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Liability of Members of a De Facto Corporation

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THESIS

Liability of Members of a De Facto Corporation.

Henry Lake Woodward

SCHOOL OF LAW.

Cornell University,
Ithaca, N.Y.
1891.
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LIABILITY OF MEMBERS OF A DE FACTO CORPORATION.

A private corporation, like a co-partnership, is a voluntary association of individuals; but business corporations of limited liability were unknown to the common law (11 Black. Com. 472), and therefore, unlike a co-partnership, can legally exist only when authorized by the state. The right of acting in a corporate capacity, with all the rights and privileges incident thereto, must be treated as a franchise, which may not be assumed without a grant of authority from the governing power. In the United States such authority is derived from the legislature, either through a special charter or a general incorporation law. These charters and general laws usually prescribe certain conditions and formalities to be complied with by parties wishing to incorporate under them, the due observance of which is ordinarily a condition precedent to the legal incorporation of a company. Thus, it is usually required as a preliminary step that a certificate of certain form, containing certain information and signed by the corporators, shall be filed in the office of the secretary of state. (See R.S. of Ohio, §§ 3236-3239). Such a condition as this is undoubtedly a condition precedent, and it frequently becomes a matter of much nicety, requiring the greatest discrimination in the application of legal principles, to determine the status of an organi-
zation, and the liability of its members, formed and doing business ostensibly under the authority of the general statute, but having failed, through inadvertence or otherwise, to comply with those conditions, either in whole or in part. Are such conditions an absolute pre-requisite to incorporation so that the stockholders of such an organization may be held to their common law liability as co-partners, or may they still enjoy the rights and immunities of a properly existing corporation?

Such an association may exist in two aspects: first, where a bona fide attempt has been made in good faith to comply with the statute, but through the inadvertence or carelessness of the promoters the strict letter of the law has not been observed; and, secondly, where no such attempt has been made and the exercise of corporate functions is a bare usurpation of powers, wholly without authority or color of law. I shall discuss these classes separately, endeavoring first to determine the liability of the stockholders on the contracts of the concern, and then the liability for its torts.

Bona Fide Attempt to Incorporate; Contract Liability.

As stated above, neither a private corporation nor a co-partnership with limited liability was known at common law. Individuals associated together in any enterprise for private gain were individually liable for all debts contracted by the
association within the scope of the business, and such liability
could not be abridged by any acts or declarations of their own.
Prima facie, therefore, such would be the liability of the mem-
bers of any association to-day, and where they claim exemption
from payment beyond a certain amount of a claim arising from its
contracts that exemption must arise in one of two ways; it
must be an especial privilege granted by the state, or it must
arise from the terms of the contract itself. Now, the stat-
ute having prescribed certain conditions precedent to legal in-
corporation and the consequent limitation of liability, and these
conditions not having been performed, they cannot, of course,
derive any exemption from statutory authority. That proposi-
tion is self-evident. Therefore, if exempted at all, the ex-
emption must grow out of the contract, and the terms of each
contract upon which they are sought to be held must be examined
for itself. The matter must be looked at thus: What were
the terms of the contract? Upon what did the minds of the
contracting parties meet? What was their mutual intention
and expectation as to liability? Did the creditor contract
with reference to a limited liability, or was the actual exis-
tence de jure of the corporation implied as an essential part
of the contract? It seems that these questions being sat-
sfactorily answered the whole problem will be solved.
Pursuing these inquiries we see that the concern has held out that it is a corporation; that its members will not be liable beyond a certain amount; and that those who deal with it must deal upon that basis. With that understanding and expectation a creditor has dealt with it. Subsequently it is discovered that through an oversight some formality in the act of incorporation has been omitted. It is certain that neither the corporation nor the stockholders can set this up to avoid the contract, for the law will not permit them to thus take advantage of their own wrong.\(^{(a)}\) Nor can a subscriber for stock when sued for calls.\(^{(b)}\) And neither does this newly discovered fact in any way alter the position or prejudice the rights of the creditor. It does not matter what the actual status of the association may be. It has assumed to enter into a contract in a corporate capacity and for only a corporate liability, and a party dealing with it upon that assumption cannot afterward be heard to deny the terms of his own contract. It is but an application of the familiar principle of estoppel, and is

