Maryland Law Review

Volume 26 | Issue 4 Article 6

Liability Under Defectively Organized Corporations - Cranson v. International Business Machines Corp.

Liability Under Defectively Organized Corporations

Cranson v. International Business Machines Corp.[1]

Cranson was asked to invest in a new corporation in April, 1961, and agreed to purchase stock and become an officer and director. The business was operated as a corporation, Cranson acting at all times as a corporate officer. However, due to an oversight on the part of the company attorney, of which defendant was not aware, the certificate

1. 234 Md. 477, 200 A.2d 33 (1964).

of incorporation, which had been acquired and acknowledged prior to May 1, 1961, was not filed until November 24, 1961. Between May 17 and November 8, the corporation purchased eight typewriters from plaintiff, for which only a portion of the purchase price was paid. Plaintiff sued defendant Cranson personally rather than the corporation, on the theory that the corporation had not come into existence due to the failure to file the certificate of incorporation. The Circuit Court for Montgomery County entered judgment for the plaintiff, and defendant Cranson appealed.

The Maryland Court of Appeals reversed, ruling that in a case such as this, no personal liability should attach to the officer of a corporation. In an opinion by Judge Horney, the court surveyed the Maryland cases on point, discussing both the doctrine of *de facto* corporations and the invocation of estoppel to deny corporate existence. The court said, "It is not at all clear what Maryland has done with respect to the two doctrines. There have been no recent cases in this state on the subject and some of the seemingly irreconcilable earlier cases offer little to clarify the problem."[2] The Maryland cases were divided into two classes: (1) those which refused to apply either the *de facto* or the estoppel doctrines where there was a failure to comply with a condition precedent to corporate existence, but applied the doctrine of estoppel where the noncompliance concerned a condition subsequent to incorporation;[3] and (2) those which ignored the distinction between conditions precedent and conditions subsequent, utilizing instead the doctrine of estoppel when the course of conduct between the parties was on a corporate basis.[4] The court went on to hold that since the plaintiff in this case dealt with the company as if it were a corporation and relied on its credit instead of on Cranson, plaintiff was estopped to assert that the company was not incorporated at the time the typewriters were purchased.

It is a general rule that one who deals with an apparent corporation in such a manner as to recognize its corporate existence is

---

2. *Id.* at 481, 200 A.2d at 34. The court also says in note 2 of the decision that inexcusably, the briefs of counsel were for the most part of no practical use in arriving at a decision of the intricate questions of law presented here. It does not appear that they were particularly limited by what counsel presented in arriving at a decision.

3. Generally, failure to comply with a condition precedent to the existence of a corporation will result in a finding that the corporation is not a legal entity and cannot be sued as such. See, *e.g.*, National Shutter Bar Co. v. Zimmerman, 110 Md. 313, 73 Atl. 19 (1909); Maryland Tube and Iron Works v. West End Improvement Co., 87 Md. 207, 39 Atl. 620 (1898); Boyce v. Trustees of Methodist Episcopal Church, 46 Md. 359 (1877). In these cases neither *de facto* nor estoppel theories are used to sustain the existence of the corporation.

On the other hand, when corporate existence has been attained but there has been a failure to comply with certain conditions subsequent, the corporate existence remains stable, and no individual liability attaches. See, *e.g.*, Murphy v. Wheatley, 102 Md. 501, 63 Atl. 62 (1906); Hammond v. Straus, 53 Md. 1 (1880).

4. See, *e.g.*, Pott & Co. v. Schmucker, 84 Md. 535, 36 Atl. 592 (1897); Grape, Sugar & Vinegar Mfg. Co. v. Small, 40 Md. 395 (1874). These cases appear to say that where the parties have assumed corporate existence and dealt with each other on that basis, the courts will apply the estoppel doctrine, preventing the parties from questioning the company's corporate existence.

estopped to deny the corporate existence.[5] The rule can apply to either of the contracting parties, by estopping the corporation shareholders from denying corporate existence,[6] or by estopping persons dealing with the company from denying its corporate existence.[7]

The doctrine of estoppel to deny corporate existence is used primarily in the absence of either *de jure*[8] or *de facto* existence. In order to have a *de facto* corporation, there must have been a bona fide effort to incorporate, an actual exercise of corporate powers, and a valid law under which a corporation could be formed.[9] In the principal case, for example, it is doubtful that *de facto* corporate existence would have been accorded the company, because the failure to file the certificate of incorporation would probably be a failure to make a bona fide effort at incorporating.[10] Estoppel, then, appears to have been the logical doctrine on which to base the ruling that no individual liability would attach to the defendant in this case. But two early Maryland cases, *Maryland Tube & Iron Works v. West End Imp. Co.*[11] and *National Shutter Bar Co. v. Zimmerman*,[12] ruled that the doctrine of estoppel could not be invoked unless a corporation had at least a *de facto* existence.[13] Since this would have precluded the use of the estoppel doctrine in the present situation, the court took the opportunity to expressly overrule these two cases. They stated:

