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## Corporations--Corporate Liability for Ultra Vires Acts

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## LEGISLATION

CORPORATIONS — CORPORATE LIABILITY FOR ULTRA VIRES ACTS. — All contracts made by corporations beyond their charter-given capacities were *ultra vires* and absolutely void at common law.<sup>1</sup> Even to-day, English courts apply this rule strictly.<sup>2</sup> But American courts have sought to soften the stringency of the rule, and consequently have left the decisional law of *ultra vires* "in a state of hopeless and inextricable confusion."<sup>3</sup> West Virginia cases have given little consideration to the problem; but it seems that except in the case of corporations affected with strong public interests,<sup>4</sup> the doctrine of *ultra vires* will be avoided by some rule of estoppel,<sup>5</sup> retention of benefits,<sup>6</sup> or

<sup>1</sup> BALLATINE, PRIVATE CORPORATIONS (1927) § 67.

<sup>2</sup> *Hawkes v. Eastern Counties Ry.*, 1 De G. N. & G. 737, 760 (1852); *Eastern Counties Ry. v. Hawkes*, 5 H. L. Cas. 331, 371 (1855); *Ashbury Ry. v. Riche*, L. R. 7 H. L. 653 (1875).

<sup>3</sup> Thompson, *The Doctrine of Ultra Vires in Relation to Private Corporations* (1894) 28 AM. L. REV. 376. See Stevens, *A Proposal as to the Codification and Restatement of the Ultra Vires Doctrine* (1927) 36 YALE L. J. 297, 300-308, where the author states the following rules on *ultra vires* as adhered to by a majority of American courts: (1) A corporation is liable for the torts of its agents done within the scope of their authority while carrying on *ultra vires* business in which the corporation has engaged; (2) Although a corporation exceeded its authority in taking or holding title to property, the validity of its title cannot be questioned on that ground; (3) An *ultra vires* contract will be enforced if fully performed on both sides; (4) Either party to a wholly executory contract may set up the defense of *ultra vires*; (5) A dissenting shareholder may enjoin a threatened *ultra vires* act; (6) Corporate existence is not *ipso facto* ended by the commission of an *ultra vires* act, but the state may demand forfeiture of the corporate charter. (7) There is no agreement among American courts as to *ultra vires* contracts fully or partly performed. West Virginia has held a corporation which has accepted the performance of the other party cannot escape contractual liability by a plea that it had no capacity to make the contract. The same rule probably will be applied when the corporation has fully performed and the other party seeks to set up the defense of *ultra vires*. See *infra* n. 5, n. 6, n. 7.

<sup>4</sup> *National Bank v. Matthews*, 98 U. S. 621, 25 L. ed. 188 (1878); *Central Transportation Co. v. Pullman's Car Co.*, 139 U. S. 24, 53, 11 S. Ct. 478, 486 (1890); *St. Louis Railroad v. Terre Haute Railroad*, 145 U. S. 393, 12 S. Ct. 953 (1892); *California National Bank v. Kennedy*, 167 U. S. 362, 17 S. Ct. 331 (1897); *Citizens' National Bank v. Appleton*, 216 U. S. 196, 30 S. Ct. 364 (1909); *Kerfoot v. Farmers' Bank*, 218 U. S. 281, 31 S. Ct. 14 (1910).

<sup>5</sup> *Chafin v. Main Island Creek Coal Co.*, 85 W. Va. 459, 102 S. E. 291 (1920) (where a corporation president made an unauthorized contract and the corporation took the benefits thereof, the court said—the exact powers of the corporation not having been shown—that by accepting the performance of the other side, the corporation had ratified the contract and was estopped to plead that its agent had no authority to make this contract.)

<sup>6</sup> *County Court v. B. & O. R. R. Co.*, 35 Fed. 161, 169 (C. C. D. W. Va. 1888) (after holding the acts in question not *ultra vires*, the court pointed out that the railroad had fully performed and said "a corporation cannot avail itself of the defense of *ultra vires* when the contract has been in good faith fully performed by the party and the corporation has had the full benefit of the

laches.<sup>7</sup> The court has not clearly marked out the rights and liabilities of shareholders, third parties, and the public.<sup>8</sup> Consequently it is uncertain to what extent the English common law or the American modifications apply in this jurisdiction. Legislation is necessary to clarify the matter.<sup>9</sup>

The problem for solution is obviously a complicated one. A statute must attempt to prevent unenforceable contractual relations being established with third parties and at the same time preserve, at least in part, both the stockholder's right to enjoin unauthorized corporate action and the state's right to dissolve

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performance of the contract'''); Neil v. Flynn Lumber Co., 71 W. Va. 708, 713, 77 S. E. 324 (1913) (holding a contract by a lumber company to furnish a competent physician to treat an employee for any sickness or accident occurring while in its service not *ultra vires*; the court saying a corporation could not plead *ultra vires* when sued on a contract full performance of which the other party had made).