equally true whether the association was in fact a corporation or not; or whether the contract was authorized by the legislature or without that authority and altogether prohibited by law. It is clear that the members of the association never agreed to be bound as partners, to become individually liable, either with the creditor or among themselves. It is equally clear that the party contracting with the association never intended to contract with its members individually. Hence, to treat the members as individually liable would not only nullify the contract actually contemplated and entered into, but would create and enforce an entirely different contract which neither of the parties thereto ever intended to make. This conclusion, so clearly arrived at, is undoubtedly supported by the great weight of authority. The first case that I find involving this proposition is the English of Henriques v. Dutch West India Co., 2 Ld. Ray., 1535, decided about 1730, in which it was held that "where an action is brought by a corporation they need not show how they were incorporated, for if the name is proper for a corporation the name argues a corporation," and that "the plaintiffs were estopped by their recognizance to say there was no such company." And the law thus enunciated has been adopted
in New York(a) and Ohio(b), and in nearly every state in the
Union.(c) In a very early New York case (3 Sand.,170) it
is said, "A defendant who has contracted with a corporation
de facto is never permitted to allege any defect in its organi-
ization as affecting its capacity to contract or sue; but all
such objections, if valid, are only available on behalf of the
sovereign power of the state... .It would be in the highest
degree inequitable and unjust to permit him to rescind a con-
tract, the fruits of which he retains and never be compelled to
restore." Such is the holding uniformly in the subsequent
New York cases. This prevailing doctrine is concisely stated
by Ashburne,J. in Newburg Petroleum Co. v. Weare,27 Oh.St.,at
page 354:

"As a general rule a party will be concluded from denying
his own acts or admissions which are designed to, and do
influence the conduct of another, and when such denial will
operate to the actual injury of that other person.....Good
faith requires that a person who has recognized the existence

Dutchess Man'g Co. v. Davis,14 John.,245.
Petroleum Co. v. Weare,27 Oh.St.,343.
(c) Canal Co. v. Warner,14 Pac.Rep.,37, and cases cited in note.
Fay v. Noble,7 Cush.188; BK. v. McDonald,130 Mass.,264;
"of a corporation by dealing with it openly, with full knowledge of its business character, is yet in the enjoyment of the fruits of the transaction with it under the contract, should be estopped from denying in this collateral way, the power of the corporation to enter into the contract."

With this principle in view, it has been held that failure to record duplicate of certificate with the county clerk(a), to file a duplicate of the articles of association with the secretary of state(b), to state in the certificate the principal place of business(c), acknowledgment of certificate before a notary public instead of before a justice of the peace(d), and failure of notary to certify that those signing the articles of incorporation were personally known to him(e), are not such irregularities as will invalidate the existence of a corporation as to corporate creditors. The only one whose rights have been violated in such cases is the state under whose authority it is sought to incorporate, and hence the due incorporation cannot be inquired into collaterally, but must be attacked in a separate proceeding which is usually a quo warranto proceeding instituted by the

(a) Humphreys v. Mooney, 5 Col., 283.
(b) Cross v. Mill Co., 17 Ill., 54.
(c) In re Spring Valley W.W. Co., 17 Cal., 132.
(e) People v. Cheeseman, 7 Col., 373.
attorney general in behalf of the state. ( R.S. of Ohio, § 6762 ).

Mr. Cook in his work on "Stock and Stockholders" ( §§ 231-235 ) seems to doubt this doctrine, but his position seems to me untenable. He says,

"A corporate creditor seeking to enforce the payment of his debt may ignore the existence of the corporation, and may proceed against the supposed stockholders as partners by proving that the prescribed method of becoming incorporated was not complied with by the company in question."

His reasons for his conclusion seem wholly unjustifiable.

"He (the corporate creditor) is not estopped from so doing, since he is not repudiating a contract, but enforcing it. The fact that he contracted with them under a corporate name is immaterial, since, at common law, parties may carry on business under any name they choose."

