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CORPORATIONS-DEBTS IN EXCESS OF STATUATORY LIMIT

CORPORATIONS—DEBTS IN EXCESS OF STATUTORY LIMIT.—Business Corporations generally have the power to borrow money for the purpose of their ordinary business, and to give the customary evidence of the debt and security therefor.[1] Such power can be limited only by statute or by the charter. Statutes frequently provide that corporations should not incur indebtedness in excess of some particular stated amount, usually a certain proportion of the capital stock. A recent Nebraska case allowed the lender full recovery from the guarantor of corporate notes given in exchange for a loan in excess of the statutory limit, holding that excessive indebtedness does not necessarily invalidate contract obligations, unless the statute so declares.[2]

In general, as to contracts prohibited by statute, the aim of the courts should be to apply such rules to the contracts in question as will best carry out the policy and purpose of the legislature in passing the statute.[3] In the first place, the court may discern a legislative intent to make the contract in question illegal in the strictest sense, so as to be analogous rather to contracts *mala in se* than to mere *ultra vires* contracts. In such cases, no action is maintainable, either on the contract, or to recover money or property parted with on the faith of the contract.[4] In the second place, the court may interpret the legislative policy as compelling the treatment of the forbidden contract as a nullity, devoid of all legal significance. Hence no action may be

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[1]3 *Thompson on Corporations*, 3rd ed. sec. 2242 et seq.

[2]Nebraska Nat. Bank of Omaha v. Parsons (1927) 215 N.W. 102.

[3]2 *Machen, Modern Law of Corporations*, sec. 1064 et seq.

[4]Re Jaycox, 12 Blatchf. 209; State ex rel. Carroll v. Corning State Savings Bank, —Iowa—, 113 N.W. 500.

maintained on the contract, even when executed.[5] Thirdly, the object of the statute may require that the statute be valid and binding *inter partes*, the effect of the prohibition being merely to subject one or both of the parties to some penalty.[6] Fourthly, the effect of the statutory prohibition may be to restrict the capacity of the corporation,—in other words, to make the prohibited contract *ultra vires* merely, and subject to the same rules as to enforceability *vel non* as other *ultra vires* contracts.[7] Some authorities hold this to be the effect of a statute limiting the amount of indebtedness which a corporation may contract,[8] and it is this construction with which the ensuing discussion will deal principally.

The statutory prohibition may be of such a character as merely to prescribe a rule of "indoor management" so that under the rule in *British Bank v. Turquand*,[9] a contract with a stranger made in violation of the regulation will nevertheless be valid unless the outsider be affected with notice of the irregularity. Moreover, in some cases the statute may be construed as directory merely,—that is to say, as laying down a rule proper to be observed, but without annexing any penalty to violation. The courts should lean towards this construction of any merely regulatory statute prescribing the method of conducting the business of the corporation.[10] In many cases, the same result would be reached whether the statute be construed as merely directory or as making the forbidden act *ultra vires*. It is therefore difficult often to determine upon which of these grounds a decision proceeds.

Treating a contract for a loan in excess of the statutory limit as *ultra vires*, for the purposes of criticism, the present inquiry is first, what will be the result of a suit on the contract, by the English, Federal and various state theories of *ultra vires* contracts, and second, what should be the result, on principle?

The English courts consistently hold that since a corporation is not capable of performing the forbidden act, an *ultra vires* contract is wholly void.[11] Not even complete execution will validate the agreement.[12] *A fortiori*, when an *ultra vires* contract has been performed on one side, as in the type of case under discussion, the opposite party cannot be compelled to perform.[13]

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[5]Mut., etc. Ins. Co. v. Barker, 107 Iowa 143, 77 N.W. 868; 70 Am. St. Rep. 149.

[6]Thompson v. St. Nicholas Nat. Bank, 146 U. S. 240, 13 Sup. Ct. 66; Oneida Bank v. Ontario Bank, 21 N. Y. 490.

