facto requisites were re-defined to accord with this fundamental reason which is the excuse for its existence. The de facto requisites should be so stated that the parties to a corporate contract would be confined to relief upon the contract, except where the person dealing with the corporation would, if his remedy were limited to the contract, suffer loss by reason of the inadequacy of incorporation. This would greatly simplify matters and give the person contracting with the corporation relief and all the relief he is entitled to in that situation.

But where relief on the corporate contract is inadequate or is denied because of defectiveness of incorporation, what remedy, if any, should the person who contracted with the associates as a corporation have?

We have seen that about half the American decisions refuse to hold the members to unlimited liability on the contract as partners upon the simple and obviously sufficient ground that the associates did not agree to be bound as partners and the party contracting with them did not intend to contract with them as such, and that to do so involved not only a nullification of the contract the parties entered into, but the imposition upon the parties, of a contract they positively intended not to make. These courts confine the relief of the person contracting with the corporation, to those persons who actively participated in making the contract, on the theory that an agent who contracts for a non-existent or incompetent principal is liable.

That an agent may be liable on the ground of an implied warranty of authority seems never to have been questioned since the decision of Collen v. Wright in 1857, and this has been ex-

2 See note 3 supra.
3 Morawetz, Private Corporations, sec. 748.
tended to a warranty of the existence of a principal and to the competency of that principal. The basis of this liability on an implied warranty is that the agent impliedly represents when he purports to enter into a contract for his principal, that he has a principal who authorized the agent to make the contract, although it is true the agent is held liable in assumpsit on the implied warranty, and many cases even hold the agent on the contract he purported to make for the principal.

It therefore seems a proper application of these principles of agency to hold liable upon a theory of implied warranty those persons who actively participate in making the corporate contract, where there was no corporation competent to contract.

Are the divers reasons given to support the view that defective corporations are partnerships sound? It is argued that the law knows but two forms of association for business or trade, corporations and partnerships, and as the members intended corporate liability, a liability of some sort, and the law refuses to impose the corporate liability intended, they must be liable as partners; that the application of the same principles by which a dormant partner is held liable will result in imposing unlimited individual liability upon the members of defectively incorporated associations; that the fact that they did not intend a partnership is no objection to holding members of such an association liable as partners, for persons may be held liable as partners who never intended to become partners; that it is no answer to holding such persons to unlimited individual liability that they intended no

27 Machen, Modern Law of Corporations, sec. 293, states this reason thus: "Although it is true that the members of the association did not intend to become partners, they did intend to engage in a joint enterprise as an associated body. Now, the law knows but two forms of associations for business or trade—corporations and partnerships; and as they are not a corporation they must be a partnership."
28 Mechem, Elements of Partnership sec. 10, states this reason as follows: "It is contended that the parties must have intended that they become liable in some way, and inasmuch as they have failed to bind themselves as a corporation, it must be assumed that they are liable as partners—that it is only through the fact that they are corporators and not partners that they escape personal liability; and hence if the corporate shield fails, the individual liability necessarily arises."
29 Burdick, Are Defectively Incorporated Associations Partnerships? 6 Col. L. Rev. 1, 6.
30 Burdick, op. cit. p. 9.
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such liability, for such liability is frequently imposed though none was intended; and that it is by virtue of legal incorporation that members of a corporation escape individual liability and not by virtue of contract, for members of an unincorporated association can escape individual liability only by a clear and express provision in the contract with the creditor, to that effect.

Let us examine these reasons seriatim.

