
Volume 44
Issue 4 *Dickinson Law Review* - Volume 44,
1939-1940

5-1-1940

Increase of Corporate Indebtedness Under Constitutional Provisions Requiring Consent of Stockholders

Thomas I. Myers

Follow this and additional works at: <https://ideas.dickinsonlaw.psu.edu/dlra>

Recommended Citation

Thomas I. Myers, *Increase of Corporate Indebtedness Under Constitutional Provisions Requiring Consent of Stockholders*, 44 DICK. L. REV. 307 (1940).

Available at: <https://ideas.dickinsonlaw.psu.edu/dlra/vol44/iss4/6>

This Article is brought to you for free and open access by the Law Reviews at Dickinson Law IDEAS. It has been accepted for inclusion in Dickinson Law Review by an authorized editor of Dickinson Law IDEAS. For more information, please contact lja10@psu.edu.

INCREASE OF CORPORATE INDEBTEDNESS UNDER CONSTITUTIONAL PROVISIONS REQUIRING CONSENT OF STOCKHOLDERS

It has been pointed out unassailably that the traditional concept of corporate control by stockholders is becoming in practice increasingly fictional. Through a great variety of devices, of all degrees of complexity, actual control of policy within the modern corporation is concentrated in the hands of a small group of persons, called "management" or "control," connected with the corporation in varying capacities, but rarely owning among them a majority of the shares.¹

Just some such development was long ago foreseen and its occurrence sought to be guarded against by a variety of restrictions on the management of corporations imposed by constitution, statute, and decision. This note seeks to discuss one such restriction and to evaluate its significance to the present-day corporation.

The Constitution of Pennsylvania provides:²

"The . . . indebtedness of any corporation shall not be increased except in pursuance of general law, nor without the consent of persons holding the larger amount in value of the stock first obtained at a meeting called for the purpose, first giving 60 days public notice, as may be provided by law."

Several state constitutions contain a like provision,³ and others a provision in virtually identical language as to "bonded indebtedness."⁴ The discussion herein will pertain particularly to the general increase of indebtedness provisions, but much of it will be equally applicable to the bonded indebtedness provisions.⁵

The provisions are generally implemented by statutes,⁶ some of which use nearly identical language.⁷ Some of the statutes set up more detailed procedural

¹See BERLE AND MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* (1933) *passim*, and especially Ch. VIII.

²Art. XVI, Sec. 7.

³N. D. CONST., Art. VII, Sec. 138; S. D. CONST., Art. XVII, Sec. 8, *e. g.*

⁴ALA. CONST., Art. XII, Sec. 234; ARK. CONST., Art. XII, Sec. 8; MO. CONST., Art. XII, Sec. 8; OKLA. CONST., Art. IX, Sec. 39.

⁵Divisions headed Purpose and Effect of the Provisions.

⁶ALA. CODE ANN. (Michie, 1928) § 7015; POPP'S DIG. (Ark., 1937) § 2135 (a); N. D. COMP. L. (1913) § 4559; 18 OKLA. STAT. ANN. § 129; MO. STAT. ANN., ch. 32, § 4546; Act of May 5, 1933, P. L. 364, Sec. 309, 15 PURD. STATS. (Pa.) § 2582.

⁷N. D. COMP. L. (1913) § 4559; MO. STAT. ANN., ch. 32, § 4546. The Arkansas statute giving corporations powers to deal with property generally incorporates the constitutional provision by reference. POPP'S DIG. (Ark., 1937) § 2135 (a). The Pennsylvania statute presents an anomalous situation. The constitutional provision requires the consent of the holders of larger amount *in value* of the shares, while the statute requires the consent of the "holders of at least a majority of the outstanding shares." This inconsistency might become very important in the light of the frequent corporate practice of issuing voting shares of very small value, for control, and more valuable shares, of smaller or no voting power, for investment. See BERLE AND MEANS, *op. cit. supra*, 76-77. No case has arisen which deals with the problem. See Metzger, *The Business Corporation Law*, (1933) 38 DICK. L. REV. 77, 86.

requirements, such as the machinery for giving notice of the meeting, but generally they add nothing of a substantive character.⁸ At least one state appears to have no statute, indicating that there the constitutional provision is deemed to be self-executing.⁹

PURPOSE OF THE PROVISIONS

The general intention of the provisions and statutes is clear, their purpose less so. The consensus seems to be that their object is the protection of stockholders.¹⁰ It has been intimated that it is the interest of the minority which is sought to be protected.¹¹ Since a bare majority in value of the shares can in some of the states consent to the increase,¹² the virtue of this theory is not apparent. But, in some states at least, non-voting shareholders may vote on the question of increase of indebtedness,¹³ and thus a policy of protecting them may readily be inferred. Quite aside from the question of shareholder's rights *inter sese*, it can safely be said that the measures seek to give the shareholders a more direct control over management policy in cases of more than ordinarily direct interest to the shareholders. That protection of stockholders from improvident financing on the part of management is the purpose is indicated by the fact that waiver by or estoppel of stockholders will cure the defect resulting from the absence of consent,¹⁴ and that in most cases only the stockholders have a clear right to assert the illegality of indebtedness so created.¹⁵

⁸E. g., 18 OKLA. STAT. ANN. § 129; 15 PURD. STATS. (Pa.) § 2582-309. But the North Dakota statute (COMP. L. 1913 § 4559) provides that the penalty for violation of its requirements shall be personal liability on the parties concerned.

