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# Corporations -- De Facto Corporations -- Estoppel -- Model Business Corporation Act

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an ascendant position. In short, the Court has yet to offer a dependable guide in this critical area, but has perhaps further confused the litter upon the commerce clause battleground. It is no doubt true, as suggested by many writers in the tax field,<sup>30</sup> that problems of this complexity are more amenable to legislative than to judicial solution. Hopefully, the solution will not be long in coming; for if one thing is certain in light of the ever-increasing economic needs of the states, it is that some consistent guide must be formulated for the convenience and protection of both states and taxpayers. It is submitted that the most equitable approach will be found within the philosophical framework of the "multiple burdens" doctrine in tandem with a realistic system of apportionment. As in other areas of life in this fast-paced world, the efforts expended in seeking absolute resolutions of problems will produce a greater net return if exerted instead in pursuit of equitable compromise.

HENRY STANCILL MANNING, JR.

#### **Corporations—De Facto Corporations—Estoppel—Model Business Corporation Act**

Although the submitted articles of incorporation were rejected, the defendant nevertheless began doing business as a corporation. Subsequently, defendant acquired plaintiff's business, giving the purported corporation's note therefor. Shortly thereafter, articles of incorporation were issued; but within six months, the corporation failed and was left without assets. Plaintiff, suing on the note given by the defendant on behalf of the purported corporation, sought to hold defendant personally liable on the basis that no corporation had existed at the time of the purchase. Defendant resisted liability on the grounds that plaintiff had dealt with either a de facto corporation or a corporation by estoppel. Defendant's contentions were rejected in *Robertson v. Levy*,<sup>1</sup> which construed statutory provisions<sup>2</sup> equivalent to sections 50<sup>3</sup> and 139<sup>4</sup> of the

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<sup>30</sup> See, e.g., Braden, *Cutting the Gordian Knot of Interstate Taxation*, 18 OHIO ST. L.J. 57 (1957); Annot., 67 A.L.R.2d 1324 (1959). For a view from the other side of the bench, see the opinion of Mr. Justice Frankfurter in *Northwestern States Portland Cement Co. v. Minnesota*, 358 U.S. 450, 476-77 (1959) (dissenting opinion).

<sup>1</sup> 197 A.2d 443 (D.C. Ct. App. 1964).

<sup>2</sup> D.C. CODE ANN. § 29-921c, -950 (1961).

<sup>3</sup> Upon the issuance of the certificate of incorporation, the corporate existence shall begin, and such certificate of incorporation shall be

Model Business Corporation Act "to eliminate the concepts of estoppel and de facto corporations . . . ."<sup>5</sup>

In situations where defective incorporation precludes de jure existence of a corporation, courts have recognized de facto existence to bar personal liability<sup>6</sup> where four requisites are met: (1) a valid law under which the corporation could have been formed, (2) a good faith attempt to comply with such law, (3) a "colorable" compliance with such law, and (4) actual user or exercise of corporate powers.<sup>7</sup> The doctrine supposedly enables courts to analyze the particular facts of each case and thus balance conflicting policy considerations: to discourage unauthorized assumptions of corporateness, and to favor doing justice to the parties and to uphold security of transactions with corporations.<sup>8</sup>

Application of this elastic concept varies with courts<sup>9</sup> and has been sharply criticized.<sup>10</sup> In fact, the framers of the Model Business Corporation Act intended that section 50, providing that corporate existence begins only upon the issuance of a certificate of incorporation, abolish any significance of de facto corporateness.<sup>11</sup> *Robertson* conforms with this intention. The result aids in ending a confusing and unpredictable state of the law.

conclusive evidence that all conditions precedent required to be performed by the incorporators have been complied with and that the corporation has been incorporated under this Act, except as against this State in a proceeding to cancel or revoke the certificate of incorporation or for involuntary dissolution of the corporation.

ABA-ALI MODEL BUS. CORP. ACT § 50 (1953).

<sup>4</sup> "All persons who assume to act as a corporation without authority so to do shall be jointly and severally liable for all debts and liabilities incurred or arising as a result thereof." ABA-ALI MODEL BUS. CORP. ACT § 139 (1953).

<sup>5</sup> 197 A.2d at 447.