Is the oft repeated argument for partnership liability, that as the law refuses to hold the members of the association to be members of a corporation they must be partners, since there are no other than the two forms of association for business known to the law sufficient? If for purposes of argument we admit that there are only two forms of association for business does it follow as a necessary inference that if the parties intended corporate liability when they entered into the contract, and that is impossible under the law, the members of the association are liable as partners? Is not the inference of no liability a possible one? In fact the usual result of a failure on the part of the law to impose the liability the parties contemplated by their contract, is not to impose a new or different contract, but to impose no contract liability at all. This argument would have the result of creating a corporation whenever a futile attempt to form a partnership was made. This is obviously absurd. There is no good reason why the law should refuse to recognize the existence of unincorporated associations which are not partnerships. In fact do we not have many associations for business or trade which are neither partnerships nor corporations? Have we not cases of tenants in common, lessor and lessee, trustee and cestui, lender and borrower, subpartnerships, unincorporated associations, and in those jurisdictions which refuse to hold defectively incorporated associations to be partnerships, a further group of associations which are neither corporations nor partnerships? This argument for partnership liability is artificial and obviously insufficient.

Is the liability of a dormant partner an analogy for holding the members of a defectively organized corporation to unlimited liability? Professor Burdick in an able article on Are Defectively Incorporated Associations Partnerships? contents that it is. He argues by way of illustration, "a business is conducted in the name

\[30\] Warren, Collateral Attack on Incorporation, 21 Harv. L. Rev. 305, 312.

\[31\] Burdick, Are Defectively Incorporated Associations Partnerships? 6 Col. L. Rev. 7-8.

\[32\] 6 Col. L. Rev. 1, 6.
of John Smith. X becomes a creditor for goods sold. He takes a promissory note for the debt signed 'John Smith.' When selling the goods and taking the note, he supposes that John Smith is the sole owner of the business and gives credit in accordance with that supposition. Afterwards, he discovers that John Jones was all this time a dormant partner of John Smith. X is entitled to sue Smith alone, or to sue Smith and Jones." And he further continues "that the creditor of a business association, who sues the stockholders as partners upon discovering they were not a corporation acts precisely as the law permits the creditor of a dormant partner to act." Let us admit the creditor is acting similarly in each situation and if he is allowed to recover there is the further analogy that in each instance the creditor gets something he did not expect to get. But when we shift from the creditor end, the right end, to the obligation end of the contract, does the analogy hold out? Are the positions of the stockholders and the dormant partners analogous? Is the element of consent and authorization the same in each case? The dormant partner, by becoming a partner, authorizes the imposition of unlimited individual liability as to transactions within the scope of the partnership business; the stockholder, on the other hand, by becoming a stockholder authorizes the imposition of only corporate liability. The dormant partner is not liable on a contract made by John Smith unless he authorized it. How jealously the courts insist on this authorization as the basis of the dormant partner's liability may be seen from the fact that if he did not authorize the contract he cannot even make himself liable by ratification. The truth is the two situations are not analogous, the dormant partner authorizes unlimited individual liability, while the stockholder authorizes only corporate liability, and the application to the contract of the member of the defectively organized corporation, of the principle by which the dormant partner is held liable, namely authorization, will hold him to corporate liability only, that is excuse him from unlimited individual liability.

Should the members of a defectively incorporated association escape liability as partners by reason of the fact that they did not intend to form a partnership? Professor Burdick argues that

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33 That the undisclosed principal (the dormant partner is an undisclosed principal) cannot make himself liable by ratification, see Keighley v. Durant, [1901] A. C. 240; 1 Mechem, Agency 2nd Ed., sec. 386. Perhaps the only state which allows the undisclosed principal to make himself a party to the contract by ratification is Massachusetts, see Hayward v. Langmaid, (1902) 181 Mass. 426, 63 N. E. 912.

34 Burdick, 6 Col. L. Rev. 9.
they should not. Is his argument sound? He supports his contention by the following quotations from the opinion of Judge Cooley in *Beecher v. Bush*.

"It is possible for parties to intend no partnership and yet to form one. If they agree upon an arrangement which is a partnership in fact, it is of no importance that they call it something else, or that they even expressly declare that they are not partners. The law must declare what is the legal import of their agreements, and names go for nothing where the substance of the arrangement shows them to be inapplicable."

