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Proposed Revision of the Ultra Vires Doctrine

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The doctrine of ultra vires had its origin in judicial deduction from the fictional conception of corporations as artificial persons, creatures of the law, which have no existence, powers or capacity except those granted by statute. Hence a contract made in the name of the corporation for purposes not included in the articles, although by authority of all the directors, and even with the consent of all the stockholders, has been held by some courts not to be attributable to the corporation at all. The doctrine was not originated to accomplish in scientific fashion the just protection of the legitimate interests and expectations of the various parties concerned, such as the security of third persons in their dealings with corporate representatives, but "having been once created, it is now probably saddled onto the backs of the courts, like Sinbad's Old Man of the Sea, not to be shaken off."¹

The Committee on a Uniform Incorporation Act in its report to the Commissioners on Uniform State Laws in 1924 included a provision, Section seven, as to the effect of ultra vires acts. This ninth tentative draft of a uniform incorporation act was the first to contain any provision with respect to the subject of ultra vires. Since there is no other topic as to which the law is in a more unsatisfactory or confused condition, it has seemed to the Committee and its draftsman, Professor R. S. Stevens of Cornell, that the opportunity of establishing uniformity in this field ought not to be lost. Section seven of the ninth tentative draft reads as follows:

"Section 7. *Corporate Capacity and Authority.*—Subdivision 1. Every corporation formed under this Act shall be a body politic and shall be deemed to have the general capacities of a natural person, provided, however, that the limits of permissible corporate action shall be those defined and restricted by the articles of incorporation and amendments thereof, and by the provisions of this Act and of the other laws and the Constitution of this State.

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Sub-division III. If any acts shall have been done by a corporation in excess of its powers, the corporation's lack of power

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¹(1878) 6 CENT. L. J. 2; Carpenter, *Should the Doctrine of Ultra Vires Be Discarded?* (1923) 33 YALE L. J. 49; Scarborough, *Ultra Vires No Defence in Private Contract* (1923) 11 KY. L. J. 197.

to do such act shall not be inquired into collaterally, provided that the act is one that the corporation might, at the time the act was committed, have been formed under this Act with power to do. Any action by a corporation in excess of its powers may be enjoined at the suit of any shareholder. The commission by a corporation of any act in excess of its corporate powers shall be a ground for the forfeiture of the corporate existence at the suit of the State, and the directors or officers engaging in such unauthorized corporate action shall be liable to the corporation for any damage suffered thereby in a suit by it, or by a shareholder in case it will not or cannot sue therefor."

The tenth draft, Section nine, to be presented to the National Conference in August, 1927, now reads as follows:²

"Section 9. *Corporate Capacity and Corporate Authority Distinguished.*

1. A corporation which has been formed under this Act, or a corporation existing 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 and which are not repugnant to law."

* * * * *

The companion section on constructive notice is Section eight, "*Purpose of Requiring Certain Papers to be Filed.*" This now reads as follows:

"The filing of articles of incorporation, or amendments thereto, and of any other papers, pursuant to the provisions of this Act, shall not charge persons who deal with a corporation with notice of the contents thereof."

Since the Committee desires all the cooperation it can get to make the proposed Uniform Act meet the proper demands of present day business, a few comments will be submitted without any attempt to discuss the authorities. The effort to restore the law to realism on this subject is certainly a timely and courageous one and deserves vigorous support. The main criticism that suggests itself as to the proposed draft is that it fails to go far enough in indicating what practical legal consequences and changes are intended to be produced. It attempts to repeal an artificial theory or premise, that of limited capacity or powers, and to establish a theory of general capacity or powers. It provides that the corporation shall have authority only to act for the accomplishment of its corporate purposes, but fails to show for whose benefit the limitations upon such authority are

²See Stevens, *A Proposal as to The Codification and Restatement of the Ultra Vires Doctrine* (1927) 36 YALE L. J. 321, 328 for original language of the committee.

impced, or who can raise the question of lack of authority and when. What are the differences between limited capacity and limited authority to act? Will the establishment of the doctrine of general capacity destroy the doctrine of ultra vires in whole or in part? May executory or partly executed contracts be collaterally attacked by either party?

The theory of the draftsman evidently is that if we wipe out the two false premises of limited capacity and constructive notice we shall leave the courts sufficiently free so that they can work out for themselves a reasonable and uniform doctrine of ultra vires without statutory guidance other than that which might be furnished by a restatement of the law by the American Law Institute.³

It is, in brief, the view of the present writer that the law on this topic cannot be expressed in terms of capacity or incapacity. It is equally a fiction to say that a corporation has certain powers only, or all the powers of an individual. The question remains, by what principle or rule is it possible to ascertain whether a transaction is to be attributed to the corporation? Neither in a practical sense is it a question of the "authority" of the corporation, but rather of the authority of the directors to bind the corporation with or without the consent of the stockholders. The corporation by legal fiction is deemed to have certain powers, but a corporation can act only by having the acts of officers and agents ascribed to it. The practical question then is not what power or capacity or authority has the state granted to an imaginary person, but rather what authority has the group of stockholders granted to their representatives, the directors, to do business on their behalf.