As a matter of fact the corporate creditor seeks not only to repudiate a contract, but to enforce a new contract which has never been made, the terms of which have never been in the contemplation of the parties. Furthermore, he not only contracted with them in the corporate name, which is perhaps immaterial, but he contracted with them in their corporate capacity and with the distinct understanding that theirs was to be a corporate liability only. And the cases cited by Mr. Cook fail to sustain
his conclusion. For example, he cites The Bank of Watertown v. Landon, 45 N.Y., 410. In this case the defendants had ceased to be a corporation, and were doing business, and sharing profits and losses strictly upon a partnership basis at the time the contract in controversy was made. And in Ridenour v. Mayo, 40 Oh. St., 9, a rather mixed up case, it seems that the trustees of a certain savings bank, which was created not so much as a business corporation as a benevolent institution, had acted in their personal capacity and done nothing whatever in the execution of corporate power. The law in Ohio is well settled contrary to Mr. Cook's view. In fact, I am confident that every case (a) cited against the proposition I have laid down may be explained and distinguished, though the limits of this thesis will not permit further citation.

The position is further strengthened by analogy in those cases of limited partnerships in which the statutory formalities have not been strictly followed. There do not seem to be many adjudicated cases on the particular point, but from much valuable dicta (b) I think it can be maintained that actual notice to a party dealing with the partnership that it is intended by its members to be a limited one, will relieve the special partner

(a) Except the Iowa case.
(b) Levy v. Lock, 47 How. Pr., 394, 397.
from a general liability. This is strongly intimated in Smith v. Argall, 6 Hill, 479, at p. 482; and in Medberry v. Soper, 17 Kan. 389, Brewer, J. (now of the U.S. Supreme Court), at p. 374, says:

"Where either party claims that his liability is limited by special contract between the partners, and no proceeding has been had under the limited partnership act, it is essential that notice to, or knowledge by, the creditor of such contract limitation be shown, or as to him it will not exist."

In a Pennsylvania case (Whilldin v. Bullock), decided in 1877, it was said, that one who sues a partnership may properly be asked whether he did not give credit to them as a limited partnership; and that if he did deal with them as such, the burden is on him to show that the partners are liable as a general partnership. I think the law on this point is analogous to that of a de facto corporation, and may be thus stated: When a party dealing with a partnership receives actual notice that one or more partners claim a limited liability, such notice becomes a part of the contract and he cannot afterward be heard to dispute the liability; but if the limited partnership statute has not been substantially complied with, the burden of proof to show such actual notice is upon the partner seeking exemption. Mere knowledge by the creditor that an attempt has been made,
11.

or that papers for a limited partnership have been executed is not alone sufficient; for he cannot know but that the partners have abandoned their design of coming under the statute.

Limitation of the Doctrine.

There appears, however, to be a tendency on the part of some of our courts to carry the doctrine that the legal existence of a corporation cannot be attacked collaterally entirely too far. There is a limit beyond which the law will not permit a violation of its express provisions. Indeed, in the case of an express contract it is not because the law looks with favor upon irregularities that they are tolerated, but because the creditor's own acts and admissions estopp him from taking advantage of them; and when a person has in no way, either expressly or impliedly, recognized or acknowledged the corporate existence of an association, and has had no dealings with it as a corporation, I am unable to find any decisive authority for holding that he may not attack the legality of its existence when such existence is prejudicial to his rights. A good illustration of the attempts to enlarge this doctrine is the case of Society Perun v. Cleveland, 43 Oh. St., 481. Society Perun had attempted in good faith to incorporate, but having failed to comply with the statutes in some particulars was ousted from its user by a quo
warranto proceeding instituted by the attorney general. The plaintiff, the city of Cleveland, having had no direct contract relation with defendant, and not having otherwise, expressly or by implication, recognized its legal corporate existence, claimed that it was entitled to dispute such existence, and that as to it the society was not a corporation de facto. But the court thought otherwise, basing its decision upon the idea that under no circumstances can the corporate existence of an association be questioned collaterally; that it can only be attacked by direct proceeding instituted by the state for that very purpose. Owen, J., in delivering the opinion, says,

"The theory that a de facto corporation has no real existence, that it is a mere phantom to be invoked only by that rule of estoppel which forbids a party who has dealt with a pretended corporation to deny its corporate existence, has no foundation, either in reason or authority. A de facto corporation is a reality. It has an actual and substantial legal existence. It is, as the term implies, a corporation."