⁹South Dakota. But see provision forbidding directors to increase indebtedness to amount greater than capital stock: S. D. REV. CODE. (1919) § 8789, and one permitting stockholders by three-fourths vote to *compel* sale or mortgage of corporate property. *Id.* § 8784.

¹⁰Westerlund v. Black Bear Mining Co., 203 Fed. 599, 613 (C. C. A. 8th, 1913); Hillcrest Land Co. v. Foshee, 189 Ala. 217, 218, 66 So. 478 (1914); Riesterer v. Horton Land & Lumber Co., 160 Mo. 141, 61 S. W. 238 (1901); FLETCHER, CYCLOPEDIA OF CORPORATIONS (Perm. ed. 1931) § 2655; 13 AM. JUR. 901. See Rochester Savings Bank v. Averell, 96 N. Y. 467, 473 (1884); Note (1938) 51 HARV. L. REV. 1074, 1076; (1936) 49 HARV. L. REV. 481.

¹¹See Commerce Trust Co. v. Chandler *et al.*, 284 Fed. 737, 740 (C. C. A. 1st, 1922).

¹²E. g. ALA. CODE ANN. (Michie, 1928) § 7015; ARK. CONST., Art. XII, Sec. 8, incorporated by reference into statute: POPE'S DIG. (Ark., 1937) § 2135 (a); MO. STATS. ANN., ch. 32, § 4546; S. D. CONST., Art. XVII, Sec. 8. See note 7, *supra*.

¹³E. g. Alabama ("... by the consent of the persons holding the larger amount in value of the entire outstanding capital stock"); Pennsylvania ("... the holders of at least a majority of all outstanding shares") Most of the statutes do not so clearly state that the voting shall be of the entire capital stock, but probably the usual provision, "persons holding the larger amount in value of the stock," has the same result. This interpretation would seem most consonant with reason, and no cases indicating the contrary have been found. "Entire capital stock" means only issued stock. Missouri Valley Grocery Co. v. Hall, 45 N. D. 419, 178 N. W. 193 (1920).

¹⁴FLETCHER, CYCLOPEDIA OF CORPORATIONS (Perm. ed. 1931) § 2763; Note (1938) 51 HARV. L. REV. 1074, 1083. See Westerlund v. Black Bear Mining Co., 203 Fed. 599, 613 (C. C. A. 8th, 1913) for discussion of this point, and *infra*, p. 316.

¹⁵See *infra*, p. 313.

SCOPE OF THE PROVISIONS

Increase.—Question has arisen as to whether a given transaction is an "increase" of indebtedness. It has been held that a mere change in the form of a debt is not an increase within the meaning of the section,¹⁶ as an obligation incurred as security for a pre-existing indebtedness.¹⁷ Nor does it apply to an original bond issue.¹⁸

There seems to be a dearth of authority as to whether it is an "increase" of indebtedness for the management to borrow money with which to meet some corporate obligation the immediacy of which makes the conversion of material assets to meet it inconvenient or impossible, in a case where the corporation has deliberately refrained from keeping a large amount of cash on hand because of the desirability of utilizing all the corporate assets in the business. Such a case might arise where the corporation has sufficient surplus with which to declare a dividend, but little cash with which to pay it. Such a borrowing seems at first sight to come within the consent provisions; however, the original indebtedness would have been incurred at the time of the declaring of the dividend: to the shareholders entitled thereto.¹⁹ The borrowing to secure such cash is thus closely analogous to a refunding transaction and as such without the scope of the consent provisions. The same problem could arise where the corporation carries on its books a reserve or sinking fund to meet depreciation or obsolescence but keeps the fund invested in property immediately useful in the business. In such case a loan to purchase a new piece of major equipment floated without shareholder consent would seem to be within the scope of the provisions, unless it could be saved from their operation by the "usual course of business" doctrine noted below.

Indebtedness.—Difficult questions arise on the question of what constitutes "indebtedness" within the scope of the provisions. It is said that the restriction does not apply to a debt arising out of an implied contract,²⁰ nor an analogous

¹⁶FLETCHER, *op. cit. supra*, § 2655.

¹⁷Ahl. v. Rhoads, 84 Pa. 319 (1877); Powell v. Blair, 133 Pa. 550, 19 Atl. 559 (1890). It should be immaterial that the new creditor is a different person. See King County Land & Livestock Co. v. Thomson, 21 Tex. Civ. App. 473, 51 S. W. 890, 897 (1899); Stuart v. Hall, 198 C. C. S. D. Cal., Ala. 73, 73 So. 390 (1916).

