

# California Law Review

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VOL. VI

JULY, 1918

Number 5

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## Ultra Vires Corporate Acts Under the California Decisions

IN the discussion of this subject we shall consider only those acts which are beyond the powers of a corporation and not those which are beyond the authority of the officers of such corporation. Although the term *ultra vires* is sometimes treated as embracing acts of the latter class it is more commonly and properly restricted to questions involving the power of the corporation itself to perform a particular act.

A survey of the California decisions dealing with the question of *ultra vires* can be better understood if we first have in mind the general rules that obtain on the subject elsewhere. The factors that occasionally render our local decisions somewhat discordant can then be better appreciated.

In England, and in a few states in this country, the subject is viewed from the standpoint of strict logic. A corporation in those jurisdictions is regarded as a creature of the law in the strictest sense of the term. Hence if it purports to enter into a contract not authorized by its charter, no rights are thereby created, even though the so-called contract is fully executed. As the Supreme Court of Ohio said in an early case involving the power of corporations to acquire title to a promissory note under certain unauthorized circumstances: "As well might a dead man, by the mere act of the indorser, be invested with the legal interest, as a corporation which only lives for the purpose and objects intended by the legislature."<sup>1</sup> This doctrine, it was held in England in 1914, excludes "any claim in personam based even

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<sup>1</sup> *Strauss and Bro. v. Eagle Ins. Co.* (1855), 5 Ohio St. 59, 64.

on the circumstances that the defendant has been improperly enriched at the expense of the plaintiff by a transaction which is *ultra vires*." The only remedy allowed to an injured party, said the court, is an action in rem "to follow and recover specifically any money which could be earmarked as never having ceased to be his property."<sup>2</sup> The vice of this doctrine, as has been pointed out by a very able text writer, consists in laying undue stress on the corporate fiction. Since corporations are composed of natural persons who do enter into unauthorized transactions, the law should adapt itself to the actual situation and recognize that justice can best be subserved by treating such transactions as actually made by the corporation.<sup>3</sup> As Mr. Morawetz stated a number of years ago: "To deny that corporations are able to enter into contracts, and do frequently enter into contracts and do acts in excess of their chartered powers, is to deny an unalterable and self-evident fact."<sup>4</sup>

Most of the courts of this country early came to the conclusion that the English doctrine, though logical, was frequently unjust in its effects. They therefore proceeded to engraft exceptions upon it. It soon came to be generally agreed that fully executed contracts, though *ultra vires*, would not be interfered with, and that an action "in the nature of a quantum meruit" could be maintained on partially executed contracts.<sup>5</sup>

The majority of the state courts finally concluded that public policy did not require that the remedies allowed in the case of *ultra vires* transactions should be limited even to that extent. They accordingly allow an action based on the contract itself when such contract has been fully performed by the party suing. The question will naturally occur why they did not go to the full length and allow actions to be maintained where based on wholly executory transactions. Very few of the courts have undertaken to give a reason for such refusal. The idea that has actuated them in refusing relief under such circumstances has probably been best expressed by Mr. Machen. He says: "The public policy which is deemed to require purely executory *ultra vires* contracts to be held unenforcible is not deemed to be of

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<sup>2</sup> *Sinclair v. Brougham* (1914) A. C. 398, 415.

<sup>3</sup> Machen, *Modern Law of Corporations*, § 1018.

<sup>4</sup> Morawetz on *Private Corporations* (2d ed.), § 649.

<sup>5</sup> *Central Transportation Company v. Pullman's Palace Car Company* (1890), 139 U. S. 24, 35 L. Ed. 55, 11 Sup. Ct. Rep. 478.

such a character as to permit one party, having enjoyed the full benefit of the contract to repudiate its burdens."<sup>6</sup> Only one state, Kansas, has as yet gone so far as to allow an action to be maintained on a wholly executory, ultra vires, contract.<sup>7</sup>

The earliest case in California in which the doctrine of ultra vires transactions was considered is *Gas Company v. San Francisco*.<sup>8</sup> It appears in that case that the plaintiff company had furnished gas to the City of San Francisco, and, upon the refusal of the city to pay therefor, it instituted suit. The defendant set up the defense that no ordinance had ever been passed authorizing the furnishing of gas to the city as required by the Charter. The plea prevailed upon the original hearing, the court holding that, "a party who deals with the officers of a municipal corporation should see that they had authority to bind the corporation." A rehearing was afterwards granted, and the former opinion held erroneous, Mr. Justice Field, speaking for the court upon the second hearing, stated that although the defendant was a municipal corporation, no distinction had ever been made between such a corporation and a private corporation under the circumstances presented. He then enunciated the doctrine that "where the contract is executory the corporation cannot be held bound unless the contract is made in pursuance of the provisions of its charter; but where the contract has been executed, and the corporation has enjoyed the benefit of the consideration, an implied assumpsit arises against it."