The result is that in general the objects and purposes clause of the articles should operate simply like by-laws or articles of partnership, as limitations on the actual authority of the directors and officers to bind the corporation, but not upon their ostensible or apparent authority, unless reasonably to be inferred or actually known. Their ostensible authority to bind the corporation would then depend upon the nature of the business, banking, insurance, etc., according to the actual course in which it is carried on by similar concerns, or by that concern, very much as in the case of partnerships.⁴

³*Ibid.* 297, 300.

⁴See Uniform Partnership Act, § 9. The act of every partner for apparently carrying on in the usual way the business of the partnership binds the partnership unless the partner so acting has in fact no authority so to act, and the person with whom he is dealing has knowledge of the fact that he has no such authority. No act of a partner in contravention of a restriction on his authority shall bind the partnership to persons having knowledge of the restriction. No act in contravention of any agreement between the partners may be done rightfully without the consent of all. § 18(h). See *Rianhard v. Hovey*, 13 Ohio 300 (1844).

Canada, like England, has two kinds of corporations, those created by letters patent or executive grant which are given the general capacity possessed by corporations created by royal charter, and those created with the limited capacity of statutory corporations. Some Provincial Companies Acts have been amended to extend to all corporations "the general capacity which the common law ordinarily attached to corporations created by charter." The effect of this grant of general capacity seems to be still more or less unsettled.⁵

Under the general capacity doctrine could a corporation incorporated say for the purpose of carrying on the sole business of mining lawfully carry on the business of butchering also? The general capacity doctrine does not mean that the directors may divert the capital of the corporation to unauthorized purposes or that shareholders have no control over the nature of the business which the directors may carry on. Even if we accept or enact the general capacity doctrine, there is still the question of agency as in the case of an individual or partnership. If contracts or conveyances are attempted outside the scope of the agency of the directors, actual or apparent, they may be enjoined. The general capacity doctrine means that the law may attribute to the corporation such rights and liabilities as its agents may be deemed authorized to acquire or incur in its behalf as in the case of an individual or partnership principal.

It may sound radical and revolutionary to propose that the objects clause of the articles should operate with no more effect than by-laws. But is not that exactly what the learned draftsmen are driving at in removing the doctrine of special capacity? The Ohio Act drafted by a committee of the Ohio Bar Association with the advice of Professor Stevens and much expert assistance, and recently adopted, seems to carry out this idea explicitly. It follows the Uniform Act but in Section eight adds these two clauses:

"The articles of incorporation 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 statements of purposes and within such limitations and restrictions as may be imposed by the articles.

"No limitations 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 officer or a person having actual knowledge of such limitation."

⁵Edwards v. Blackmore, 42 Ont. L. Rep. 105, 42 Dom. L. Rep. 280 (1918); Thomson, *The Doctrine of Ultra Vires* (1920) 40 CAN. L. T. 993; Thomson, *Joint Stock Companies* (1922) 42 CAN. L. T. 143, 245, 302-361; Garrett, (1922) 42 CAN. L. T. 433, 466, 478; 7 PROC. CAN. BAR. ASS'N. 382 (1922); 7 *ibid.* 176 (1925); Gurd, (1924) 2 CAN. BAR REV. 485, 488.

The theory underlying this modernized Ohio corporation act is simply that the corporation is the result of an agreement among the parties who organized it and are conducting it, subject to proper supervision in the interests of the public.⁶ Limitations of authority contained in the articles are binding upon the directors and the officers of the corporation and persons dealing with the corporation with knowledge thereof. The statement of "purposes" in the articles is binding to this extent. But the objects and powers clauses are merely directions by the shareholders to their agents intended to govern them in conducting the corporation's business. Those limitations cannot be asserted to invalidate transactions with the corporation except where the rules of agency permit.⁷ The burden of proof would no doubt be on the corporation to prove that anyone contracting with it was aware of the limitations. A contract might doubtless be ratified by the corporation though both the corporate agent and the third party knew when it was made that the transaction would be ultra vires. The third party could withdraw prior to ratification.

The distinction sometimes drawn between acts or contracts in abuse or excess of granted powers and acts in reference to a subject lying entirely beyond the range of objects of the corporation has been criticized.⁸ In either case the contract is authorized or not authorized by the charter. In either the contract is equally within any supposed common law or statutory prohibition against all unauthorized corporate action. There may, however, well be apparent authority or estoppel in one case where there would not be in the other. A corporation should be bound by the acts of its agents though unauthorized and in excess of the corporate purposes as against a party who was entitled to assume that the agents acted within the authority conferred upon them.⁹

If the third party trusting to the ostensible authority of corporate officers, held out by the corporation to the public as worthy of credit and confidence, contracts or changes his position in reliance upon this appearance, the corporation should be estopped to plead its own want of "power" or the lack of authority of the officer to bind it. The proposition amounts to this:—That a person dealing with a corporate officer may ordinarily rely on the implied representation

⁶See Report of the Committee of the Ohio Bar Ass'n., Dec. 28, 1926, at 5, 30.