¹⁸Union Loan & Trust Co. v. So. Cal. Motor Rd. Co., 51 Fed. 106 (C. C. S. D. Cal., 1892); McKee v. Title Ins. & Trust Co., 159 Cal. 206, 113 Pac. 140 (1911); Merced River Elec. Co. v. Curry, 157 Cal. 727, 109 Pac. 264 (1910). *Contra*: Maas v. Pa. Poughkeepsie & N. E. R. Co., 1 Monaghan 497 (Pa. 1889); Pittsburgh & State Line R. Co. v. Rothschild, 4 Cent. Rep. 106 (Pa. 1886); (*semble*). See Harrisburg & Eastern R. Co.'s Appeal, 1 Monaghan 692 (Pa. 1888).

¹⁹18 C. J. S. 1114, n. 97. There has been no intimation that declaration of a dividend requires prior shareholder consent. On the contrary, it is said that this lies within the discretion of the directors and may be enjoined by shareholders only if it is in impairment of capital. 18 C. J. S. 1142. Creditors have no standing to complain of a dividend declared out of surplus (*ibid.*) nor are they generally permitted to assert stockholder consent provisions. (See *infra*, p. 314).

²⁰See Humphrey v. Patrons' Mercantile Association, 50 Ia. 607 (1878) (recovery in quasi-contract for money furnished by the manager of the company without consent of shareholders on theory that shareholders protected by receipt of consideration); FLETCHER, *op. cit. supra*, § 2582.

restriction to an unliquidated claim for damages.²¹ It is likewise held that the provision does not apply to notes given by the corporation to a shareholder for the value of property given for a stock subscription in excess of the amount of the subscription.²² The reasoning is not clear. In an opinion of the Attorney General of Pennsylvania it was said that the restriction did not apply to mortgage guarantee contracts, on the ground that these were not debts but merely a conditional liability.²³ It might well be asked what effect a default on the part of the mortgagor would have. There would certainly result an indebtedness on the part of the corporation without the consent of the shareholders. A more plausible basis for removing such contracts from the operation of the restriction would appear to be that these contracts come within the rule as to debts incurred in the ordinary course of the corporate business, discussed below.

The most important and significant of the limitations on the application of the constitutional provisions, arising from judicial interpretation, is the rule that stockholder consent is unnecessary where the indebtedness is incurred "in the ordinary course of business."²⁴ This rule may well have had its origin in the language of the English cases of *Ex parte Chippendale, Re German Mining Company*,²⁵ *Hawtayne v. Bourne*,²⁶ and *Hawken v. Bourne*.²⁷ In these cases, the companies involved were joint stock companies operating under articles which contained provisions against borrowing. The manager in each case borrowed funds, from certain shareholders or from third persons, with which to meet current obligations. Upon winding up, it was sought to hold the shareholders generally liable for the debt or advancement. A distinction was drawn in the *German Mining Company* case between that case and the *Hawken* case, on the one hand, and the *Hawtayne* case on the other, based on the fact that the debts in the first two were merely obligations for wages and supplies which the shareholders would eventually have had to pay, because, such obligations being in the regular course of business, they had thereby impliedly authorized the manager to contract them; while in the last case the debt was to a bank and was not within the scope of the implied authorization of the managing agent, because not within the usual course of the business carried on.

²¹ *Watkins et al. v. Cotton et al.*, 180 Okla. 73, 67 P. (2d) 957 (1937).

²² *Krebs v. Oberrender*, 274 Pa. 154, 118 Atl. 19 (1922).

²³ *In re Philadelphia Co. for Guaranteeing Mortgages*, 11 Dauph. Co. 224 (1908).

²⁴ *Manhattan Hardware Co. v. Phalen*, 128 Pa. 110, 18 Atl. 428 (1889); *West v. Dyson*, 230 Pa. 619, 79 Atl. 782 (1911); *Riesterer v. Horton Land & Lumber Co.*, 160 Mo. 141, 61 S. W. 238 (1901); *Bennett v. Rittenhouse Short-Term B. & L. Assoc.*, 313 Pa. 391, 169 Atl. 757 (1934); *Aarons v. Public Service B. & L. Assoc.*, 314 Pa. 26, 170 Atl. 626 (1934); *Curtis v. Natalie Anthracite Coal Co.*, 89 App. Div. 61, 85 N. Y. S. 413, *aff'd* 181 N. Y. 543, 73 N. E. 1122 (1905). The rule was enacted into the Pennsylvania statute in 1935. 15 PURD. STATS. (Pa.) § 2852-309.

²⁵ De G. M. & G. 19 (1854).

²⁶ M. & W. 595 (1841).

²⁷ M. & W. 703 (1841).

The analogy between the implied *authorization* to incur debts in the usual course of business and an implied *consent* to the same is not unreasonably remote. It is therefore submitted that, if a legal theory must be found as a basis for the rule, it is an implied consent on the part of the shareholders that management be free to incur or increase indebtedness in the usual course of business.