<sup>6</sup> *ROBINSON, NORTH CAROLINA CORPORATION LAW AND PROCEDURE* § 11 (1964). Under the de facto doctrine it was held that although the validity of the corporate entity was subject to direct attack by the incorporating state, it was not subject to collateral attack by outside parties. *Ibid.*

<sup>7</sup> See *Tulare Irrigation Dist. v. Shepherd*, 185 U.S. 1 (1902); *Midwest Air Filters Pac., Inc. v. Finn*, 201 Cal. 587, 258 Pac. 382 (1927); *Mabel First Lutheran Church v. Calwallader*, 172 Minn. 471, 215 N.W. 845 (1927); *Pearson Drainage Dist. v. Erhardt*, 239 Mo. App. 845, 201 S.W.2d 484 (1947); *Hansen v. Village of Ralston*, 147 Neb. 251, 22 N.W.2d 719 (1946); *Culkin v. Hillside Restaurant, Inc.*, 126 N.J. Eq. 97, 8 A.2d 173 (1939).

<sup>8</sup> *STEVENS, CORPORATIONS* § 27 (1949).

<sup>9</sup> See *BALLENTINE, CORPORATIONS* § 30 (1946).

<sup>10</sup> *E.g., id.* § 20 ("the conglomeration of judicial decisions present a discouraging and baffling maze"); *STEVENS, op. cit. supra* note 8, § 26 ("inaccurate and confusing").

<sup>11</sup> ABA-ALI MODEL BUS. CORP. ACT ANN. § 50, ¶ 4 (1960).

*Robertson*, however, not only denies the de facto doctrine, but also rejects the concept of corporation by estoppel.<sup>12</sup> Although some early cases viewed de facto corporateness as a prerequisite to corporation by estoppel,<sup>13</sup> the majority now recognizes the two concepts as distinct and capable of independent application.<sup>14</sup> While the de facto doctrine in many cases imparts to a defective corporation a general corporate status,<sup>15</sup> the concept of corporation by estoppel applies only to some particular transaction where there have been dealings on a purportedly corporate basis.<sup>16</sup> However, the term "corporation by estoppel" is somewhat misleading in that it implies the existence of a third type of corporation in addition to corporations de jure and corporations de facto. The term does not refer to an entity, but rather describes a result the courts reach by applying the equitable doctrine of estoppel to the dealings between the parties.

Assuming the desirability of eliminating the conceptualistic de facto doctrine, its benefits may yet be retained by using estoppel concepts to do justice in individual cases and preserve security of transactions.

Estoppel applies where there is a misrepresentation, reliance on the misrepresentation by a third party, and a change of position by the third party.<sup>17</sup> Thus, if an association deals with third parties on a corporate basis despite its failure to file a certificate, it could be estopped from denying its corporate existence where the third party is suing it.<sup>18</sup> Similarly, a third party could be estopped from

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<sup>12</sup> Since N.C. GEN. STAT. § 55-8 (1960) is an enactment of section 50 of the Model Business Corporation Act, it seems likely that North Carolina would rule that de facto corporateness was abolished by the enactment of the statute. However, since North Carolina has not enacted section 139 of the Model Act, it seems very unlikely that it would go so far as to hold that corporation by estoppel was also abolished.

<sup>13</sup> *E.g.*, *Bibb v. Hall*, 101 Ala. 79, 14 So. 98 (1893); *Midland Bank v. Harris*, 114 Ark. 344, 170 S.W. 67 (1914); *Talbert v. Grist*, 198 Mo. App. 492, 201 S.W. 906 (1918).

<sup>14</sup> See LATTIN, CORPORATIONS ch. 4, § 6 (1959); 14 CALIF. L. REV. 486 (1926).

<sup>15</sup> See LATTIN, *op. cit. supra* note 14, ch. 4, § 4.

<sup>16</sup> 14 CALIF. L. REV. 486, 487 (1926).

<sup>17</sup> *Id.* at 486.