But further quotations from this same opinion of Judge Cooley's will make it obvious that it cannot be cited as authority for holding members of a defective corporation liable as partners. He says:

"Every doubtful case must be solved in favor of their intent; otherwise we should carry the doctrine of constructive partnership so far as to render it a trap to the unwary. Except when one allows the public or individual dealers to be deceived by the appearances of partnership when none exists, he is never to be charged as a partner unless by contract and intent he has formed a relationship in which the elements of partnership are to be found. And what are these? At the very least the following: Community of interest in some lawful commerce or business for the conduct of which the parties are mutually principals of and agents for each other, with general powers within the scope of the business. The test of partnership must be found in the intent of the parties themselves. Our conclusion is that Beecher and Williams having never intended to constitute a partnership are not as between themselves partners. There was no common property, no agency of either to act 'for the other or both, no participation in profits, no sharing of losses."

We must admit that if the parties "agree upon an arrangement which is a partnership in fact"—a relationship which has the essential characteristics of a partnership, it is unimportant that the parties intended not to be subjected to partnership liability,—a liability the law inevitably imposes by virtue of assent to that relationship. But such admission is not a sanction for the imposition of partnership liability upon persons who subscribe for or purchase stock in a corporation. The person who takes stock in a

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corporation intends to enter into a relationship or association with characteristics differing in almost every conceivable respect from those of a partnership.

One of the outstanding differences between partnerships and corporations is in the power of the members to subject the association to liability. When the parties enter into a partnership relation they contemplate the transaction of a business which they are to own in common and carry on as principals and agents for each other and for their mutual pecuniary gain. If they contemplate such an association, it matters not that they did not call it a partnership nor that they did not intend to assume partnership liability, for that is a mere consequence of the relation they have established, of the power they have vested in the other members. Because of this power of general agency in the partners it follows that an express limitation on the power of a partner not known to the one dealing with him is ineffectual where the transaction is one in the scope of the partnership business. On the other hand, when a person takes stock in a corporation he does not contemplate entrance into the business as a mutual principal and agent, and because of this absence of general agency, the other stockholders have no power by virtue of membership, to bind him even within the scope of the corporation's business, and limitations of power are unnecessary.

But the corporation differs from the partnership not only in respect to the powers of its members, but in respect to the interests, rights and duties of the members inter sese and with those who deal with them, and also in respect to the transferability of those powers, interests, rights and duties. In fact the differences are so marked that it seems inexcusable to ignore them and say intent to enter into one may make a person a member of the other.

Should the members of a defectively incorporated association escape unlimited liability by reason of the fact that they intended only a limited or corporate liability? Professor Warren argues that they should not. He says "The contention that out of a consensual transaction no obligation can arise except such as the parties intended to arise is not sound. The law frequently imposes upon the parties to a consensual transaction certain obligations not covered by their actual or expressed intent. Thus A, owner of a tract of land, may convey a portion of it to B, and A may find that the law imposes an easement for B over the land retained, although he had no intent that B should have such easement. Thus A may sell goods to B and find that the law imposes upon
him a warranty of their quality, although he had no intent to make such a warranty. Then A may, without authority, assume as agent of B, to contract with C, and may find the law imposes upon him personally a liability under the contract.

"The agent does not intend to be bound himself at all, but if he acts without authority, full liability for the act rests upon him. The associates intend to be bound, but with limited liability. If they are without authority to limit their liability, full liability for the act rests upon them."49

Are these cases of easement by necessity and implied warranties analogies for holding the stockholders to a liability they intended not to assume? In the first place it is not clear that the examples given are cases in which the obligation which the law imposes was not intended. "The grant or reservation of a way of necessity is implied merely to accord with the presumed intent of the parties,"41 and it has been ably argued that warranties, such as those cited, have sufficient consensual element to make them contractual rather than quasi-contractual in nature,42 and it would seem clear in the easement and warranty cases that no obligation would be imposed if the parties expressed an intent against such implication. It is the law that the implication of a way of necessity may be excluded by particular language in the conveyance,43 and that no warranties of quality by a seller, nor of implied authority by an agent will arise if the seller or agent by words or by conduct indicates a warranty is not intended.44