[7]White v. Franklin Bank, 22 Pick. (Mass.) 181; Tracy v. Talmage, 14 N. Y. 162; 67 Am. Dec. 132 (approved in Curtis v. Leavitt, 15 N. Y. 1); Pixley v. Western Pac. R. R. Co., 33 Cal. 183.

[8]Beach v. Wakefield, 107 Iowa 567, 76 N.W. 688, 78 N.W. 197. "The phrase 'ultra vires' in its proper sense denotes some act or transaction on the part of the corporation which is beyond the legitimate powers of the corporation as they are defined by the statutes under which it is formed or are applicable to it, or by its charter or incorporation paper." *2 Machen, Modern Law of Corporations*, sec. 1012.

[9]Royal British Bank v. Turquand, 6 E. & B. 327.

[10]Southern Life, etc., Co. v. Lanier, 5 Fla. 110, 58 Am. Dec. 448; Dayton Ins. Co. v. Kelly, 24 Oh. St. 345, 15 Am. Rep. 612. But see Crouch v. City Fire Ins. Co., 38 Conn. 181, 9 Am. Rep. 375.

[11]*2 Machen, Modern Law of Corporations*, sec. 1027.

[12]*Ibid*, sec. 1030.

[13]*Ibid.*

A contract for a loan in excess of the statutory limit is in its nature severable.[14] There is no principle of any force preventing such a contract from being so treated. Even under the strict English rules, recovery is permitted up to the authorized limit.[15] Apparently, however, there is no hope for recovery on that part of the contract that is regarded as *ultra vires* and hence void.[16]

The federal courts follow upon the subject of *ultra vires* the decisions of the supreme court of the state whose laws they are enforcing.[17] But in the absence of any settled rule enunciated by the highest state court, they follow their own doctrine.[18]

The Supreme Court will not upset or rip open a fully executed contract.[19] In all other respects, the federal courts approximate the rigorous English rules.[20] From a comparatively early date, the Supreme Court has held that although one party to an *ultra vires* contract has fully performed, and the other party has received all the benefits thereof, yet the former has no remedy on the contract.[21]

The principle upon which this conclusion is based has been forcibly pronounced by Mr. Justice Gray, in oft quoted language.[22] In essence, an *ultra vires* contract is to be regarded as wholly void, and of no legal effect. The objection to the contract is not merely that the corporation should not have made it, but that it could not have made it. Performance can not validate the contract. Such statements, however, standing alone, are too sweeping and are not borne out by decisions of the Supreme Court, for instance, in the case of fully executed *ultra vires* contracts. This view leads to the same conclusion as the English view, as to recovery on the contract, where the same has been partly executed.

The decisions of the state courts in this connection are in hopeless contradiction. Some of the courts follow the federal view in holding that there can be no recovery on the contract, even though the plaintiff has fully performed.[23] But a larger number hold that where an *ultra vires* contract has been fully executed by one party, he may recover on the contract for the failure of the opposite party to perform.[24] The rule is often said to be based on the principle of estoppel, but probably a more correct statement would be that the public policy which is deemed to require purely executory *ultra vires* contracts to be held unenforceable is not of such a character as to permit one party, having enjoyed the full benefit of the contract, to repudiate its bur-

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[14]Curtis v. Leavitt, 15 N. Y. 9.

[15]Ann. Cas. 1918 B, p. 970, and cases cited.

[16]*Ibid.*

[17]Sioux City, etc. Co. v. Trust Company of North America, 173 U. S. 99, 19, S. Ct. 341; Eastern Bldg., etc. Ass'n. v. Williamson, 189 U. S. 122, 129-30, 23 S. Ct. 527.

[18]Anglo-American Land etc. Co. v. Lombard, 132 Fed. 721.

[19]2 *Machen, Modern Law of Corporations,* sec. 1033 and cases cited.