And further,

"Where it has been reputed and dealt with as a duly incorporated body, and valuable rights and interests have been acquired and transferred by it, no substantial reason is suggested why its corporate existence, in a suit involving
"such transactions, should be subject to attack by any other party than the state, and then only when called upon in a direct proceeding for that purpose, to show by what authority it assumes to be a corporation."

These observations of the court are dicta, entirely unnecessary to the decision of the case at bar, and while the real decision is undoubtedly a sound one, it is arrived at by most fallacious reasoning. It is true that, although the plaintiff had never dealt with defendant as a corporation, it could not be permitted to so far impeach its existence as to disregard its transactions made before the judgment of ouster, but not because plaintiff could not attack its existence collaterally. An examination of the facts discloses that Society Perun, supposing itself a corporation, had acquired property from a previously existing corporation called Perun. Presumably there was a consideration. Perun had already mortgaged the property to the city of Cleveland, but the latter had failed to have the mortgage recorded for more than five years. After the conveyance to Society Perun, and before the recording of the city's mortgage, the former, acting in its supposed corporate capacity, from time to time mortgaged and conveyed different parcels of these lands to various parties. The city brought this action, pending the proceedings in \textit{quo warranto}, to foreclose her mortgage, and also to foreclose
her supposed vendor's lien on the mortgaged premises, as against these subsequent grantees and mortgagees. From these facts it is apparent that the corporate existence or non-existence of defendant was not essential to the decision. In some capacity or another Society Perun, or the members composing it, as the case may be, parted with a valuable consideration and acquired an interest in the real estate, and so far as the city of Cleveland was concerned it did not matter what that capacity may have been; whether it was as a corporation de jure, a corporation de facto, or a co-partnership. That matter could not affect her rights and it was wholly unnecessary for the court to pass upon that question. It is not contended that Society Perun had "no real existence", that it was a "mere phantom". It undoubtedly had "an actual and substantial legal existence", as Judge Owen asserts. Without question it was a reality—a legal entity. This is evident from the very fact that people could contract with it at all, because one cannot contract with an imaginary corporation or association any more than with an imaginary individual. But the fallacy lies in failing to distinguish between the actual existence of an association and its legal status after it has been formed. Thus, in Williamson v. Kokomo B. & L. Association, 89 Ind., 339, a case cited to sustain the opinion in the above case, one Leach gave to an acting cor-
poration his mortgage on real estate. Subsequent to the execution and recording of it, he executed another mortgage on the same land to Williamson. In a proceeding to foreclose the junior mortgage, Williamson maintained that the pretended corporation had no legal existence by reason of defective organization and that the senior mortgage was void. He was for no reason estopped from denying the corporate existence, but the court held that "this rule is not limited to cases where one by contract admits corporate existence, but is a rule of general application."

Yet it is apparent that here too the question does not arise. It does not matter what the exact legal status of the corporation was, or whether the plaintiff could attack it. Whatever its members may have been from a legal point of view, they had parted with valuable property and taken a mortgage, and whatever name or status the law may give them, they are still entitled to the security of that mortgage. All the cases cited to sustain the doctrine of the Society Prun case might be distinguished in the same way if space permitted. (a) In every case in Ohio in which the question has fairly arisen, it has been decided squarely upon the ground of equitable estoppel. The same principle was

(a) See Pope v. Capitol Bank, 20 Kan., 440. Thompson v. Candor, 60 Ill., 244.
introduced into the New York law upon the grounds stated in
Henriques v. Dutch West India Co. (supra), and has been the basis
of all subsequent decisions in that state. An examination of
a large number of cases arising in nearly every state shows that
the decisions are uniformly placed upon the ground of estoppel,
and the few cases that attempt to broaden the doctrine may be
easily distinguished.

Usurpation of Corporate Powers; Contract Liability.