<sup>7</sup> Boyce v. Montauk Gas Coal Co., *infra* n. 8, where an equity court said a stockholder having actual or constructive notice of a contract of which he complains as *ultra vires* cannot wait an unreasonable length of time to ascertain whether the contract would result profitably, and then repudiate it if it has resulted in loss.

<sup>8</sup> Boyce v. Montauk Gas Coal Co., 37 W. Va. 73, 16 S. E. 505 (1892) (holding parties dealing with a corporation are presumed to have knowledge of the limitations upon its authority contained in the charter, but that in special cases such parties will not be presumed to have this knowledge. The example is given that if the question of authority depends not only on the law under which the corporation acts, but also on certain extrinsic facts resting peculiarly within the knowledge of the corporate officers then the corporation would be estopped to deny its want of authority and the other party would not be bound to have had constructive notice of the charter limitations. This rule permits the court to apply or withhold the constructive notice rule at its caprice, depending on whether it decides the plaintiff should have had notice in a given case. Under this litigant would never know whether the rule would be applied and his rights defeated. A statutory abolition of this rule would work no hardship and is entirely justified. The reason assigned for the constructive notice rule is that the legislature must have intended all persons to be bound with notice of the articles of incorporation since it required them to be filed in a public office. The fallacy is that this presupposes the legislative intent to have been to favor the corporation rather than the public.

<sup>9</sup> Pennsylvania, for example, as early as 1876 adopted the majority rule on *ultra vires* that the receipt of benefits under an unauthorized contract waived a plea of want of authority to make it. Oil Creek & Allegheny R. E. Co. v. The Pa. Transp. Co., 83 Pa. 160 (1876). This rule was followed until 1932, when the Pennsylvania Supreme Court in suddenly reversing to the ancient common law rule, said that "contracts *ultra vires* of the corporation making them are not merely voidable but wholly void and of no effect and no performance by either party can give the unlawful contract any validity." Bedell v. Oliver H. Bair Co., Inc., 158 Atl. 651 (Pa. 1932). It is uncertain what doctrine is now in force in Pennsylvania. This uncertainty and confusion can only be remedied by legislation. Cf. Knupp, *Is Pennsylvania Swinging to the Federal Rule on Corporate Ultra Vires Contracts?* (1932) 36 Dick. L. Rev. 289, n. 13. (The term "unlawful" in the quotation above seems rather loosely used here, since if the contract were truly unlawful it could in no way be enforced. This error is common in cases on *ultra vires* contracts. See Central Transp. Co. v. Pullman's Car Co., *supra* n. 4.)

the corporation or enjoin its acts.<sup>10</sup> In short, the object of regulation must be the imposition of corporate responsibility within the limits of reasonable corporate activity.<sup>11</sup>

<sup>10</sup> A suggested difficulty with the "general capacity" doctrine is that while it protects third parties dealing with the corporation, it also deprives the shareholder who has been injured by the *ultra vires* act of his protection. This obstacle may effectively be remedied by additional provisions, as in the proposed amendment, *infra* n. 28.

<sup>11</sup> See for example:

VT. GEN. LAWS (1917) §§ 4919, 4923, Laws (1915) No. 141, § 15. Sec. 4919: "A corporation shall have authority to do any lawful act which is necessary or proper to accomplish its purposes . . . ." Sec. 4923. "Ultra Vires acts; ratification. If an act done in behalf of a corporation is authorized or ratified by the directors or trustees, or such act is done within the scope of authority given by the directors or trustees, such act shall, provided that a corporation with authority to do such might, at the time it was done, have been formed under the laws of this state, be regarded as the act of the corporation and the corporation shall be liable therefor, even if such act was not necessary or proper to accomplish its purposes, to the same extent that it would have been liable for such act had it been necessary or proper to accomplish its purposes."

