Volume 39
Issue 3 *Dickinson Law Review - Volume 39, 1934-1935*

4-1-1935

Partnership Liability of Members of Defective Corporations

W.H. Wood

open by another employee the defendant is not liable.[13] The reason here is obvious: first, the defendant did not violate the statute, and second, because there is no duty upon the manager to follow his employees to see if they perform their tasks properly.

In summary we submit the following rule, if the statute was violated and the person injured was one whom the statute aimed to protect, then:

1. If it was a statute prohibiting the sale of firearms to minors or the employment of minors at certain dangerous occupations, then the violation is negligence *per se* and is treated as the proximate cause of the injury. Further, the defendant may not use the defence of voluntary assumption of risk or the contributory negligence of the minor.[14]

2. If the statute is one involving the violation of statutes providing for the general safety in mining, manufacturing, and buildings then the violation is negligence *per se*, but proximate cause must be established in order to make the violation actionable. The contributory negligence of the plaintiff will be available as a defense, but voluntary assumption of risk will not be.

Dale F. Shughart.

PARTNERSHIP LIABILITY OF MEMBERS OF DEFECTIVE CORPORATIONS

As the body of law governing corporations is being refined and perfected, the question of defective incorporation and the results which arise therefrom is steadily growing less important. However, there still remain situations in which it may become necessary to determine just what is the status of the members of a supposed corporation which actually has no legal existence as such.

In this discussion the term "defective corporation" is used to describe an association of individuals which purports to be a corporation, but which has not attained either a de jure or a de facto corporate existence. Consequently, since by hypothesis no corporate existence of any sort has been attained in these cases, it is not necessary to consider at all the provisions of the various

---

[13]Beach v. Hyman, 254 Pa. 135.
[14]36 Dickinson Law Review 192.
[15]36 Dickinson Law Review 192.

statutes which we have in Pennsylvania governing corporations. In other words, although the statutory requirements for and the results of incorporation differ materially for different types of groups, if no incorporation has been attained these provisions of the various statutes become immaterial, and it is safe to assume that whatever rules of law may be found to govern one defective corporation will be equally applicable to all.

In situations involving suits by third parties against members of a defective corporation, the most frequent statement made by the courts is that the members are liable as partners.

This is a generality which, while it may seem sound at first glance, is very difficult to apply to specific factual situations. It gives no hint as to the persons who are to be included under the partnership liability, or as to how many of the incidents of a true partnership are involved. This doctrine of partnership liability has been questioned and criticised,[1] and the results of its application in various jurisdictions are not at all uniform.[2]

The best expression of the doctrine in the Pennsylvania Reports is to be found in the cases arising under that portion of the Act of 1874 which requires the certificate of incorporation to be recorded in the office for the recording of deeds in the county where the chief operations are to be carried on. As will be seen from the following cases, under this statute a group cannot attain even de facto corporate existence unless the certificate has been recorded.

In New York National Exchange Bank of the City of New York vs. Crowell,[3] the plaintiff was suing upon a $2500 note given by the Crowell and Class Cold Storage Company. The company had failed to record the certificate of incorporation as required by the Act of 1874. The defendants had withdrawn from the group before the note was executed, but the court held them liable as partners, on the ground that the members of a defective corporation are liable as partners, and that the defendants had not given the requisite notice of their withdrawal from a partnership.

---

[1] "Partnership Liability of Stockholders in Defective Corporations." E. Merrick Dodd, Jr., 40 Harvard Law Review 521. The author discusses four reasons which have been advanced why the stockholders in a defective corporation should not be liable as partners.

1. The enterprise is abortive and the shareholders were only such on condition that a valid corporation be formed.
2. The shareholders did not intend to be partners.
3. The shareholders do not have the rights of partners.
4. It is unfair to treat the shareholders as partners.

[2] See the above note for an exhaustive list of cases showing the various extent and results of the doctrine in various jurisdictions.

[3] 177 Pa. 313.