Practically, the basis for the rule is clear. The strict application of a requirement of a shareholders' meeting specially called with 30 or 60 days' written notice before each action which would in any manner increase the corporate indebtedness, in the ordinary sense of the term, would swiftly paralyze the business activity of every large modern business corporation. Plainly, there was need in the interpretation of the provisions to restrict somewhat their application. This need was met by decisions which, whether or not by the analogy to the joint stock company cases above noted, held the stockholder consent provisions inapplicable to indebtedness incurred in the ordinary course of business.

This "rule" of course takes only such shape as is given it by judicial application. One of the leading cases is *Manhattan Hardware Company v. Phalen*.²⁸ There, a corporate mortgage was given to secure a loan for the purpose of erecting a new factory and moving the business into it. No previous consent of the stockholders was obtained. The court allowed enforcement of the mortgage as against the receiver of the corporation, indicating in its decision that it deemed this indebtedness one incurred "in the conduct of its ordinary business." The case need not have been considered authority for a proposition so broad, as there was another ground—subsequent "ratification" by the shareholders—on which it was decided. Nevertheless, it has been widely cited and followed as establishing the "ordinary course of business" exception.

A second case which seems to give management extreme latitude in the face of the consent provision is *West v. Dyson*.²⁹ This was an action for damages for breach of an agreement to lend money on a corporation mortgage given for the purpose of liquidating past debts and for acquiring land and erecting buildings thereon. The charter purposes of the company were of "erecting buildings, purchasing, holding, leasing, mortgaging, improving and selling real estate." The court held that the defense—that the mortgage was invalid because given without consent of the stockholders under the Pennsylvania Constitution—was insufficient, because the mortgage was in fact valid, having been to secure debts contracted "in the ordinary course of business." Despite the fact that the corporation's business in this case was that of dealing in real estate, it would seem that the loan here was of more than mere working capital. Doubt on this point apparently prompted a cautious statement by the trial court that the question was a dubious one in the absence of a definite statement from the Supreme Court. Unfortunately, that court

²⁸128 Pa. 110, 18 Atl. 428 (1889).

²⁹230 Pa. 619, 79 Atl. 782 (1911).

merely affirmed on the opinion of the lower court, leaving the doubt unanswered as to the scope and limits of the exception relied on.

In two more recent cases,³⁰ it was held that a promise by a building and loan association to pay interest and principal of a first mortgage upon the association's foreclosure of a second mortgage held by it, in consideration of the first mortgagee's forbearing to execute on his mortgage, was valid and binding on the corporation without the previously secured consent of the stockholders. The courts proceeded on the theory that, since this was the only manner in which a second mortgagee could hope to realize any of its investment in depreciated real estate, it was in the usual course of the business of building and loan associations and, therefore, within the rule excepting such indebtedness from the scope of the consent provision. The courts laid stress on the factor of preservation of assets through such a device. The materiality of this to the issue in an abstract sense is questionable, but preservation of corporate assets is an eminently relevant consideration where the question is protection of stockholders' interests.

In only two cases does there appear to be any limitation actually applied to the broad sweep of this exception. Both are weak cases. A common pleas court has indicated by dictum that a loan for the purpose of "raising the funds necessary to purchase the real estate and the erection of buildings required for the prosecution of its business" is not within the ordinary course of the corporation's business.³¹ The significance of this, if any, lies chiefly in the fact that the case has been cited virtually alone as placing a limit on the ordinary course of business exception.³² And it is held that a corporation may assert the invalidity of bonds issued by its predecessor the day after incorporation.³³ Obviously here, the corporation not yet having begun business, the indebtedness could not have been found to be within the ordinary course of business.

EFFECT OF THE PROVISIONS

No less vexed is the question of what effect shall be given the provisions in a case where there is an increase of indebtedness of a character within their scope, without the previously secured consent of the stockholders in accord with constitutional direction. The words of the constitutions are of little aid: "The . . . indebtedness . . . shall not be increased . . . without the consent . . ." Considerations of fairness have led the courts to look beyond the form of the transaction, and to formulate rules strongly limiting the number of cases in which the provisions may be successfully asserted.

³⁰Bennett v. Rittenhouse Short-Term B. & L. Assoc., 313 Pa. 391, 169 Atl. 757 (1934); Aarons v. Public Service B. & L. Assoc., 314 Pa. 26, 170 Atl. 626 (1934).

³¹Nicholas v. Putnam Machine Co. (2), 7 North. Co. 137 (1900).

³²See, e. g., 19 C. J. S. 699.

³³Maas v. Pa., Poughkeepsie & N. E. R. Co., 1 Monaghan 497 (Pa. 1889). See Harrisburg & Eastern R. Co.'s Appeal, 1 Monaghan 692 (Pa. 1888).