<sup>18</sup> See, *e.g.*, *Ehrlich & Co. v. Slater Co.*, 183 Cal. 709, 192 Pac. 526 (1920); *Russell Lumber & Supply Co. v. First Nat'l Bank*, 262 Ky. 388, 90 S.W.2d 372 (1936); *Dobson v. Maytag Sales Corp.*, 292 Mich. 107, 290 N.W. 346 (1940); *Empire Mfg. Co. v. Stuart*, 46 Mich. 482, 9 N.W. 527 (1881); *Perine v. Grand Lodge A.O.U.W.*, 48 Minn. 82, 50 N.W. 1022 (1892); *Jewell v. Grand Lodge A.O.U.W.*, 41 Mich. 405, 43 N.W. 88

denying the existence of the corporation where the corporation is suing the third party.<sup>19</sup> But since the third party has not represented the association as a corporation, there is, strictly speaking, no estoppel.<sup>20</sup> However, courts normally say that the third party is "estopped"<sup>21</sup> since he admitted or acquiesced in the "corporation's" pretension.<sup>22</sup> The reasoning for such a holding is more persuasive in the case of a counterclaim by the third party.<sup>23</sup>

Courts are split on the question of estoppel in situations where

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(1889); Taylor v. Aldridge, 180 Miss. 635, 178 So. 331 (1938); Warren v. Stanton County, 145 Neb. 220, 15 N.W.2d 757 (1944) (dictum); Alco Finance Co. v. Moran, 178 Okla. 575, 63 P.2d 747 (1936); Cavaness v. General Corp., 272 S.W.2d 595 (Tex. Civ. App. 1954); Mauritz v. Schwind, 101 S.W.2d 1085 (Tex. Civ. App. 1937).

<sup>19</sup> See, e.g., California Fruit Exch. v. Buck, 163 Cal. 223, 124 Pac. 824 (1912); California Cured Fruit Ass'n v. Stelling, 141 Cal. 713, 75 Pac. 320 (1904); Grangers' Business Ass'n v. Clark, 67 Cal. 634, 8 Pac. 445 (1885); Flash Cleaners v. Columbia Appliance Corp., 319 P.2d 454 (Cal. App. 1957); Wynn v. Treasure Co., 303 P.2d 1067 (Cal. App. 1956); City of Jefferson v. Holder, 195 Ga. 346, 24 S.E.2d 187 (1943); West v. Flynn Realty Co., 53 Ga. App. 594, 186 S.E. 753 (1936); Lowell-Woodard Hardware Co. v. Woods, 104 Kan. 729, 180 Pac. 734 (1919); McGuire v. Bastain Blessing Co., 275 Ky. 622, 122 S.W.2d 513 (1938); Richards v. Minnesota Sav. Bank, 75 Minn. 196, 77 N.W. 822 (1899); Continental Ins. Co. v. Richardson, 69 Minn. 433, 72 N.W. 458 (1897); Columbia Elec. Co. v. Dixon, 46 Minn. 463, 49 N.W. 244 (1891); Minnesota Gas Light Economizer Co. v. Denslow, 46 Minn. 171, 48 N.W. 771 (1891); Springfield Tobacco Redryers Corp. v. City of Springfield, 293 S.W.2d 189 (Tenn. 1956); Ingle System Co. v. Norris & Hall, 132 Tenn. 472, 178 S.W. 1113 (1915); Dickenson v. Boyd, 167 Va. 90, 187 S.E. 479 (1936).

<sup>20</sup> In Mauritz v. Schwind, 101 S.W.2d 1085 (Tex. Civ. App. 1937), the court said:

Estoppel by contract is not, strictly speaking, an estoppel *in pais*, because it lacks several of the essential elements of an estoppel *in pais* but is regarded merely a form of quasi estoppel based on the idea that a party to a contract will not be permitted to take a position inconsistent with its provisions, to the prejudice of another.

*Id.* at 1092.

<sup>21</sup> See cases cited note 19 *supra*.

<sup>22</sup> "We agree that no full, formal, technical estoppel to deny corporate existence arises from such a state of facts, but we think it accords with modern views of good practice and tends to promote substantial justice. . . ." Lowell-Woodard Hardware Co. v. Woods, 104 Kan. 729, 730, 180 Pac. 734 (1919). "[Y]et as between private litigants they may, by their agreements, admissions, or conduct, place themselves where they would not be permitted to deny the facts of the existence of the corporation." Ingle System Co. v. Norris & Hall, 132 Tenn. 472, 474, 178 S.W. 1113, 1114 (1915).