In Guckert vs. Hacke,[4] which is generally considered the leading Pennsylvania case upon the point, the plaintiff entered into a contract with Hughes and Gawthrop Company to repair a building. The certificate of incorporation had not been recorded and the plaintiff brought suit against the incorporators in their individual capacity. The court held: " * * * those who transact business upon the strength of an organization which is materially defective are individually liable as partners to those with whom they have dealt."

In Tonge vs. Item Publishing Company,[5] the plaintiff was suing for damages sustained by reason of injuries caused through the negligence of a servant of the company. The court, by way of dictum, made this statement: "Appellees would without doubt have had a right of action against appellants as partners, but they chose rather to sue the Item Publishing Company as a corporation."

In Campbell vs. Beaman,[6] the plaintiff was suing for breach of contract to sell land, and the court held: "The charter of the Sayre and Athens Real Estate Company, not having been recorded * * * the stockholders of the Sayre and Athens Real Estate Company became liable to the plaintiff as partners."

In Peerless Oil Company vs. Michaels et al, trading as the Lackawanna Trucking Company,[7] and in Fergetti vs. Treverton Electric Light and Power Company et al,[8] the stockholders were liable as partners.

From these cases it is safe to say that the Pennsylvania courts hold all the stockholders of a defective corporation liable as partners to third persons suing on a contract or for a tort of such corporation.[9] There are two serious faults to be found with this doctrine: (1) it is unnecessary and undesirable to phrase it "Liable as partners," (2) it is too wide in scope.

As to the first of these objections, it would seem that the phrase "liable as partners" is an unfortunate one. Much of the dispute and controversy which has arisen upon this question is due to the feeling that the status of members of a defective corporation cannot logically be termed a partnership. In this

---

[4]159 Pa. 3.

[5]244 Pa. 421.

[6]68 Pa. Superior Ct. 30.

[7]8 Dist. and Co. 383.

[8]46 Co. Ct. 326.

[9]In this connection it might be noted that the failure of a foreign corporation to register before doing business in Pennsylvania, as required by statute, does not make its incorporators, members or directors liable as partners on contracts made in behalf of the foreign corporation. Bala Corporation vs. McGlinn, 295 Pa. 74, 144 A. 823.

dispute the main issue is often obscured, for it does not follow that if such members are not liable as partners they are not liable at all. There is no good reason why this liability of members of a defective corporation should be forced into logical conformation with any certain set of legal concepts. It is difficult to understand why, each time the courts impress a new liability to meet a new situation, there is a feeling that it must conform to and be explainable in terms of established legal principles. Why should not this liability be recognized as one distinct and apart from either corporate or partnership liability and as one to be governed by it own rules?[10] There are numerous reasons why it cannot be logically supported by partnership principles and it is admittedly not corporate in nature.[11] Also, basing the liability upon partnership principles may serve to inject all the involved relationships of the true partnership into the problem and make the working out of the rights of the parties even more difficult.

As to the question of the scope of the doctrine, it is doubtful in the majority of these cases if the courts actually intended to extend the partnership liability to all the shareholders. In most of these situations the statement that the members are liable as partners concedes too much. Usually only those few members who were actively participating in the business were actually made defendants, and individual liability could well have been fixed upon them with language much less broad in its scope.

The factual situations may differ widely in these defective corporations, and it would seem that the failure of the courts to distinguish between them has been the cause of much of the confusion which exists at present in various jurisdictions as to the nature and extent of the personal liability of the members of defective corporations.

After a consideration of the problem from the point of view of both the members and the person attempting to fix personal liability upon them, it is submitted that the following situations might well be differentiated and liability imposed accordingly.

---

[10]Wecheselberg vs. Flour City National Bank, 64 Fed. 90. "While the courts have differed in naming the liability—whether in the nature of co-partners or resting upon the ordinary principle of contract and agency or upon fraud—they agree in holding liable in some form all who engaged in the defective corporate enterprise."

[11]"Are the Members of a Defectively Organized Corporation Liable as Partners?" Charles E. Carpenter, 8 Minnesota Law Review 409.

The author of this note suggests that the liability be worked out upon the agency principle of implied warranty. However, this solution would not be applicable in tort cases; and it might well be just as confusing to attempt to force the situation into logical conformity with agency principles as it is to attempt it with partnership principles.