OHIO GEN. CODE (Page 1926) §§ 8623-8 and 8623-9, as amended by Laws, 1927, p. 12 and Laws 1929, p. 416. Sec. 8: "Every corporation in this state, heretofore or hereafter organized, shall have the capacity possessed by natural persons to perform all acts, within or without the state.

"The articles shall constitute an agreement by the directors and officers with the corporation that they will confine the acts of the corporation to those acts which are authorized by the statement of purposes and within such limitations and restrictions as may be implied by the articles.

"No limitation on the exercise of the authority of the corporation shall be asserted in any action between the corporation and any person, except by or on behalf of the corporation, against a director or an officer or person having actual knowledge of such limitation."

Sec. 9: "The filing and recording of articles and other certificates pursuant to this act is required for the purpose of affording all persons the opportunity of acquiring knowledge of the contents thereof, but no person dealing with a corporation shall be charged with constructive notice of the contents of any such articles or paper by reason of such filing or recording." This section is based on the Uniform Business Corporation Act, § 10, which has also been adopted in Louisiana, Laws, 1928, Act No. 258, § 11 and Idaho, Laws, 1929, c. 262, § 9.

*Louisiana Laws, 1928, Act No. 258, § 12:* "Corporate Capacity and Corporate Authority: The Same Distinguished. L. A corporation which has been formed under this Act, or a corporation which existed at the time this Act took effect and of a class which might be formed under this Act, shall have the capacity to act possessed by natural persons, but such a corporation shall have authority to perform only such acts as are necessary or proper to accomplish its purposes as expressed or implied in the articles or that may be incidental thereto, and which are not repugnant to law."

*Idaho Laws, 1929, § 10* is *verbatim* the Louisiana law above. This section was based on the Tenth Tentative Draft of the Uniform Business Corporation Act, which was soon thereafter approved by the National Conference on Uniform State Laws and recommended to the several states for adoption.

CAL. CODE, HILLYER'S SUPPL., 1930, § 355, Laws, 1929, c. 711, § 25: "Effect of Articles. The enumeration in the articles of the objects, purposes, powers and authorized business of the corporation shall have no effect other than as between the corporation and its directors or officers, as an authoriza-

Modern legislation has sought to define the scope of corporate liability in terms of "general capacity", that is, of corporate liability for acts done in excess of the charter grant. The test of liability under such a theory is a test of "authority" as in the agency situation. Thus the corporation will be responsible for contractual obligations made with third parties in reasonable reliance on corporate authority.<sup>12</sup>

The rule of the common law that the filing of articles of incorporation was notice to all the world of their content would, of course, prevent the plea of reasonable reliance.<sup>13</sup> Consequently some states<sup>14</sup> require that articles be filed so that all persons will have the opportunity to know the corporate powers, but specifically declare that the filing of the articles will not charge the public with "constructive notice" of the contents of the charter. In West Virginia, the rule of constructive notice apparently applies if the act done is obviously beyond the powers granted by the corporation, but does not apply if the act done conflicts with the powers granted only because of other extrinsic facts known only to the officers of the corporation.<sup>15</sup> A more certain test is desirable. It is not unreasonable to protect all executed or

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tion to the directors and as a limitation on the actual authority of the representatives of the corporation.

"No limitation upon the business, purposes or powers of the corporation contained in or implied by the articles shall be asserted as between the corporation or any shareholder and any third person. Such limitations may be asserted in action by a shareholder or at the suit of the state, to enjoin the continuation of unauthorized business, or to dissolve the corporation, or in an action by the corporation or by the shareholders suing it in a representative suit, against the officers or directors of the corporation for violation of their authority.

"Any contract or conveyance made in the name of the corporation, which is authorized or ratified by the directors, or is done within the scope of the authority, actual or apparent, given by the directors, shall bind the corporation, and the corporation shall acquire rights thereunder, whether the contract be executed or wholly or in part executory."

<sup>12</sup>A corporation can clearly recover, under the agency principles governing the "general capacity" doctrine, against a third party who knew the impending transaction was *ultra vires* when entering into it. However, it may seem uncertain whether the legislators intended this defense to be used *only* when the third party had *actual* knowledge that corporate limits were being overstepped. By analogy to settled agency principles, it is probable that the corporation will be allowed this defense against a third party both where that third party actually knew of the limitations and where he reasonably should have known thereof but actually did not.