> There is, as we see it, a wide difference between creating a corporation by means of the *de facto* doctrine and estopping a party, due to his conduct in a particular case, from setting up the claim of no incorporation. Although some cases tend to assimilate the doctrine of incorporation *de facto* and by estoppel, each is a distinct theory and they are not dependent on one another in their application.[14]

---

5. On estoppel generally, see 18 AM. JUR. 2d *Corporations* §§ 74–80 (1965); 18 C.J.S. *Corporations* §§ 108–19 (1939); Note, 14 CALIF. L. REV. 486 (1926); Note, 31 TENN. L. REV. 336 (1964).

6. See, *e.g.*, Seaton v. Grimm, 110 Iowa 145, 81 N.W. 225 (1899); Carozza v. Federal Finance & Credit Co., 149 Md. 223, 139 Atl. 332, 43 A.L.R. 1 (1925); Kingsley v. English, 202 Minn. 258, 278 N.W. 154, 115 A.L.R. 654 (1938); Bennett v. Baum, 90 Neb. 320, 133 N.W. 439 (1911).

7. See BALLENTINE, CORPORATIONS § 34 (1946); 8 FLETCHER, CORPORATIONS § 3910 (1959). Also see Bushnell v. Consolidated Ice Machine Co., 138 Ill. 67, 27 N.E. 596 (1891); Newcomb-Endicott Co. v. Fee, 167 Mich. 574, 133 N.W. 540 (1911); Swofford Bros. Dry Goods Co. v. Owen, 37 Okla. 616, 133 Pac. 193 (1913).

8. A *de jure* corporation is one organized in substantial conformity to the applicable statute and one whose right to exercise the corporate function is unassailable. Mackey v. N.Y., N.H.&H. Ry. Co., 82 Conn. 73, 72 Atl. 583, 586 (1909); Parks v. James J. Parks Co., 128 Neb. 600, 259 N.W. 509, 510 (1935).

9. See Parks v. James J. Parks Co., 128 Neb. 600, 259 N.W. 509 (1935); Asplund v. Marjohn Corp., 67 N.J. Super. 255, 168 A.2d 844 (1961); 8 FLETCHER, *op. cit. supra* note 7, § 3763; 18 AM. JUR. 2d *Corporations* §§ 49–56 (1965).

10. The fact that the court felt that they had to decide whether estoppel could be applied in the absence of the elements of a *de facto* corporation is indicative of the fact that there could be no *de facto* corporation here.

11. 87 Md. 207, 39 Atl. 620 (1898).

12. 110 Md. 313, 73 Atl. 19 (1909).

13. Other cases having the same requirement for employing the estoppel doctrine are Jones v. Aspen Hardware Co., 21 Colo. 263, 40 Pac. 457 (1895); Puro Filter Corp. v. Termbly, 266 App. Div. 750, 41 N.Y.S.2d 472 (1943); James v. Unknown Trustees, 203 Okla. 312, 220 P.2d 831, 20 A.L.R.2d 1077 (1950).

14. 234 Md. at 487, 200 A.2d at 38.

This view has substantial support. Fletcher has stated, "The doctrine of a *de facto* corporation has nothing to do with the principle of estoppel. Such a corporation cannot be created by estoppel, and, on the other hand, may exist although no elements of an estoppel are present."[15] Also, there is ample case authority to the effect that estoppel is not limited to cases of *de facto* corporations.[16] Thus, by overruling precedent to the contrary, the Maryland Court of Appeals has freed the estoppel doctrine from the bonds of *de facto* requirements and has placed Maryland with the majority of states employing the estoppel doctrine.