Who may question the legality of the increase?—Although the purpose of the consent provisions is generally said to be protection of the stockholders,³⁴ it has been held that the corporation itself may assert the lack of consent as a defense to a bond issue.³⁵ And, under a statute requiring stockholder consent to a corporate mortgage, it is held, though not uniformly, that the trustee in bankruptcy may assert the lack of consent as a defense,³⁶ possibly on the theory that he represents the corporation and hence, ultimately, the stockholders. This view is questionable, since the trustee as a practical matter is more nearly a representative of the creditors.³⁷ Cases in which the corporation may question the legality of the indebtedness are exceptional, however. Generally, the corporation may not assert its lack of power to borrow as against its creditor, who is bound to look merely to the authority of the person representing the corporation.³⁸ It is not clear whether the lack of stockholder consent affects the power of the corporation to borrow or merely the authority of the management to do so,³⁹ but certainly if the creditor need look only to the authority of the management to *represent the corporation*, the consent of the shareholders is immaterial to him as against the corporation. The question of whether the corporation may assert the lack of consent is largely academic, however, for in most cases some form of estoppel may be applied against it.

It is well settled that the stockholders, for whose benefit the consent pro-

³⁴See discussion of Purpose, *supra*.

³⁵Vail v. Hamilton, 85 N. Y. 453 (1881) (receiver of corporation allowed to assert invalidity of mortgage under analogous statute); Jackman v. Leffert, 227 N. Y. 310, 125 N. E. 446 (1919) (court expressly refuses to follow protection of stockholders theory); Maas v. Pa., Poughkeepsie & N. E. R. Co., 1 Monaghan 497 (Pa. 1889). See Pittsburgh & State Line R. Co. v. Rothschild, 4 Cent. Rep. 106 (Pa. 1886); Harrisburg and Eastern R. Co.'s Appeal, 1 Monaghan 692 (Pa. 1888). A distinction should be noted between cases which hold a mortgage "void" under a provision requiring consent to mortgages, and hence no lien in insolvency proceedings (e. g. Matter of James, Inc., 30 F. (2d) 555 (C. C. A. 2d, 1929) and cases under the general indebtedness provisions here involved, because the former often leave the debt standing, striking down merely the security. The different considerations involved under the latter and more stringent type of provision are apparent.

³⁶Maryland Cas. Co. v. Schaefer Const. Co., 141 Misc. 629, 253 N. Y. S. 709 (Sup. Ct. 1930) *aff'd mem.* 256 N. Y. 663, 177 N. E. 183 (1931); *In re Lincoln Bakery, Inc.*, 18 F. Supp. 998 (D. Mass. 1937); *In re Astell Engineering & Iron Works, Inc.*, 284 Fed. 967 (C. C. A. 2d, 1922); Matter of Day & Niger, Inc., 29 Am. B. R. (N. S.) 11 (Referee, N. D. N. Y., 1935), (1936) 49 HARV. L. REV. 481. An equity receiver was allowed to attack a mortgage in Commerce Trust Co. v. Chandler, *et al.*, 284 Fed. 737 (C. C. A. 1st, 1922). Outside New York and Massachusetts, however, judicial statement at least indicates that the trustee or receiver will in no case be permitted to assert lack of consent. Westerlund v. Black Bear Mining Co., 203 Fed. 599, 613 (C. C. A. 8th, 1913); Stuart v. Holt, 198 Ala. 73, 73 So. 390 (1916). See Note (1938) 51 HARV. L. REV. 1074, 1078.

³⁷See Note (1938) 51 HARV. L. REV. 1074, 1078. Though that note deals with consent to mortgage statutes, there is no consideration there applied in this connection which is not, in some degree at least, relevant here.

³⁸FLETCHER, *op. cit. supra*, § 2618.

³⁹Compare *In re Lincoln Bakery, Inc.*, 18 F. Supp. 998 (D. Mass. 1937) with Westerlund v. Black Bear Mining Co., 203 Fed. 599 (C. C. A. 8th, 1913).

visions exist, may assert the illegality of the loan.⁴⁰ Thus, a shareholder may enjoin an increase of indebtedness sought to be incurred in violation of a prohibition of fictitious indebtedness.⁴¹ The question whether the shareholders themselves might secure a rescission in a proper case seems not to have arisen. It is submitted that where all other requisites to rescission are present, this remedy would be available.⁴² The availability of lack of consent as a defense to enforcement of the obligation by the creditor is greatly limited in the case of stockholders by the doctrines of waiver or estoppel discussed below. But it has been specifically held that where stockholders' consent to a bond issue was obtained by fraud this may be asserted in their behalf as a ground for rescission.⁴³

The prevailing view seems to be that third persons may not complain of lack of proper formality in the increasing of indebtedness.⁴⁴ Thus, it is held that mere creditors of the corporation may not assert the invalidity of such indebtedness.⁴⁵ There is authority to the opposite effect under other restrictive provisions as to bond issues,⁴⁶ and it has been held in a bankruptcy proceeding that a mortgage secured without formal consent in accordance with a statute requiring the same was subject to collateral attack and did not constitute a lien.⁴⁷ But even though creditors generally be permitted to attack the legality of the loan, those who extended credit subsequently with knowledge of the prior indebtedness cannot assert the illegality of such prior indebtedness.⁴⁸

Against whom may the illegality not be asserted?—When the indebtedness is evidenced by the issuance of negotiable securities, it is generally held that failure of the corporate debtor to comply with internal rules in the issuance may not be asserted as against a bona fide holder.⁴⁹ This rule seems not to depend entirely

⁴⁰*Boyd v. Heron*, 125 Cal. 453, 58 Pac. 64 (1899). See *Powell v. Blair*, 133 Pa. 550, 19 Atl. 559 (1890); *Westerlund v. Black Bear Mining Co.*, 203 Fed. 599 (C. C. A. 8th, 1913); *Nelson v. Hubbard*, 96 Ala. 238, 11 So. 428 (1892); *Tallassee Oil & Fertilizer Co. v. Royal*, 209 Ala. 439, 96 So. 620, 621 (1923).