[20]*Ibid.* sec. 1042.

[21]*Ibid.*

[22]*Ibid,* sec. 1043.

[23]*Ibid,* sec. 1055, and cases cited.

[24]*Ibid.*

dens.[25] The confusion of decisions is probably due to the fact that few courts have consistently adhered to any one doctrine upon the subject.

A few references will suffice to show the perplexing variety of conclusions which have been reached by courts in attempting to reconcile various conceptions of *ultra vires* with the obvious equities in favor of the lender in the case of a loan in excess of the statutory limit. Some courts hold that a creditor who did not know that the statutory limit of indebtedness had been exceeded, and who had no reasonable grounds to believe that such was the fact, can enforce the contract against the corporation.[26] Others hold that such loans are made at the lender's peril, and he can recover only the amount which the corporation was entitled to borrow.[27] One court, at least, held that such a debt was valid to the extent of the consideration received.[28]

Some courts follow the principal case in substance, holding that a corporation may not take advantage of the debt limitation clause in its charter or articles of incorporation and defeat a liability where the laws do not expressly invalidate debts in excess of the limitation.[29] A resume and criticism of the arguments given in support of the theory that there should be no recovery on a debt in excess of the statutory limit, in an action on the contract, lead to the conclusion that in principle there is no reason to bar recovery to the full extent of the loan. This is certainly so where the lender, though aware of the statute, was, *bona fide,* ignorant that the particular loan brought the total indebtedness of the corporation above the limit. It is debatable where the lender knew the facts, and thus may be said to be *in pari delicto* with the corporation.

The doctrine of constructive notice is the chief argument advanced to bar recovery in excess of the statutory limit. To charge the lender with notice of the particular statute, the ubiquitous formulae of "ignorance of the law is no excuse," and "everyone is presumed to know the law," are dragged to the fore.[30] These expressions, however, have reference chiefly to criminal or illegal acts, in neither of which category can we place *ultra vires* contracts of the type under discussion.

It has been stated that while everyone may be presumed to have access to the statutes of the states affecting incorporation thereunder, and to their articles of incorporation, to impute a knowledge of the probable construction the courts would put upon these statutes and articles to determine questions raised upon a given contract, is carrying the doctrine of constructive notice too far.[31] In view of the many possible interpretations of prohibiting statutes

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[25] *Ibid.*

[26] 3 *Thompson on Corporations,* 3rd ed., sec. 2252 and cases cited.

[27] *Ibid.*

[28] Peatman v. Centerville Light etc., Co., 100 Iowa 245, 69 N.W. 541.

[29] 3 *Thompson on Corporations,* 3rd ed., sec. 2252 and cases cited.

[30] "Ignorance of the law is no excuse for violation of the law. It seems, therefore, that persons dealing with a corporation are bound at their peril to take notice of all general legislation of the state by which dealings with the company are in any way affected, even though such legislation may not constitute a part of the company's charter." 2 *Morawetz on Private Corporations,* sec. 592.

[31] 10 *Corn. L. Q.* 498.

mentioned at the outset of this discussion, such a statement is peculiarly applicable to our problem.

If we accept the principle that a lender should not be charged with notice of all possible interpretations of statutes regulating the amount of indebtedness which a corporation may contract, it follows that a lender, even though he knows that his particular loan is in excess of the statutory limit, should nevertheless be allowed full recovery, in the absence of a showing of fraud or collusion. *A fortiori,* the lender who is ignorant of that fact, should be allowed the same recovery.

Even granting that a lender is charged with constructive notive of such statutes, and that one loaning money knowing of his participation in an *ultra vires* act should not recover, the innocent lender, that is, the lender who knows of the statute but who is, *bona fide,* ignorant that the particular loan is *ultra vires,* should not be barred from recovery. The doctrine of constructive notice should by no means be extended to charge one with notice of the condition of the corporate books at a given moment. For one thing, an actual examination of the books of a going corporation would very likely produce no definite information, due to the fluctuation of indebtedness from day to day. A practical objection is the probability that if potential lenders were so charged, they would be quite cautious in extending credit, a condition not very alluring to corporations in general.