However, the Maryland court in the principal case, by relying on the doctrine of estoppel to reach its decision, refused in effect to join the modern trend toward departing entirely from both the *de facto* and the estoppel doctrines. The authorities following this trend have been strictly applying their statutory requirements for incorporation. Every state has by statute marked the point at which corporate existence begins. The Maryland Corporation Statute, section 131, reads in part as follows:

> Upon acceptance for record by the Commission [now the State Department of Assessments and Taxation] of any articles of incorporation, the proposed corporation shall, according to the purposes, conditions and provisions contained in such articles of incorporation, become and be a body corporate by the name therein stated. Such acceptance for record shall be conclusive evidence of the formation of the corporation except in a direct proceeding by the State for the forfeiture of the Charter.[17]

This section must be read, for purposes of this case, in conjunction with section 31(a) of the Corporation Act:[18]

> A subscriber to, or a holder of, stock of a corporation shall be under no obligation to the corporation or its creditors with respect

15. 8 FLETCHER, *op. cit. supra* note 7, § 3763. See also 18 AM. JUR. 2d *Corporations* § 74 (1965): "It is generally conceded that corporations by estoppel are not based upon the same principles as are corporation de facto. The doctrine of de facto corporations has nothing to do with the principle of estoppel."

16. See, *e.g.*, Rogers v. Toccoa Power Co., 161 Ga. 524, 131 S.E. 517 (1926); Marshall-Wells Co. v. Kramlich, 46 Idaho 355, 267 Pac. 611 (1928); Gardner v. Minneapolis and St. L. Ry. Co., 73 Minn. 517, 76 N.W. 282 (1898); Pearson Drainage Dist. v. Erhardt, 239 Mo. App. 845, 201 S.W.2d 484 (1947).

17. MD. CODE ANN. art. 23, § 131(b) (1957). Maryland is the only state requiring filing with the State Department of Assessments and Taxation. Most states require filing with the Secretary of State. See, *e.g.*, CAL. CORP. CODE ANN. § 308 (1947); MICH. STAT. ANN. § 21.5(2) (1948); N.J. STAT. ANN. §§ 14:2-4 (1939); N.Y. BUS. CORP. LAW § 403 (1963). Some states require filing with both the Secretary of State and the county in which the principal office of the corporation will be. See, *e.g.*, ARK. STAT. ANN. § 64-102 (1931); DEL. CODE ANN. tit. 8, § 103 (1949). Others require filing only with the county. See, *e.g.*, LA. REV. STAT. ANN. § 12:5 (1950) and TENN. CODE ANN. § 48-110 (1932). Several states require filing in the office of a judicial officer. See, *e.g.*, ALA. BUS. CORP. ACT § 10-21(6) (1959) and GA. CODE ANN. § 22-1813 (1937-38). A great number of states provide that corporate existence begins with the issuance of a certificate of incorporation by the Secretary of State. See, *e.g.*, D.C. CODE ANN. § 29-921(c) (1954); W. VA. CODE ANN. § 3020 (1923); TEX. BUS. CORP. ACT art. 3.04 (1955).

18. MD. CODE ANN. art. 23, § 31(a) (1957).

> to such stock, except to the extent of any (1) that the subscription price or other agreed consideration therefore has not been paid and (2) that any liability may be imposed pursuant to any other provision of this Article.

Bearing in mind that the primary question here is whether limited liability has attached to corporate shareholders and officers, it can be seen that section 131 must be read together with subsection (2) of section 31(a) as the failure to comply with section 131 is obviously one of the provisions imposing the liability in question. As such, the question of whether the incorporation process has been properly carried out will be determinative of liability, and a sound interpretation of the statute becomes essential.

In the past, the requirements for corporate existence in the various states have not been strictly enforced. Though they are clearly set forth, it seems that as long as some effort is made to incorporate and the parties carry on a relationship on a corporate basis, the importance of the statutory requirements diminishes. This is particularly true in the states recognizing the *de facto* and estoppel doctrines.

The cases concerning a failure to file corporation papers particularly emphasize whether or not the dealings between the parties were transacted on a corporate basis.[19] Most cases are in agreement that personal liability will be imposed where there was no attempt to act as a corporation.[20] But even where there is activity conducted on a corporate basis, the cases seem to be split as to whether or not personal liability will attach as a result of the failure to file corporate documents.[21] Where there has been no attempt at incorporation at all, *i.e.*, a complete disregard of the conditions precedent, most courts have imposed individual liability.[22] Of course, in these cases there could be no *de facto* corporate existence due to a failure to make any bona fide effort at incorporation. Any findings for the defendant would have to be made on the theory of estoppel, and the courts have been reluctant to do this.[23]

---

19. The cases are collected in Annots., 22 A.L.R. 376 (1923) and 37 A.L.R. 1319 (1925). A good discussion of the cases appears in Frey, *Legal Analysis and the "De Facto" Doctrine,* 100 U. PA. L. REV. 1153 (1952).

20. See, *e.g.,* Owen v. Shepard, 59 Fed. 746 (8th Cir. 1894); Bigelow v. Gregory, 73 Ill. 197 (1874); Bank of De Soto v. Reed, 50 Tex. Civ. App. 102, 109 S.W. 256 (1908).