⁴¹*American Ice and Industries Co. v. Crane*, 142 Ala. 620, 39 So. 233 (1905).

⁴²See *Powell v. Blair*, 133 Pa. 550, 19 Atl. 559 (1890) (debt not within scope of provision; stockholders' standing to seek rescission not questioned).

⁴³*A. B. Leach & Co. v. Grant*, 54 F. (2d) 731 (C. C. A. 6th, 1932) cert. denied 286 U. S. 546 (1932) (receiver permitted cancellation of an illegal bond issue held by fraudulent creditor).

⁴⁴See 13 AM. JUR. 901.

⁴⁵*McKee v. Title Ins. & Trust Co.*, 159 Cal. 206, 113 Pac. 140 (1911); *Anderson v. Bullock Co. Bank*, 122 Ala. 275, 25 So. 523 (1899); *Hammond Lumber Co. v. Adams*, 7 Cal. (2d) 24, 59 P. (2d) 1030 (1936).

⁴⁶*Keystone National Bank v. Palos Coal & Coke Co.*, 150 Ala. 245, 43 So. 570 (1907); *Bingaman v. Commonwealth Tr. Co.*, 15 F. (2d) 119 (M. D. Pa. 1926). Compare *Mann v. Mann*, 57 N. D. 550, 223 N. W. 186 (1929).

⁴⁷*Maryland Casualty Co. v. Schaefer Const. Co.*, 141 Misc. 629, 253 N. Y. S. 709 (Sup. Ct. 1930) aff'd mem. 256 N. Y. 663, 177 N. E. 183 (1931); *Matter of James, Inc.*, 30 F. (2d) 555 (C. C. A. 2d, 1929); *In re Lincoln Bakery, Inc.*, 18 F. Supp. 998 (D. Mass. 1937). *Contra*: *Stuart v. Holt*, 198 Ala. 73, 73 So. 390 (1916).

⁴⁸*Mann v. Mann*, 57 N. D. 550, 223 N. W. 186 (1929). *Contra*: *Bingaman v. Commonwealth Tr. Co.*, 15 F. (2d) 119 (M. D. Pa. 1926).

⁴⁹*Louisville, N. A. & C. Ry. v. Louisville Trust Co.*, 174 U. S. 552 (1899); *State v. Cobb*, 64 Ala. 127 (1879).

upon negotiable instruments law, for it has been held (1) that the burden is on the bondholder to show that bonds issued without sufficient formality are obligations of the corporation;⁵⁰ (2) that the bona fide holder may assert validity only to the extent of the consideration received by the corporation;⁵¹ and it is said (3) that lack of consent is no defense "at least where [the stockholders] took no steps to repudiate the action of the directors but allowed bonds to be sold and availed themselves of the proceeds."⁵² Whether this doctrine would be extended to instruments not strictly negotiable is doubtful, with perhaps the more weighty considerations leading to a negative result.

Liability of Directors.—There is no suggestion in any of the cases involving consent provisions of the kind here under discussion that a violating of the provision by the directors will subject them to any extraordinary liability, either to the creditor or to the shareholders.⁵³ Some statutes limiting the amount of debt a corporation might incur have included provisions for personal liability of the directors upon incurring debt in excess of such limitation. These have been construed strictly in favor of the directors, on the theory that they are penal statutes.⁵⁴ Since this is the case even with an express statutory liability, *a fortiori* the courts will not hold the directors to any extraordinary liability arising impliedly out of disregard of stockholder consent provisions. It is submitted that the result should be otherwise where the disregarding amounts to fraud.

Substitutionary Elements.—A writer in discussing provisions for stockholder consent in the execution of corporate mortgages,⁵⁵ a problem in many respects analogous to the present one, has classified under nine heads circumstances which may operate to effectuate such instruments in the absence of compliance with statutory formalities relating to consent. Some or all of these are equally applicable to the present problem and are discussed briefly below.

(1) Ratification. A formal ratification of an increase in indebtedness appears in no case involving the general increase of indebtedness provisions. It has been held in connection with the mortgage provisions that a subsequent ratification by more than the required proportion of the stockholders will validate the mortgage from the date of the ratification.⁵⁶ There seems to be no reason why the analogy should not be applied to a case under the general increase restrictions.

⁵⁰Hicks v. Fruen Cereal Co., 182 Minn. 93, 233 N. W. 828 (1930).