<sup>23</sup> Mechanics' Lumber Co. v. Yates Am. Mach. Co., 181 Ark. 415, 26 S.W.2d 80 (1930); Wynn v. Treasure Co., 303 P.2d 1067 (Cal. App. 1956); Rialto Co. v. Miner, 183 Mo. App. 119, 166 S.W. 629 (1914); Bell v. Commercial Inv. Trust Co., 118 Okla. 230, 246 Pac. 1102 (1926); Brandtjen & Kluge, Inc. v. Biggs, 205 Ore. 473, 288 P.2d 1025 (1955). See generally Annot., 51 A.L.R.2d 1449 (1957).

a third party, having dealt with a defective corporation on the basis that it is a corporation, attempts to hold the members personally liable.<sup>24</sup> It seems the best result is to estop the third party from denying the existence of the corporation,<sup>25</sup> except where the members knowingly misrepresented the status of the association.<sup>26</sup> To hold otherwise allows the third party a right against the members that he did not bargain for and imposes liability on the members that they did not agree to assume.<sup>27</sup> With the flexibility of the estoppel doctrine, applied sparingly where justice demands it, the intention of the parties is carried out and security of transactions is maintained.

On this analysis, the *Robertson* case erred when it abolished both the estoppel and the de facto concepts. The other eight jurisdictions<sup>28</sup> that have enacted these two sections of the Model Act have not construed them as abolishing the concept of estoppel. The injustice that would result from abolishing corporation by estoppel as well as de facto corporations seems great. For instance, where a purported corporation has contracted with a third party or otherwise incurred liability before obtaining its certificate, it clearly should not be allowed to escape liability by denying its existence. Another example is illustrated by *Cranson v. International Business*

<sup>24</sup> See Frey, *Legal Analysis and the "De Facto" Doctrine*, 100 U. PA. L. REV. 1153, 1178 (1952).

<sup>25</sup> See *Whitney v. Wyman*, 101 U.S. 392 (1879); *Magnolia Shingle Co. v. J. Zimmer's Co.*, 3 Ala. App. 578, 58 So. 90 (1912); *Wesco Supply Co. v. Smith*, 134 Ark. 23, 203 S.W. 6 (1918); *Tarbell v. Page*, 24 Ill. 46 (1860); *Heald v. Owen*, 79 Iowa 23, 44 N.W. 210 (1890); *John Lucas & Co. v. Bernhardt's Estate*, 156 La. 207, 100 So. 399 (1924); *Tulane Improvement Co. v. S. A. Chapman & Co.*, 129 La. 562, 56 So. 509 (1911); *Berlin Bank v. Nelson*, 231 Mich. 463, 204 N.W. 92 (1925); *Tisch Auto Supply Co. v. Nelson*, 222 Mich. 196, 192 N.W. 600 (1923); *Lockwood v. Wynkoop*, 178 Mich. 388, 144 N.W. 846 (1914); *A. W. Mendenhall Co. v. Booher*, 226 Mo. App. 945, 48 S.W.2d 120 (1932); *Mason v. Stephens*, 16 S.D. 320, 92 N.W. 424 (1902). For cases contra to this view, see Frey, *supra* note 24, at 1159 n.21.

<sup>26</sup> *Hiele v. Torrance Millworks, Inc.*, 272 P.2d 780 (Cal. App. 1954); *Ryan v. Katz*, 126 Conn. 555, 12 A.2d 835 (1940); *Parker Peanut Co. v. Felder*, 200 S.C. 203, 20 S.E.2d 716 (1942).

<sup>27</sup> *Carpenter, De Facto Corporations*, 25 HARV. L. REV. 623, 633-35 (1912); *Carpenter, Are the Members of a Defectively Organized Corporation Liable as Partners?*, 8 MINN. L. REV. 409, 421 (1924).

<sup>28</sup> ALASKA STAT. ANN. §§ 10.05.261, .810 (1962); COLO. REV. STAT. §§ 31-28-4, -29-4 (Perm. Supp. 1960); ILL. ANN. STAT. ch. 32, §§ 157.49, .150 (1954); IOWA CODE ANN. §§ 496A. 51, 141 (1962); N.D. REV. CODE §§ 10-19-23, -55 (1960); ORE. REV. STAT. §§ 57.321, .793 (1963); UTAH CODE ANN. §§ 16-10-51, -139 (1962); WYO. STAT. §§ 17-36.48, .122 (Supp. 1963).