21. For cases imposing personal liability, see, *e.g.,* Harrill v. Davis, 168 Fed. 187 (8th Cir. 1909); Harris v. Ashdown Potato Curing Ass'n, 171 Ark. 399, 284 S.W. 755 (1926); Campbell v. Rukamp, 260 Mich. 43, 244 N.W. 222 (1932); Federal Advertising Corp. v. Hundertmark, 109 N.J.L. 12, 160 Atl. 40 (1932). For cases in which liability attached to the corporation and the individuals were exonerated, see, *e.g.,* Whitney v. Wyman, 101 U.S. 392 (1879); Tisch Auto Supply Co. v. Nelson, 222 Mich. 196, 192 N.W. 600 (1923); Mason v. Stevens, 16 S.D. 320, 92 N.W. 424 (1902).

22. See, *e.g.,* Hagan v. Asa G. Candler, Inc., 189 Ga. 250, 5 S.E.2d 739 (1939); Amer. Mutual Liab. Ins. Co. v. Condon, 280 Mass. 517, 183 N.E. 106 (1932); Puro-Filter Corp. v. Trembley, 266 App. Div. 750, 41 N.Y.S.2d 472 (1943); Perrine v. Levin, 123 N.Y.S. 1007 (1910).

23. In the states requiring multiple filing, the cases seem to be split, although filing with the Secretary of State seems to be more important than filing with the more localized registrar. The defendants were personally liable where they filed in

The estoppel and *de facto* doctrines have come under attack by many writers on the subject. For example, in discussing *de facto* corporations, one commentator has said that, "[N]othing is gained or clarified by including the statement that the association 'is a de facto corporation' or that it 'is not a de facto corporation'. . . . Consequently, the statement . . . that the association is or is not a 'de facto' corporation is literally nothing more than a somewhat obscure way of stating that the associates do or do not enjoy limited liability."[24] The *de facto* doctrine has served only to make the point at which corporate existence begins confusing and unpredictable.[25] As Ballantine has stated, it has resulted in a "conglomeration of judicial decisions [presenting] a discouraging and baffling maze."[26]

The attack on the estoppel doctrine is based upon the absence of representation, one of the essential elements of an estoppel.[27] The doctrine can properly be applied to estop an association, which holds itself out as a corporation, from denying its corporate existence in an action against a third party.[28] But in the case of a corporation seeking to defend itself, the doctrine cannot properly be applied, since the third party made no representation at all. In these cases, the courts which apply the estoppel doctrine employ the fiction of "estoppel by conduct," saying that the third party should be estopped merely because he interacted with the corporation under the pretense that it was properly incorporated.[29]

However, there is no real need for the courts to resort to such fictions.[30] Without the doctrine of estoppel, the burden of defective incorporation would fall where it should — on the incorporators themselves. The persons who sought to insulate themselves from individual liability through the use of a corporation, and not third parties, should bear the responsibility of seeing that the statutory requirements for incorporation are met. Forcing third parties to examine incorporation records every time they deal with a corporation would place an unreasonable burden on them and an unjustified encumbrance on commercial activities.

---

the proper county though not with the Secretary of State in Morse v. Burkart Mfg. Co., 154 Ark. 362, 242 S.W. 810 (1922) and Heisen v. Churchill, 205 Fed. 368 (7th Cir. 1913). They were not liable in Wesco Supply Co. v. Smith, 134 Ark. 23, 203 S.W. 6 (1918); Doty v. Patterson, 155 Ind. 60, 56 N.E. 668 (1900); Burstein v. Palermo, 104 N.J.L. 414, 140 Atl. 326 (2928); Vanneman v. Young, 52 N.J.L. 403, 20 Atl. 53 (1890). Where the parties filed with the Secretary of State, the defendants were not personally liable in Newcomb-Endicott Co. v. Fee, 167 Mich. 574, 133 N.W. 540 (1911); Diamond Rubber Co. v. Fohey, 111 Miss. 654, 71 So. 906 (1916); Swofford Bros. Dry Goods Co. v. Owen, 37 Okla. 616, 133 Pac. 193 (1913). But in all the multiple filing cases, in which the corporation was held rather than the individual defendant, all transactions were carried out on a corporate basis.

24. Frey, *supra* note 19, at 1178. The doctrine also comes under attack in Warren, *De Facto Corporations*, 20 HARV. L. REV. 456, at 468 (1907).