⁵¹Peatman v. Centerville Light, Heat & Power Co., 100 Ia. 245, 69 N. W. 541 (1896).

⁵²FLETCHER, *op. cit. supra*, § 2754.

⁵³But see Watkins *et al.* v. Cotton *et al.*, 180 Okla. 73, 67 P. (2d) 957 (1937). The North Dakota statute (COMP. L. 1913 § 4559) expressly places personal liability on the directors and/or officers responsible.

⁵⁴Woolverton v. Taylor, 132 Ill. 197, 23 N. E. 1007 (1890); Margrage & Green Co. v. Zeigler, 9 Pa. Super. 438 (1899).

⁵⁵Note (1938) 51 HARV. L. REV. 1074.

⁵⁶Rochester Savings Bank v. Averell, 96 N. Y. 467 (1884).

(2) Waiver. This is a term much used by courts in finding a factual substitute for consent.⁵⁷ As pointed out by the writer of the note above mentioned, cases of true waiver are rare, and when present relate to the formalities. The shareholders cannot, in the very nature of things, waive the actual consent without giving it in fact. When the question has arisen, most courts are inclined to permit a waiver of formalities attendant upon the giving of consent, such as the 30 or 60 days notice and the special meeting. The cases are not uniform on the point.⁵⁸

(3) Laches. Circumstances which will constitute laches almost invariably also constitute an "estoppel" under the type of consent provision here under discussion.

(4) Estoppel. Used in a broad and perhaps inaccurate sense, estoppel is found and applied to prevent assertion of lack of consent in a large proportion of the cases. Such estoppel apparently consists of (a) retention of the benefits of the indebtedness by the corporation after (b) knowledge thereof by the stockholders.⁵⁹ The effect of such estoppel is to bar assertion of the lack of consent by both stockholders and corporation.⁶⁰ It is submitted that retention of benefits will be present in virtually every case in which the question of consent will arise, for complaint of the increase will rarely be made while the corporation is still sufficiently sound financially to permit of a return of the benefits, tangible or intangible, of the indebtedness. As for the second element, little effort seems to be made to ascertain whether there was actual knowledge on the part of the required number of the stockholders, this being assumed after the elapse of a certain length of time,⁶¹ in the absence of special circumstances affecting the possibility or probability of knowledge. The same broad principle has been used to nullify an attempted revocation of consent by stockholders.⁶²

It should be pointed out that it would be at least inconvenient for the shareholders, confronted with a *fait accompli* even where they actually become

⁵⁷See *Nelson v. Hubbard*, 96 Ala. 238, 11 So. 428 (1892); *Reisterer v. Horton Land & L. Co.*, 160 Mo. 141, 61 S. W. 238 (1901); Note (1938) 51 HARV. L. REV. 1074.

⁵⁸*In re Constantine Tobacco Co.*, 290 Fed. 128 (C. C. A. 2d, 1923); *Hillcrest Land Co. v. Foshee*, 189 Ala. 217, 66 So. 478 (1914); *Maryland Cas. Co. v. Schaefer Const. Co.*, 141 Misc. 269, 253 N. Y. S. 709 (Sup. Ct. 1930) *aff'd mem.* 256 N. Y. 663, 177 N. E. 183 (1931). *Contra: In re Lincoln Bakery*, 18 F. Supp. 998 (D. Mass. 1937) (though directors owned sufficient stock to constitute required majority). See *Tally-on-Top Salesbook Co.*, 17 Pa. C. C. 199 (1895) (meeting may not be waived because of public interest in deliberation before increase of stock).

⁵⁹*Manhattan Hardware Co. v. Phalen*, 128 Pa. 110, 18 Atl. 428 (1889); *In re Quigley Motor Sales, Inc.*, 75 F. (2d) 253 (C. C. A. 2d, 1935).

⁶⁰*Mann v. Mann*, 57 N. D. 550, 223 N. W. 186 (1929); *Manhattan Hardware Co. v. Phalen*, 128 Pa. 110, 18 Atl. 428 (1889).

⁶¹*Manhattan Hardware Co. v. Phalen*, *supra* note 60. *Cf. In re Quigley Motor Sales, Inc.*, 75 F. (2d) 253 (C. C. A. 2d, 1935), where court places burden of proof to show knowledge upon the creditor seeking to assert the estoppel. The case appears to be unique in exacting this requirement.

⁶²*Columbia Nat. Bank v. Williamsport Gas Co. et al.*, 17 Phila. 617 (C. P. 1884) *aff'd* 42 Leg. Int. 226 (Pa. 1885).

aware of the illegal increase, to set about not retaining the consideration. Broad application of the estoppel doctrine would seem to constitute in practical effect a forced consent on the part of the shareholders of the average corporation. It was to avoid this that the constitutional provisions embody requirements of formal notice to them, and to the same end was the statutory machinery implementing these requirements set up. If the interests of third persons demand the existence of an estoppel doctrine in these cases, it would be only consistent with judicial declarations that the provisions are for the protection of the shareholders for the courts to apply the doctrine very cautiously, requiring a showing of real knowledge of the facts on the part of the shareholders before penalizing their lack of action, and even then doing so only in situations where by some feasible course of action the shareholders could remedy the condition.