It has been forcibly stated that stockholders are but one portion of the public entitled to protection, and that "another portion, with equal rights of protection, is that with whom these multiform corporations deal in the daily exercise of their assumed powers."[32] Furthermore, the necessity of imputing notice is eliminated by the existence of other checks on *ultra vires* action. The state can always apply for forfeiture of the charter of the unruly corporation. Then there is the remedy of injunction by the stockholders against the unauthorized action. If the *ultra vires* act is perpretrated, there is the liability of the directors to the corporation for any loss occasioned by their unauthorized action, providing the stockholders have not expressedly or impliedly consented to such action, in which event their right to complain is not very appealing. In addition, there is the possible liability of the directors to *intra vires* creditors directly, if the acts of the former have diminished the assets to which they are entitled to look. The objection that *ultra vires* creditors may be placed on an equal footing with *intra vires* creditors is not of great force if we concede that both have acted in good faith.[33]

If we adopt this reasoning, the seeming injustice of compelling the *intra vires* creditor to seek the difficult remedy above, allowing to the *ultra vires* creditor the simple remedy against the corporation, disappears. If the assets are sufficient to pay all debts, there is certainly no injustice. If insufficient,

[32]Denver Fire Ins. Co. v. McClelland, 9 Colo. 11, 20.

[33]10 *Corn. L. Q.* 501; "It may be suggested that it does not prejudice M [the ultra vires creditor] to lose his suit against the corporation, for he should be entitled to some remedy against the associates individually who consented to the prosecution of the ultra vires venture. The argument is as broad as it is long. If the future shareholders or the creditors are prejudiced through M's recovery, they should be entitled to some remedy against such associates." 24 *Harv. L. Rev.* 541.

both creditors stand on an equal footing, so far as payment out of the assets of the corporation is concerned, while the *intra vires* creditor has the additional remedy of an action against the directors.

The present discussion to be complete requires a brief consideration of the various theories as to recovery in quasi contract, in the event of denial of relief on the contract as *ultra vires* or for any other reason. It appears to be settled in England that money borrowed *ultra vires* is not recoverable at law.[34] In equity, however, it is held that money so borrowed must be refunded to the extent that it has been used in the discharge of legitimate debts of the corporation.[35] This rule was based originally on the doctrine of subrogation, but in later cases it is said to rest upon the theory that if money borrowed is so expended as not to increase the liabilities of the corporation, there is in substance no borrowing at all, and the transaction should not be regarded in equity as *ultra vires*.[36]

It seems most simple and equitable to allow recovery in quasi contract whenever it appears that the money loaned to a corporation was loaned in reliance on the validity of the company's contract and either remains in the company's hands or has been used in the legitimate business of the company, whether in the payment of debts, purchase of property or otherwise.[37] The reason usually given in denying recovery where the money borrowed is expended in the legitimate business of the corporation, but not in the payment of debts, is that to permit a recovery would be in effect to enforce the *ultra vires* contract of loan.[38] Even so, what actual harm would result if the lender were allowed a quasi-contractual recovery? At the worst, such a rule might offer encouragement to the making of *ultra vires* contracts of loans. On the other hand, it would afford adequate protection to the innocent lender, consistent with the English theory of corporate capacity.[39]

Since the federal courts repudiate the English doctrine that *ultra vires* contracts are pure nullities, and adopt the view that whatever is actually done under an *ultra vires* contract stands as an accomplished fact, they cannot alleviate the hardship of the rule by the English expedient of permitting a person who has parted with property or money on the faith of the contract to follow and retake the property or money as if no contract had been made.[40] However inconsistent with the above, dicta by the supreme court in a number of cases suggesting that a party to an *ultra vires* contract who has performed his side in whole or in part is entitled upon the repudiation of the agreement by the other party to recover, not upon the express contract, but *quasi ex*

[34]See In re Wrexham, etc. R. Co., (1899) 1 Ch. 440, 457.