This leads to the next phase of the subject, viz., the liability
of stockholders when no attempt whatever has been made
to comply with the statute, where individuals have simply formed
themselves into an association, elected officers, issued shares
of stock, business to be conducted and profits and losses to be
shared as in a de jure corporation, and hold themselves out to
the world as such. It has not often arisen for determination
as the corporate existence is usually colorable, but it is fre-
quently asserted that such a concern is not a de facto corporation
within the meaning of the term, and for that reason a distinc-
tion is sought to be made between it and the class of associa-
tions just considered. From a stand-point of abstract morality
there is undoubtedly a difference, because in one case the best
of faith has been manifested, while in the other there has been
a wilful misrepresentation. But such misrepresentation is not material to the contract, and does not operate as a fraud upon the creditor to induce him to enter upon an agreement which he would not otherwise have made, and from a legal standpoint I fail to see any distinction. There are two things which it is essential to show in order to establish a corporation de facto, (1) The existence of a charter or some general law under which a corporation with the powers assumed may be lawfully created, and (2) A user by the party to the suit of the rights claimed to be conferred by such charter or law. (a) It is only necessary to show that by the laws of the state such a corporation might exist, and in Wood v. Jefferson County Bk., 9 Cow., 205, it is held to be sufficient evidence to prove the existence of a de facto corporation if the statute under which the alleged corporation might exist is read in court, and a user of franchises in pursuance thereof proved. But whether or not the second class of associations may be denominated de facto corporations is at best only a useless quibble over terms, having nothing to do with the legal aspect of the case. I am unable to discover in reason or authority, where there is any distinction between

the legal liability of members of the two classes of associations. I am unable to see any line of reasoning applying in one case that does not apply with equal force in the other. As suggested at the beginning, there are but two grounds upon which limited liability may be predicated, exemption by statute or exemption by virtue of the particular contract. In neither case can any statutory exemption be claimed, because in neither case has there been a compliance with those conditions which the statutes make essential. It does not matter that in one case there has been a total disregard of conditions and in the other only a partial disregard. Either is fatal. And the principle of estoppel applies equally. In each case the creditor has acknowledged the corporate existence, has contracted with it upon a corporate basis, agreeing upon a corporate liability only, and is estopped in the one case as in the other from afterward repudiating the terms of his contract and enforcing another which has never been made or contemplated. But it is urged that such a doctrine is against public policy, and it is asked, What is the use of enacting laws if they need not be obeyed? Why prescribe conditions if there is no necessity for complying with them? If, as in some places it is made a penal offense, punishable as a misdemeanor, to usurp corporate functions, it may perhaps change the aspect of the case; In New York and Ohio, and in most other states, the statutes contain various
enactments by which officers and stockholders are made individually liable for debts contracted in case of non-compliance with certain requisites, but no provision is made by which such individual liability attaches by reason of any omission to organize in the manner prescribed by law. The statutes prescribe the mode of organization, but annex no penalty or liability to the neglect or omission to comply with it. Therefore the argument is not affected, because precisely the same objections may be urged and the same questions asked, whether the statute has been violated entirely or partially, purposely or by mistake. As has been already shown, the courts universally hold that an omission or other mistake caused by inadvertence does not render the corporators liable, as partners, and therefore I conclude that upon the same reasoning applied in those cases the same conclusion must be reached, even though the whole organization be a bare-faced usurpation. If rights and franchises have been usurped they are the rights and franchises of the sovereign, and of the sovereign only. The question has never been before the highest court either of Ohio or of New York in this shape, but it arises squarely in the case of Seacord v. Pendleton, 55 Hun 579, where a bank purported to be a corporation and for a long time did business as such though entirely unauthorized by law, and the supreme court, without dissent, held the stockholders
liable as incorporators only to a depositer who sought to establish a general partnership among them. There is much dicta to sustain the decision. In Booske v. Gulf Ice Co., 5 So. Rep., (Fla), 247 it is said:

"It is settled that a conveyance by a corporation will not be treated as invalid merely because the corporation was not formed under authority of law."

In Eaton v. Walker, 43 W.W. Rep., (Mich), 638, the stockholders were held liable as partners because there was no statute in existence under which they could constitutional incorporate and could not therefore claim to be a de facto corporation, but it is intimated that it would be otherwise had such a statute existed. See also Bank v. Stone, 38 Mich., 779.