<sup>13</sup>BALLANTINE, PRIVATE CORPORATIONS (1927) § 79.

<sup>14</sup>See Statute, *supra* n. 11, wherein Ohio expressly abolishes the constructive notice rule.

<sup>15</sup>Boyce v. Montauk Gas Coal Co., *supra* n. 8.

partially executed transactions<sup>16</sup> made in *bona fide* reliance upon the existence of corporate capacity.<sup>17</sup>

Some states have attempted to remedy the situation by marking out the situations in which the plea of *ultra vires* will not be heard. That is done by excluding the plea in suits between the corporation and a third party,<sup>18</sup> or between a stockholder and a third party,<sup>19</sup> but permitting it in suits by the state or stockholders against the corporation or its officers.<sup>20</sup>

The Ohio legislation appears both to change the theory of corporate organization and to enumerate specifically the results of such change.<sup>21</sup> The limited capacity doctrine and the rule of constructive notice are abolished. Lack of authority cannot be raised in litigation between a corporation and any person, but the articles of incorporation constitute an agreement between the corporation and its directors and officers which may always be raised "by or on behalf of the corporation, against a director or an officer or person having actual knowledge of such limitation. This attempt to establish a general capacity doctrine and to define

<sup>16</sup> Logically there is no reason why the protection should not extend to wholly executory contracts but apparently only California has gone so far. The claim of the third party to performance seems equal whether the contract is executory or only partially executed. The shareholder's demand that the corporate assets be conserved is also equal. To draw a line between wholly and partially executed contracts is thus an arbitrary division of interest.

<sup>17</sup> *Supra* n. 3.

<sup>18</sup> But if the shareholder may enjoin the corporation the corporation may by a circuity of a stockholders suit avoid all disadvantageous contracts. *Cf.* OHIO GEN. CODE, §§ 8623-9; *Calif. Laws*, 1929, ch. 711, § 25, *supra* n. 11.

<sup>19</sup> *Cf.* OHIO GEN. CODE, §§ 8623-8; *Calif. Laws*, 1929, ch. 711, § 25, *supra* n. 11.

<sup>20</sup> The California statute, *supra* n. 11, so provides and thus has been criticized as inconsistent:

"For if a stockholder's injunction against performing an existing unauthorized contract is held to affect the other contracting party, the express exemption of third persons from the effect of the defense of *ultra vires* might be circumvented. On the other hand, if such an injunction binds only the corporation, corporate liability for breach of contract makes the stockholder's expressly granted right a hollow one. The clauses might be reconciled somewhat by restricting the stockholder's remedy to an injunction against future unauthorized contracts, provided that such an injunction could be invoked against a third party who later contracts with the corporation. Still it is doubtful whether the stockholder's rights were intended to be so emasculated." Note (1930) 44 HARV. L. REV. 284.

While there is no inconsistency as to future actions it is suggested that future protection is ineffective to prevent the depletion of corporate finances by present *ultra vires* contracts. See the proposed amendment, *infra* n. 28 as limiting shareholder's right to enjoin to future unauthorized contracts.

<sup>21</sup> See the Ohio Statute, *supra* n. 11.

its effects raises these questions: (1) If corporations are to have the capacities of natural persons will they have the power to engage in the professions now closed to them?<sup>22</sup> (2) What will be the effect of the transaction being not only unauthorized but also illegal?<sup>23</sup> (3) Will executory contracts be given the full protection of the statute?<sup>24</sup> (4) Is a stockholder's suit to enjoin unauthorized action a suit "on behalf of the corporation" within the meaning of section 8623-8?<sup>25</sup> (5) What effect do the new provisions have upon former special remedies?<sup>26</sup> (6) Does the "agreement" between directors and officers and the corporation impose liability for unintentional excessive exercise of authority?<sup>27</sup> Most of these objections do not seriously damage the Ohio statute; its operation is for the most part satisfactory.

A statute incorporating the best features of the legislation in other states should be enacted in West Virginia. The desirability of a clear and certain rule for the protection of business transactions is apparent, and this result may be accomplished without any serious change in the present law. A proposed

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<sup>22</sup> Natural persons may, subject to regulations, engage in the practice of certain professions such as law, medicine, etc. Corporations have been traditionally prohibited from engaging therein and, it is submitted, giving corporations "natural powers" should not be interpreted to admit them to the practice of these professions. The proposed amendment avoids this difficulty by expressly excepting the right to engage in such business. See *infra* n. 28.