*Machs., Inc.*,<sup>29</sup> where the defendant had served as an officer and director of what he innocently thought to be a validly organized corporation. Because of an oversight of the attorney, the certificate of incorporation had not been filed at the time the corporation dealt with the plaintiff. When the corporation subsequently failed, the plaintiff sued the defendant individually, contending that the failure to file the certificate precluded *all* corporate existence. Although the court did not decide whether failure to file precluded de facto corporateness, it did expressly hold that estoppel was not precluded by such failure and that the plaintiff was estopped to deny the existence of the corporation and sue the defendant personally.<sup>30</sup> With respect to the estoppel question, such a holding seems much sounder than that of *Robertson*.

The *Robertson* holding that a de jure corporation arises only on issuance of the certificate of incorporation leaves uncertain the protection to third parties where the certificate is issued but the corporation does not complete its organization. This problem is most acute where no capital has been paid in. The third party cannot sue the associates personally since de jure corporateness began when the certificate was issued. But, if the corporation is without assets, a suit against it would avail nothing. Statutory solutions to this problem vary. In all but seventeen states a minimum capital must be paid in before a corporation starts its business.<sup>31</sup> Many of these states, including North Carolina,<sup>32</sup> make directors jointly and severally liable to the corporation if it prematurely commences business.<sup>33</sup> Other states expressly provide that the directors are liable to third parties for the debts of the corporation where business is commenced before the required capital is paid into the corporation.<sup>34</sup> The most apparent shortcoming of these statutes is that the directors are liable only to the extent of the capital that was required, either by statute or by the articles of

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<sup>29</sup> 200 A.2d 33 (Md. 1964).

<sup>30</sup> *Id.* at 39.

<sup>31</sup> See ABA-ALI MODEL BUS. CORP. ACT ANN. § 51, ¶¶ 2.02, 2.03 (1960, Supp. 1964).

<sup>32</sup> N.C. GEN. STAT. § 55-32(g) (1960).

<sup>33</sup> See ABA-ALI MODEL BUS. CORP. ACT ANN. § 43, ¶ 2.02, at 15 (1960). States which have enacted this section are Alaska, Illinois, North Carolina, North Dakota, Ohio, Oregon, Texas, Wisconsin, and the District of Columbia.

<sup>34</sup> *Id.* at 16. States which have enacted this section are Idaho, Kansas, Louisiana, Washington, and Vermont.

incorporation, to be paid in before the corporation was to commence business.<sup>35</sup> Nevertheless, statutes of this type offer some protection to third parties who have dealt with such corporations. In addition to this protection, an awareness of this problem by persons who deal with corporations and inquiry by them as to the financial condition of such corporations should do much to protect third parties in this situation.

WILLIAM L. STOCKS

### Corporations—Restricted Stock Transfers—First Options Consequent Upon the Death of Shareholder

In the recent case of *Globe Slicing Mach. Co. v. Hasner*,<sup>1</sup> the Court of Appeals for the Second Circuit held that a bylaw<sup>2</sup> prohibiting the sale or disposition of the capital stock by a shareholder without first offering the same to the corporation or remaining shareholders was inapplicable to a transfer consequent upon the death of a shareholder and effected pursuant to the shareholder's will. The court, interpreting the bylaw provisions under the New York policy of construing first option restraints narrowly, stated: "First option provisions in order effectively to restrain dispositions by will must specifically so provide. This was not done here."<sup>3</sup>

The question now arises whether or not a narrow construction of such bylaw restrictions is justifiable in view of the reasons for their existence.<sup>4</sup> The usual purpose of such restrictions is to main-

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<sup>35</sup> See note 34 *supra*. But see S.C. CODE § 12-14.6(b) (Supp. 1964), which provides:

If a corporation has transacted any business in violation of this section, any person (whether a promoter, incorporator, shareholder, subscriber, or director) who has participated therein, shall be jointly and severally liable for the debts or liabilities of the corporation arising therefrom.

<sup>1</sup> 333 F.2d 413 (2d Cir. 1964).

<sup>2</sup> No sale or disposition of any shares of the capital stock of this corporation by any stockholder shall be valid unless and until he shall give notice in writing of such intention to the corporation, and to all the present stockholders of the company . . . whereupon the company and all of said stockholders shall jointly and/or severally have the option and right to purchase the same within thirty days after receiving such notice . . . .

*Id.* at 414.

<sup>3</sup> *Id.* at 415.

<sup>4</sup> In the management of corporations few things are more apparent than the desire to keep the control in the same hands of people