Reasoning Fails Where Members are Actually Partners.

It will be understood that in this entire argument I have assumed that the members of a de facto corporation are acting as such among themselves; that they are merely stockholders, sharing profits and losses as such and not as partners; and interfering in no way with the conduction of the business, for the carrying on of which proper officers have been elected. Of course, if as between themselves they are partners and act as such they will be so liable to third persons. But in Bank v.
Walker, 66 N.Y., 424 it was held that to establish a liability against a party as a partner for the act of others, it must be made to appear that a co-partnership was formed by express agreement, or that there was an authorization in advance and a consent to be bound by such acts as a partner, or a ratification of the acts after performance, with full knowledge of all the circumstances, or some act by which inequitable estoppel has been created. And in Fuller v. Rowe, 57 N.Y., 23 it was held, that while parties assuming to act in a corporate capacity without a legal organization as a corporate body are liable as partners to those with whom they contract, to charge any one of them as such, it must be shown that he was so acting at the time the contract sued upon was made, or that upon some consideration he agreed to become liable with the others.

This satisfactorily disposes of the question of contract liability.

Liability for Torts.

The liability of stockholders for torts suffered by third persons at the hands of the defectively organized corporation would seem to be an important question and one quite likely to arise, yet the text-books fail entirely to discuss or mention
it, and cases requiring its decision rarely appear in the reports. Its consideration, the must be more upon reason than upon precedent, and I think may be quickly disposed of by following the same lines that have been established in considering contract liability. Suppose an agent or an officer of the organization commits a tort upon the person or the property of a third party. The tort is not committed with reference to any particular liability, or in view of any particular legal status. The third party has not recognized or admitted the corporate capacity to commit the tort, and is not thus by his own acts estopped to deny the corporate existence. The tort having been committed, all concerned should be held for just what they legally are. Every individual owning stock in the alleged corporation has directly or indirectly authorized, and is responsible for, the commission of the tort, and in some capacity, either as an incorporator or as a co-partner is liable therefor. It is certain that they cannot claim the privilege of corporate liability only, because they have never been legally incorporated. The terms of the statutes from which such privileges are derived, and whose observance is a positive prerequisite to legal existence, have not been complied with. The only logical conclusion, then, is that they must be held individually liable as joint tortfeasors, a conclusion entirely consistent with the theory of equitable
estoppel already set forth. In some respects it is analagous to the well settled principle of partnership which holds a secret partner jointly liable with all other partners for contracts made, or torts committed, while he was actually a member of the firm, although the fact of his being such was unknown to the third party at the time the contract was made or the tort committed. The point is sustained and well illustrated in the case of Vredenburg v. Behan, 33 La. Ann., 627. Defendants members of a defectively incorporated club for "literary, scientific and charitable purposes" kept a bear chained upon their premises. A. and his hired boy were passing and the boy teased the bear by setting a dog on it? The bear slipped its collar and attacked and wounded A. who died of his injury. The keeping of the bear was within their corporate authority but their incorporation having been defective, defendants were held individually liable, even including one defendant who was away at the time and altogether ignorant of their having the bear. (a) While the rule may prove harsh in individual cases, it seems consistent with legal reasoning.

Recapitulation.

To recapitulate, I think the following propositions,

(a) See also Kruse v. Dusenbury, 19 N.Y., Weekly Digest 201.
founded in reason and established by authority, may be safely laid down with a reasonable certainty of maintaining them:

1. Persons who, by contracting with a *de facto* corporation, recognize and acknowledge its corporate capacity to so contract are estopped from afterward denying such corporate capacity, and as to them it stands upon the same footing as a corporation *de jure*;

2. Persons who have not so estopped themselves may, in any proceeding where it would be pertinent, question the regularity of incorporation collaterally, and to them the members may be made liable individually as co-partners or joint tort-feasors, as the case may be;

3. The state may at any time attack the legal existence of a *de facto* corporation by bringing an action for that purpose against the individuals composing it, to oust them from their illegal use.
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