25. See Note, 43 N.C.L. REV. 206, 207 (1964).

26. BALLANTINE, *op. cit. supra* note 7, § 20, at 71 (1946).

27. See, *e.g.*, Dodd, *Stockholders in Defective Corporations*, 40 HARV. L. REV. 521, 553 (1927); Lewinsohn, *Defective Corporations*, 13 MICH. L. REV. 271 (1915).

28. See, *e.g.*, Alco Finance Co. v. Moran, 178 Okla. 575, 63 P.2d 747 (1936); Cavaness v. General Corp., 272 S.W.2d 595 (Tex. Civ. App. 1954).

29. See, *e.g.*, McGuire v. Blessing Co., 275 Ky. 622, 122 S.W.2d 513 (1938); Springfield Tobacco Redryers Corp. v. City of Springfield, 293 S.W.2d 189 (1956).

30. It should be noted that the estoppel doctrine is not without its proponents. See Note, 43 N.C.L. REV. 206 (1964).

Still, there is no denying the possible injustice of refusing to apply the estoppel doctrine. The main case is a prime example, for it is evident that a refusal to apply estoppel and the consequent personal liability of Cranson would penalize him for the negligence of his attorneys. To all intents and purposes, the parties dealt with each other as if a corporation existed, with Cranson merely an agent of it. To hold Cranson liable as an individual, merely because of the failure of the corporation's attorneys to file the certificate of incorporation, appears to work great injustice. It is against this possible injustice that a repudiation of the estoppel doctrine must be weighed. Though Cranson is not without remedies of his own — he could still maintain an action against the attorneys — the initial loss would fall on one who was not really guilty of any negligence or fault.

The modern view tends to depart from using the *de facto* and estoppel doctrines altogether, placing primary emphasis on the literal requirements for incorporation set out in the corporation statutes.[31] The Model Business Corporation Act is indicative of this.[32] Under this act, corporate existence would commence upon the issuance of the certificate of incorporation. In the comment to this section, it is said that "since it is unlikely that any steps short of securing a certificate of incorporation would be held to constitute apparent compliance, the possibility that a *de facto* corporation could exist under such a provision is remote."[33]

Robertson v. Levy[34] is a recent judicial pronouncement departing from the traditional *de facto* and *estoppel* doctrines. In that case, plaintiff sued defendant individually on a note, refusing to sue the corporation since there had been a failure to incorporate in accordance with the provisions of the District of Columbia Corporation Act,[35] which was based on the Model Act. The trial court ruled for defendant based on the estoppel doctrine, as in the principal case, but the decision was reversed. The appellate court stated, "One of the reasons for enacting Modern Corporation Statutes was to eliminate problems inherent in de jure, de facto, and estoppel concepts."[36] The opinion then went on to add:

> The corporation comes into existence only when the certificate has been issued. Before the certificate has been issued, there is no corporation de jure, de facto, or by estoppel. After the certificate is issued . . . , the de jure corporate existence commences. . . . It is immaterial whether the third person believed he was dealing with a corporation or whether he intended to deal with a corporation. The certificate of incorporation provides the cut-off point; before it is issued, the individuals, and not the corporation, are liable.[37]

31. HORNSTEIN, CORPORATION LAW AND PRACTICE § 26 (1959).
32. MODEL BUSINESS CORPORATION ACT ANNO. § 50 (1959).
33. *Ibid.*, comment to § 50.
34. 197 A.2d 443 (D.C. Mun. Ct. App. 1964).
35. Business Corporation Act, D.C. CODE §§ 29–921(c) (1961).
36. 197 A.2d 443, 446.
37. *Id.* at 446–47. For views similar to this one, see HORNSTEIN, *op. cit. supra* note 31, § 29 and Frey, *supra* note 24, at 1180.

It is unfortunate that in light of the confused state of Maryland case law and the comprehensive scope of the modern Maryland Corporation Act, around which new case law could be built, the doctrine of estoppel was used to decide *Cranson.* With an obvious trend pointing in the direction of the Model Act and *Robertson v. Levy,* this would have been an ideal opportunity for a Maryland judicial pronouncement in this direction. It is most probable that in drafting the Maryland statute, the drafters were aware of the unpredictable and confusing law surrounding the problem of defective corporations and desired a result similar to that reached by the Model Act[38] and the *Robertson* case. Unfortunately, it appears that section 131 of the Maryland Corporation Act still lacks the strength of a literal interpretation, and the same problem which has weakened prior statutes and has led to wide-spread use of the *de facto* and estoppel doctrines will continue to dominate this area of corporation law in Maryland.

38. See note 30 *supra.*