[35]Troup's Case, 29 Beav. 353; In re Cork, etc., R. Co., L. R. 4 Ch. 748; Blackburn Building Society v. Cunliffe, 22 Ch. Div. 61; Baroness Wenlock v. River Dee Co., 19 Q. B. D. 155.

[36]Blackburn Building Society v. Cunliffe, supra; In re Wrexham, supra.

[37]*Woodward, The Law of Quasi Contracts,* sec. 158.

[38]In re Wrexham, supra.

[39]*Woodward, The Law of Quasi Contracts,* sec. 158.

[40]2 *Machen, Modern Law of Corporations,* sec. 1045.

contractu, the reasonable value of the property with which he has parted on the faith of the agreement; were at last followed by a direct decision.[41]

The doctrine of the state courts may be stated as follows: In cases where an *ultra vires* contract is not enforceable, but where benefits have been conferred in pursuance of the transaction upon one party or the other, the party receiving the benefits is liable to pay for them under a contract implied in law upon a quantum meruit.[42] This rule may become operative in cases where the *ultra vires* contract has been partly performed by one party, or, in jurisdictions where no action will lie on the contract, even by a party who has fully performed, in cases where the contract has been fully performed on one side.[43]

This rule will be applied, however, only where a substantial benefit has been received.[44] Moreover, the rule has not always been carried out logically.[45] The fact that the amount recoverable in disaffirmance of the contract is the same as would have been recoverable if the contract had been binding is certainly no reason for refusing to allow a disaffirmance and restoration of the *status in quo.*[46]

Ignorance or mistake of law ought not to bar a recovery in quasi contract. Fortunately the fallacious maxim that everyone is presumed to know the law has rarely been appealed to in cases arising out of *ultra vires* contracts.[47] Fraud is a different matter. *Ignorantia juris non excusat* has no proper application either in law or in policy to the case of one who has done no wrong and who seeks not to inflict a loss upon another, but to save himself from a loss.[48]

It may well be argued that a contract for a loan in excess of the statutory limit is not *ultra vires,* but is to be settled on the ordinary principles of agency or otherwise.[49] Assuming the situation to be one which calls for the application of the doctrines of *ultra vires,* there is no reason in principle to bar recovery on the contract to the full extent of the loan. Should courts persist in denying relief on the contract, the lender should be allowed a remedy in quasi contract to the full extent of the benefits conferred.

N. P. F.

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[41]Central Transportation Co. v. Pullman's etc., Co., 139 U. S. 24, 60, 111 S. Ct. 478; Thomas v. City of Richmond, 12 Wall 349, 354-356.

[42]Pullman's Palace Car Co. v. Central Transportation Co., 171 U. S. 138, 18 S. Ct. 808. See cases in accord cited by *Machen,* supra, in sec. 1045, note 3.

[43]See cases cited in *2 Machen,* supra, sec. 1056, note 3.

[44]See Franklin Co. v. Lewiston Institution, 68 Me. 43, 28 Am. Rep. 9.

[45]See Railway Co. v. I Co., 46 Oh. St. 44, 18 N.E. 486; 1 L. R. A. 412; Grand Lodge v. Waddell, 36 Ala. 313.

[46]*2 Machen,* supra, sec. 1056.

[47]*Woodward,* supra, sec. 160.

[48]*Ibid.* sec. 36.

[49]*Thompson,* supra, sec. 2251 and cases cited in note 31. See Hawke v. California Realty etc., Co., 28 Cal. App. 377, 152 Pac. 959, citing Underhill v. Santa Barbara Land, Building & Imp. Co., 93 Cal. 300, 310, 28 Pac. 1049.