<sup>23</sup> Where the corporate act is both unauthorized and illegal, the Ohio statute does not apply. Its operation is confined to legal action which is objectionable only because it is beyond the purposes and limitations specified in the charter. For example, the result is the same both before and after the adoption of this statute if the corporate act is one which would be illegal if committed by an individual, or which by law the corporation is expressly prohibited from doing, no legal effect or protection will be afforded such act. See Stevens, *Ultra Vires Transactions Under the New Ohio General Corporation Act* (1930) 4 CUN. L. REV. 419 for a good discussion of this and other points arising under the Ohio statute.

<sup>24</sup> See *supra* n. 16.

<sup>25</sup> It appears uncertain whether the Ohio legislators intended this to be included in the phraseology used. If so, this statute is subject to the same inconsistency as the California statute. See *supra* n. 20.

<sup>26</sup> The Ohio statute does not abolish or limit special remedies formerly afforded against the harshness of the *ultra vires* doctrine—an *ultra vires* act may be enjoined or damages therefor recovered if the corporation is bound by such act, both before and after this statute. The state may sue for forfeiture of the corporate charter because of its unauthorized action. A corporation may acquire both rights and liabilities on performed *ultra vires* contracts. The statute in no way does away with these remedies, but on the contrary strengthens the reason for their existence and usage. See Stevens, *op. cit. supra* n. 24.

<sup>27</sup> This action will probably not be applied where the directors were not negligent and reasonably thought their conduct was *intra vires* (when in fact it was *ultra vires*), especially where the boundaries of corporate authority are not clearly delineated.

## LEGISLATION

amendment<sup>28</sup> to the present code section<sup>29</sup> should give legislative definition to the existing doctrine of general capacity, remove the threat of constructive notice, protect third parties who have dealt in reliance on the corporation's power to act, and at the same time preserve the rights and protections of shareholders and the public.

—KINGSLEY R. SMITH.

THE AMENDMENT OF WEST VIRGINIA STATUTES. — The recent case of *De Turk v. City of Buckhannon*,<sup>1</sup> has cast doubts upon the validity of numerous amendatory statutes in this state. Inasmuch as the major portion of legislation is amendatory in form,<sup>2</sup> a safe, simple, and practical amending device is a legislative neces-

<sup>28</sup> The following is submitted as an amendment to the present code provision—see n. 29, *infra*.

“Except for the carrying on of professions, every corporation of this State shall have the capacity to act possessed by natural persons, but shall have authority to perform only such acts as are necessary or proper to accomplish the purposes expressed or implied in its charter.

“No limitation on the exercise of the authority of the corporation shall be asserted in any action between the corporation and any person, except:

- (1) by or on behalf of a corporation against a director or officer having actual knowledge of such limitation;
- (2) by a shareholder to prevent the performance of a wholly executory contract;
- (3) by a corporation or shareholders suing in a representative suit against the officers or directors of the corporation for violation of their authority;
- (4) by the State to enjoin the continuation of unauthorized business, or to dissolve the corporation;
- (5) in any action in which the liability of a public utility or banking corporation is in issue.

“The filing and recording of the articles and other certificates pursuant to this Act is required for the purpose of affording all persons the opportunity of acquiring knowledge of the contents thereof, but no person dealing with a corporation shall be charged with constructive notice of the contents of any such articles or paper by reason of such filing or recording.”

<sup>29</sup> W. VA. REV. CODE (1931) c. 31, art. 1, § 3, is the section defining the powers of corporations, and to which the amendment is suggested.

<sup>1</sup> 163 S. E. 812 (W. Va., 1932). In this case the court held unconstitutional a statute which sought to amend the charter of the city of Buckhannon by reference only. The statute (Municipal Charters, 1925, c. 35) was in the following form: “That section fifty-six of chapter fifteen of the acts of the legislature of West Virginia at its one thousand nine hundred and nineteen session be amended and re-enacted by adding after the words ‘one year’ in the one hundred and fifth line of said section fifty-six the following: \*\*\*\*\*” The court declared this procedure invalid for failure to include the original section as amended.

<sup>2</sup> Statutes are ordinarily in one of three forms: original, amendatory, and repealing. The West Virginia Legislature in the 1929 session passed 164