Now contracting on a corporate basis is manifesting an intent not to contract on a basis of individual liability, and should therefore prevent the implication of an obligation intended not to be assumed from arising. The easement and warranty cases instead of being an analogy for unlimited liability, on the contract, are an analogy for not imposing such liability. To impose partnership liability, or any sort of individual liability, in contract on the stockholders, is substituting in place of the intended contractual obligation, (the corporate obligation), a contractual obligation which neither of the parties intended should be assumed.

It is admitted to be well established law that partners may by a provision in their contract limit their personal liability to their

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40Collateral Attack on Incorporation, 21 Harv. L. Rev. 312.
412 Tiffany, Real Property, 2nd Ed., 1302.
42Costigan, Implied-in-fact Contracts and Mutual Assent, 33 Harv. L. Rev. 376, 400.
43Seeley v. Bishop, (1848) 19 Conn. 128.
interest in a specific fund or the funds or property of the partnership.45 It would seem that this limitation may be accomplished by a stipulation in the partnership's agreement or other agreement between the partners known to the one dealing with the partnership.46 But as limited personal liability can be secured by the partners only by a clear stipulation to that effect,47 it is argued that as the corporate contract contains no such stipulation, stockholders in a defective corporation should be held to unlimited individual liability.48 But does not this argument ignore the fundamental distinction between partnership and corporate methods of doing business, in particular, the distinction which exists between the usual and normal liabilities of partners and of stockholders? Since universally partners are liable personally unless it is expressly provided to the contrary, partners have no ground to complain if they are held personally liable in the absence of restrictive stipulations. Since stockholders are universally held free from unlimited personal liability in the absence of express provisions49 for liability in the statutes or articles of incorporation, and since


46 That restrictions on the powers of partners known to persons dealing with the partner are effectual is so well recognized that it needs no citation of authority to the learned readers of this Review. The Uniform Partnership Act, sec. 9, par. (4), provides: "No act in contravention of a restriction on authority shall bind the partnership to persons having knowledge of the restriction." See also Story, Partnership, sec. 164, as to limiting liability to a specific fund in partnership articles.

47 Thus in Hess v. Werts, (1818) 4 Serg. & R. 356, 361, a partnership issued notes "payable to bearer on demand out of the joint funds, according to the articles of association," and the articles provided the payment was to be made when convenient. The partners were held to personal liability on these notes. The court said, "they may limit their responsibility, by an explicit stipulation made with the party with whom they contract, and clearly understood by him at the time." But the court thought this stipulation equivocal and one facilitating the commission of fraud.

48 Burdick, 6 Col. L. Rev. 6.

49 "By the common law there was no individual liability of the members of a corporation for corporate debts beyond the enforcement of their agreed contribution to the capital stock." Wechselberg v. Flour City National Bank, (1894) 12 C. C. A. 56, 26 L. R. A. 470, 64 Fed. 90; citing Terry v. Little, (1879) 101 U. S. 216, 25 L. Ed. 864; United States v. Knox, (1880) 102 U. S. 422, 26 L. Ed. 216.

"No doubt it has been settled for a long time that individual members are not liable for the debts of a corporation, and it has even been said that 'the personal responsibility of the stockholders is inconsistent with the nature of a body corporate;' yet in the Roman law it seems that if the corporation became insolvent the persons constituting it were obliged to contribute their private fortunes; and though it may be hazardous to assert that at common law the rule was the same in England, it is certain that, so far as the evidence goes, it points to that conclusion." 2 Harv. L. Rev. 160.
incorporation statutes usually provide for limited liability, the stockholder who knows nothing of the defect in incorporation does have a good basis for complaint if he is held liable by reason of the absence of a provision for limited liability in his contract with the third person.