⁷See discussion as to by-laws in *Putnam v. Ensign Oil Co.*, 272 Pa. 301, 307, 116 Atl. 285, 287 (1922).

⁸2 MORAWETZ, CORPORATIONS (2nd ed. 1886) §§ 704, 706; 3 FLETCHER, CORPORATIONS (1917) §§ 1598-1600.

⁹*Monument Nat. Bank v. Globe Works*, 101 Mass. 57, 3 Am. Rep. 322, (1869) 3 FLETCHER, CORPORATIONS (1917) §§ 1591-1597.

that an officer accredited by the directors is acting within the scope of the corporate business, unless there is good reason to suppose otherwise. This is particularly the case if the contract pertains to the usual and ordinary business carried on by that corporation, and such a contract might not under all circumstances be beyond the authority conferred by the articles. But if the transaction is manifestly beyond the scope of the business of the corporation the party dealing with the officer acts at his peril.¹⁰

In the world's business, business men cannot be expected to read and construe the charters of corporations before each contract is made. The charter is practically a matter of private record like the by-laws or articles of partnership. "If the law does expect and require all who deal with the corporation to be familiar with and understand the charter, the requirement is unreasonable and the expectation is doomed to disappointment. The exigencies of ordinary business alone will often prevent a search of corporate records. Indeed, in many cases the search could not be made if desired."¹¹

A conflict arises to some extent between the interests of the stockholders and of third persons who deal with the corporation. In some foreign systems of law it is provided that limitations of power cannot be set up against third persons acting in good faith. It is difficult to find a solution which reconciles the complete security of the stockholders with that of third persons, without requiring of them an impracticable examination into the probable interpretation of the charter powers.¹²

The main field of conflict as to ultra vires transactions, as Professor Stevens shows,¹³ is concerned with the rights and liabilities arising out of ultra vires contracts which are wholly or partly executory. The so-called "estoppel" to plead ultra vires by the retention of benefits of performance may best be explained as a species of adoption or ratification of the contract. Under the apparent agency doctrine even an executory ultra vires contract may be enforceable (as it is now in certain cases of estoppel) if within the apparent scope of the

¹⁰Sturdevant v. Farmers & Merchants Bank, 69 Neb. 220, 95 N. W. 819 (1903)

¹¹J. L. Parks, *Ultra Vires Transactions* (1922) MO. BAR BULL., Law Series 25, p. 21. In Bissell v. Michigan Southern Railway Co., 22 N. Y. 258, (1860) Comstock C. J. says, "A traveler from New York to Mississippi can hardly be required to furnish himself with the charters of all the railroads on his route, or to study a treatise on the law of corporations."

¹²Demogue, *The Impossibility of Effecting Contractual Incompetence* (1922) 31 YALE L. J. 626, 629; SCHUSTER, PRINCIPLES GERMAN CIVIL LAW (1907) §§ 52, 58. The doctrine of *ultra vires* has no application in the case of any German trading corporation. No transaction entered into by one of the primary agents of a trading corporation is invalid on the ground that it is outside of the scope of the corporation's usual business or the objects for which it was created.

¹³Stevens. *op. cit.*, *supra* note 2, at 297, 308.

authority of the directors. An executed conveyance or transfer on the other hand might be subject to attack, except as protected by ratification and estoppel, if entirely unauthorized or unsupported by apparent authority.

The directors are something more than ordinary agents. It is through them that the corporation lives, wills, acts and has its being. Stockholders, like bondholders, are more in the position of lenders and investors than of principals and proprietors. They submit their capital and business to the direction and control of the proper officers of the company. The law may therefore more easily infer ratification from silent acquiescence than in the case of an individual principal and impose a duty upon stockholders to inquire as to the conduct of directors and officers, and to restrain such conduct if improper or unauthorized because outside the scope of the specified corporate business.¹⁴

The Vermont statute,¹⁵ the only one on ultra vires beside the new Ohio act, goes to the extent of declaring that any act done in behalf of a corporation, authorized or ratified by the directors, shall 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 as if the act had been necessary or proper. That is, the corporation will be bound if the act is within the apparent scope of the authority conferred upon them. No doubt the same force would be given the articles as to the by-laws, and third persons who join with delinquent officers in violating known limitations could not enforce their agreements.¹⁶

¹⁴Warren, *Executory Ultra Vires Transactions* (1911) 24 HARV. L. REV. 534-537; Stevens, *op. cit.*, *supra* note 2, at 297, 331, 333.

¹⁵Vt. Laws 1915, No. 141, § 15; Vt. Gen. Laws (1917) §§ 4919, 4923.

¹⁶Compare Stevens, *op. cit.*, *supra* note 2, at 297, 333 note 124.