1. The plaintiff is attempting to fix liability upon the group as the result of a contractual relationship in the formation of which he dealt with and recognized the group as a corporation. In this event he should be estopped from showing that incorporation was never attained. When the transaction was entered into he did not rely upon the personal liability of the members, and there are no equitable reasons why he should be permitted to extend his claim to the individual members.[12]

2. The plaintiff is attempting to fix liability upon the group as a result of a contractual relationship, in the formation of which he did not deal with or recognize the group as a corporation.

(a) All the members actively participating in the transaction should be held personally liable.[13] Where the plaintiff did not rely upon corporate liability he did rely upon the individual liability of the persons with whom he dealt; and persons who actively conduct business as a corporation should be under a duty to make sure that one actually exists.

(b) The inactive shareholders who had knowledge of the fact that the incorporation of the group was defective should be held individually liable, along with the active participants in the the transaction.[14] It may be fairly

---

[12]The Pennsylvania courts have restricted the application of this doctrine of estoppel rather narrowly. In Guckhert vs.Hacke (supra) the court said: "It may be conceded that had plaintiff dealt with defendants as a corporation he would have been estopped from claiming against them in any other capacity, even though they had failed to record their charter. But it is not pretended that they had any knowledge of the existence of the charter, and there was certainly nothing either in the name under which they did business or in their conduct, which should have put them on inquiry. In these circumstances he was amply justified in dealing with them as partners."

In New York National Exchange Bank vs. Crowell (supra) the court held: "There is no merit in the contention that the name of Crowell and Class Cold Storage Company, and the form in which the note is signed, etc. were sufficient to put the plaintiff bank upon inquiry. * * * * Such business names are perhaps as commonly used at present by unincorporated associations, partnerships and individuals as by corporations."

[13]The question of what is meant by active participation will arise here to give difficulty, but it seems impossible to formulate a rule which will be workable in all situations. The active participants in each case will have to be determined from a consideration of the various facts involved. The solution of this problem should be no more difficult than others which are constantly arising, such as the tort question of proximate cause.

[14]Christian and Craft Grocery Company vs. Fruitdale Lumber Company, 25 Southern 566 (Ala.). That where there is no bona fide purpose and effort to organize a real corporation with a capital to respond to its liabilities but the purpose and effort are to put forward a sham without capital or assets to cover a real partnership and the carrying on of a partnership business exempt from the liability as a partnership, the purpose and effort are abortive, the pretended existence of a corporation is open to collateral attack as a mere fraudulent device, and, though on the face of the proceedings there is a regular and complete incorporation, the pretended corporate entity is to be taken as non-existent except as to persons who have contracted with it as a corporation in such a way as to estop themselves to show the fraud."

supposed that these persons, knowing there was no corporation in existence and maintaining their connection with it without taking steps to perfect the incorporation, assented to personal liability.

(c) The inactive shareholders who supposed that a corporation existed should not be held personally liable.[15]

3. The plaintiff is attempting to fix liability for a tort committed by the defective corporation or its agents. Those actively participating in or authorizing the act,[16] and those inactive shareholders who knew of the defective incorporation should be liable.

W. H. Wood.

---

[15]Baker vs. Bates Street Shirt Company, 6 Fed. (2nd.) 854; Rainwater et al vs. Childress, 182 Southwest 280 (Ark.).

[16]Bonfils vs. Hayes, 201 Pac. 677 (Colo.). Three defendants were directors and shareholders in a defective corporation which committed a tort resulting in the death of the plaintiff's daughter. The court held: "Some argument is made that the defendants are not partners even if there was no corporation; but if they were actively co-operating in a business enterprise, and in connection therewith committed the tort in question, they are liable whatever the title of their combination—partners, co-adventurers, joint tort-feasors or what." There is dictum to the effect that inactive shareholders are not liable.

In Mandeville vs. Courtright et al, 142 Fed. 97, all the defendants, who were officers or directors and shareholders, were held liable for a tort of a defective corporation.