(5) Retention of benefits. This fact, in the absence of knowledge by the stockholders, logically estops the corporation, though not necessarily the stockholders, from setting up lack of consent as a defense.⁶³

(6) Executed transactions. It is doubtful whether the mere fact that the transaction is executed would have any legal effect except as it bears upon the question of retention of benefits.⁶⁴

(7) Negotiable instruments. This factor has already been considered.

(8) "Indoor management." The writer above referred to considers this theory—that it cannot be asserted against a third person that the internal affairs of the corporation were conducted improperly—as being primarily an English doctrine and of little significance in the United States. The applicability of similar theories is discussed above under the heads of persons who may deny validity, and against whom illegality may not be asserted.⁶⁵

(9) Estoppel through recitals in the instrument. In several of the cases, the instrument evidencing the indebtedness in question has contained a recital indicating that all the requisite formalities have been complied with, when this was

⁶³But see note 60, *supra*.

⁶⁴A distinction has been made between transactions which the corporation lacks *power* to enter (ultra vires) and those which are within its powers with certain requirements super-added (consent provisions). See *Westerlund v. Black Bear Mining Co.*, 203 Fed. 599, 612 (C. C. A. 6th, 1913). It would seem that if common law policy discouraged the avoidance of executed ultra vires transactions, the same policy should apply a *fortiori* here. If there be any valid connection between consent provisions and the ultra vires doctrine, it would seem that modern statutes abolishing the latter as a defense against third persons should also work an increasing liberalization of consent provisions as to third persons. The virtue of such reasoning in the present case is questionable, in view of the more direct protection of stockholders sought by the consent provisions.

⁶⁵See statutes abolishing defense of ultra vires, *e. g.* 15 PURD. STATS. (Pa.) § 2852-303, and note 64, *supra*. Such statutes seem to tend toward a broader acceptance of the theory in the United States.

contrary to fact.⁶⁶ These recitals were treated as being of little if any importance to the result and were not strongly urged by counsel. In the absence of other grounds for holding the debt enforceable despite lack of proper consent, it is conceivable that defense by the corporation might be barred by such a recital.

One additional curative element might be mentioned. Under the mortgage statutes, the question has arisen whether an actual contemporaneous assent by the shareholders without the formalities of notice or special meeting will supplant the statutory requirements. There is conflict on the point.⁶⁷ It is submitted that a court, in dealing with the more sweeping provisions as to increase of indebtedness, would make short shrift of an attempt by a corporation or a stockholder to assert lack of consent as against a creditor, when stockholders in sufficient number had in fact assented to the increase at the time of its incurrence.

CONCLUSION

The conclusion is inescapable that provisions for consent of stockholders to an increase of corporate indebtedness are of little real value as currently applied by the courts. Perhaps this is the result of their being couched in language too broad to make them practicable. Certainly this seems to have been their impression on the minds of the courts. The exception as to debts incurred in the ordinary course of business can only have been the result of the inclusion of every kind of credit transaction within the literal scope of the constitutional provision. That the exception is so broad seems the result of the lack of signposts to guide the course of interpretation, plus the readiness on the part of the courts to place considerations of business convenience ahead of protection of stockholders. That the force of the provisions is further diminished to the point of virtual non-existence by unwillingness to give them effect to the detriment of creditors or other third persons may also be laid to the lack of positive enactment governing their effect. That some such device as this can be a potent factor in a redemocratizing of business practice is clear, but if the shareholders are to be aided by consent provisions in a recapture of the traditional spirit and function of owners and ultimate managers of the corporation, a more positive definition of scope, and some declaration of effect, are necessary. Further legislation is called for.

THOMAS I. MYERS

⁶⁶*Manhattan Hardware Co. v. Phalen*, 128 Pa. 110, 18 Atl. 428 (1889). See also *West v. Dyson*, 230 Pa. 619, 79 Atl. 782 (1911); *Bennett v. Rittenhouse Short-Term B. & L. Assoc.*, 313 Pa. 391, 169 Atl. 757 (1934); *Aarons v. Public Service B. & L. Assoc.*, 314 Pa. 26, 170 Atl. 626 (1934).

⁶⁷Obligation valid: *Black v. Ellis*, 129 App. Div. 140, 113 N. Y. S. 558 (1st Dept. 1908) *aff'd on other grounds* 197 N. Y. 402, 90 N. E. 958 (1910); *Maryland Casualty Co. v. Schaefer Const. Co.*, 141 Misc. 629, 252 N. Y. S. 709 (Sup. Ct. 1930) *aff'd mem.* 256 N. Y. 663, 177 N. E. 183 (1931). *Contra*: *Matter of Joseph*, 46 F. (2d) 324 (W. D. N. Y. 1931) 30 MICH. L. REV. 302; *In re Lincoln Bakery, Inc.*, 18 F. Supp. 998 (D. Mass. 1937).