Thus we have found no sufficient reason for violating the contract of the stockholder of the defectively organized corporation, and we may go further and say that an examination of the cases will show there is no real support for so doing in the great majority of the cases which purport to stand for partnership liability. The facts of these cases do not show that the doctrine of partnership liability is needed to explain the result reached nor that the principle of the liability of an agent for impliedly warranting the competency of his principal to contract, will not explain the decisions. In few, if any, of the cases, do the facts show that the defendants held liable were not actively participating in making the corporate contract. In most of them it is not an unfair inference that they were actively participating. It must be borne in mind that these cases were dealt with on the theory of partnership liability, and under that theory membership in the association is all that is required for liability, and therefore the facts relating to active participation by the defendants are more or less submerged or only mentioned incidentally. In most of these cases the facts show the defendants were incorporators who were few in numbers, and therefore presumptively active or

\[50\] Thus in Wechselberg v. Flour City Nat. Bank, (1894) 12 C. C. A. 56, 64 Fed. 90, 26 L. R. A. 470, only the three original incorporators were held liable and one of them sought to escape liability on the ground that he did not participate in the business which was undertaken, but the court found that he had participated sufficiently to make himself a party to the assumption of corporate powers.

In Garnett v. Richardson, (1879) 35 Ark. 144, only the three original incorporators of the company were held liable and it is probable that each was active.

In Bigelow v. Gregory, (1874) 73 Ill. 197 and Pettis v. Atkins, (1871) 60 Ill. 454, only the signers of the original articles were sued.

In Central Nat. Bank v. Sheldon, (1912) 86 Kans. 460, 121 Pac. 340, it was only the two incorporators who were sued and in McLennan v. Hopkins, (1895) 2 Kans. App. 260, 41 Pac. 1061 while the number does not appear, it was only the organizers who were held.

In Kennedy v. Fulton Merc. Co., (1908) 33 Ky. L. Rep. 60, 108 S. W. 948, only the persons who subscribed for stock and elected officers and authorized the lease of P's store were held liable.

In Abbot v. Omaha Smelting Co., (1876) 4 Neb. 416 defendant was an incorporator and president but had no stock.

In Perrine v. Levin, (1910) 68 Misc. 327, 123 N. Y. S. 1007, original incorporators were the only defendants.

In Guckert v. Hacker, (1893) 159 Pa. St. 303, 28 Atl. 249 only subscribers were held liable.

In Empire Mills v. Alston Grocery Co., (1891) 4 Willson (Tex.) 221, 15 S. W. 200 only incorporators were held.
show positively active participation. Liability of the defendants in assumpsit on the corporate contract, while unwarranted on sound principle, is not out of accord with a liability imposed on the basis of implied warranty. Frequently the agent is held on his principal’s contract where the basis is breach of implied warranty of authority.

The result reached in some of these cases which hold the defendant on the ground that he is liable as a partner, are not unjust if the facts are such that he would have been liable on an implied warranty of the competency of his principal, but if the facts are such that he would not be held liable as an agent, they may have been such that the result reached was grossly unjust. For example in Kaiser v. Lawrence Savings Bank if the defendant, who was not an original incorporator was nevertheless active in the management of the Kansas corporation, it is no greater hardship for him to be held liable to the creditor of the corporation than is the hardship that is commonly imposed upon agents, but if the defendant was a resident of Iowa and purchased one or a few shares of stock in this Kansas corporation, in which there is a large outstanding stock, and plaintiff finds it convenient to sue defendant because he resides in Iowa and has

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51 In Harrill v. Davis, (1909) 94 C. C. A. 47, 168 Fed. 187, each of the defendants either expressly authorized or actively participated in incurring the indebtedness for which they were held liable.

In Forbes v. Whittemore, (1896) 62 Ark. 229, 35 S. W. 223 each of the defendants authorized or participated in incurring the indebtedness for which they were held liable.

In Cincinnati Cooperage Co. v. Bate, (1894) 96 Ky. 356, 26 S. W. 538, 49 A. S. R. 300 three defendants purchased all the stock of a corporation, changed its name (not in manner required by state) and continued its business. Held individually liable on draft given in corporate name.

In Eaton v. Walker, (1889) 76 Mich. 579, 43 N. W. 638, 6 L. R. A. 102 three defendants incorporated under a law which was void because of defective title. Plaintiff was allowed to hold them individually as partners, although one of them had received no benefit from the business and taken no part in its affairs, other than attending meetings, he being a director and vice-president.

In Journal Co. v. Nelson, (1908) 133 Mo. App. 482, 113 S. W. 690 the four defendants organized a fraudulent mining company and were held liable as partners for the cost of publishing their prospectus, signed by one of their members. No authorization was mentioned but it seems a necessary inference.

In Sexton v. Snyder, (1906) 119 Mo. App. 668, 94 S. W. 562, all steps had been taken to form a corporation but the secretary of state refused a certificate. Defendants who were directors and among the original incorporators held individually liable.

In De Soto Bank v. Reed, (1908) 50 Tex. Civ. App. 102, 109 S. W. 256 the members were held individually liable on a draft drawn by an agent. From the agreed statement of facts “all the defendants actively participated in the business of the Beaumont-Port Arthur Co., prior and subsequent to the filing of said charter.”

52 (1881) 56 Ia. 144, 8 N. W. 772.
property sufficient to satisfy the plaintiff's demand, it is harsh and unjust and the corporate method of doing business has operated as a trap to the unwary purchaser of stock.

There are usually two groups of stockholders, the one, managing and controlling the corporate business, and the other merely investors in corporate stock with little or no actual voice in the control of the corporation. There is no necessity for treating these two groups alike, and to do so frequently works injustice. The courts have been exceedingly solicitous to protect creditors who, as experience has shown, are usually alert to guard themselves from imposition. Should there not be a disposition to give more adequate protection to the unwary investor in stocks who, more frequently than the creditor, is the victim of imposition and fraud, and who stands in need of greater protection?\(^3\)

To hold persons who take stock in a corporation unlimitedly liable individually upon the contracts of the corporation because it is defectively organized, is not only unsound on legal theory but is bad economic policy. One of the most promising of recent developments in economic history is the greatly extending distribution of shares in corporations which means greater investment in such securities by smaller capitalists and employees.\(^4\)

The successful pursuit of the corporate method of doing business is absolutely essential to our economic prosperity and development. To make the innocent purchaser of stock in a corporation liable to the full extent of his fortune, because it may turn out that the incorporating statute was unconstitutional\(^5\) or organized in one state to do business in another,\(^6\) or is organized under a statute authorizing a different sort of corporation than the one in question, or the incorporators did not act in good faith, or because the corporation may have been found to be defective for a variety of other reasons, is to subject him to a real

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\(^3\)The recent blue sky legislation shows a realization by legislatures of the need and is in the right direction.

\(^4\)In 1913 the Wall Street Journal calculated that 327 large corporations had 1,251,468 shareholders listed on their books. The average holdings of stock in corporations is rapidly becoming less and more of it is being owned by employees. Thus Armour & Company stock is owned by 77,000 persons, 40,000 of whom are employees of the company who have invested their savings.


hazard which is unjust and unreasonable, and one which would tend to impair a proper usefulness of the corporate device.

To summarize: Since it is opposed to a correct conception of the nature of the stockholder's liability, a violation of his contract, the imposition upon him of a contract he never assumed, and the reasons, one and all, given for so doing are insufficient, and the decisions in the cases which purport to do so can, at least in a majority of instances, be reached without so holding and upon a ground that reconciles them with the cases which reject this view, and finally, since the doctrine is harsh and unjust and opposed to sound economic considerations, the members of a corporation, no matter how defectively organized, should not be held liable as partners.