A short time thereafter a case involving a private corporation was presented to the court for decision. The corporation in question had contracted to purchase certain real estate, and upon suit being brought for the purchase price, pleaded that it was authorized to acquire only such real estate as was necessary to enable it to carry on its operations, and that the acquisition of the parcel of land in question was not essential for that purpose. The court held that the burden was on the defendants to show that the purchase of the property was not necessary in view of the presumption of the validity of contracts, and that proof upon the point had not been offered.

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<sup>6</sup> Machen, *Modern Law of Corporations*, § 1055. Also see Woodward, *The Law of Quasi Contracts*, p. 244.

<sup>7</sup> *Harris v. Independence Gas Co.* (1907), 76 Kans. 750, 92 Pac. 1123.

<sup>8</sup> (1858), 9 Cal. 453.

"Moreover," said the court, "it does not follow because an agent purchases property which is not absolutely necessary for the purposes of the company that the latter can, after receiving the property, avoid the payment of the purchase money. This question arose in the case of *Moss v. The Rossio Mining Co.* (5 Hill 137). Cowen, Justice, in delivering the opinion of the court said: 'I am not aware that a corporation, more than another, can purchase and convert an article to its own use and then object that it acted beyond the statute power. . . . ' This authority applies directly to the case before us."<sup>9</sup>

The same question as to the right of a corporation to interpose the defense that certain property contracted for by it was not necessary to its corporate purposes again arose in 1860. Mr. Justice Field in deciding against the corporation enunciated a much more sweeping doctrine. He said:

"Whether or not the premises in controversy are necessary for those purposes, it is not material to inquire; that is a matter between the government and the corporation, and is no concern to the defendants. It would lead to infinite inconveniences and embarrassments, if, in suits by corporations, to recover the possession of their property, inquiries were permitted as to the necessity of such property for the purposes of their incorporation, and the title made to rest upon the existence of that necessity."<sup>10</sup>

It will be noted that this principle, if logically applied, would preclude the interposition of the defense of *ultra vires* in all cases even though the contract involved was wholly executory. Although the courts of many states have cited this case with approval, but one of them has followed the reasoning to its logical conclusion. The Supreme Court of Kansas in the case already cited,<sup>11</sup> in allowing a recovery upon a wholly executory contract, said: "The doctrine that only the state can challenge the validity of acts done under color of a corporate charter, if accepted, must necessarily protect an executory contract from collateral attack equally with one that has been executed."

The language of the Supreme Court in a recent decision is quite significant in this connection. In that case<sup>12</sup> it appeared that a promissory note had been executed by a corporation in favor

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<sup>9</sup> *Shaver v. Bear River, etc. Co.* (1858), 10 Cal. 396.

<sup>10</sup> *Natoma, etc. Co. v. Clarkin* (1860), 14 Cal. 544, 552. To the same effect is the recent decision in the case of *McCann v. Children's Home Society of California* (1917), 54 Cal. Dec. 476, 168 Pac. 355.

<sup>11</sup> *Harris v. Independence Gas Company*, *supra* n. 7.

<sup>12</sup> *Sergeant v. Palace Cafe Co.* (1917), 54 Cal. Dec. 161, 167 Pac. 146.

of one of its three directors as part payment of the purchase price upon a sale made by him of all of his stock to another director. It appeared that the director making this sale owned all of the stock of the corporation, except two shares held by the other directors solely to qualify them as such directors. Upon action against the corporation being instituted upon the note, the corporation interposed the defense, among others, that the note was merely accommodation paper, the issuance of which was *ultra vires*. In disposing of the defense the court said:

"The rule covering transactions of this sort is thus stated by a distinguished writer: '(2) The theory of a corporation is that it has no powers except those expressly given or necessarily implied. But this theory is no longer strictly applied to private corporations. A private corporation may exercise many extraordinary powers, provided all of its stockholders assent, and none of its creditors are injured.' There is no one to complain except the state, and, the business being entirely private, the state does not interfere. . . . There is no rule of public policy which prohibits a private corporation having a capital stock from becoming the accommodation indorser of commercial paper, provided such indorsement is made with the knowledge and assent of all the directors and stockholders, and provided corporate creditors are paid. . . . (3) A corporation may execute its note for the personal indebtedness of its sole stockholder, and no one but the creditors of the corporation can complain.' (Cook on Corporations (7th ed.), vol. 1, ch. 1, sec. 3). This statement of the law, supported by abundant authority, is a complete answer to all of appellant's contentions."

The doctrine of Mr. Justice Field that a corporation when sued for the purchase price of property contracted for by it cannot successfully interpose the plea of *ultra vires*, and that the state alone can raise the question, was followed in the cases of *Porter and Allen v. Liscom*<sup>13</sup> and *Union Water Company v. Murphy's Flat Company*.<sup>14</sup>

The California decisions thus far considered would seem to have settled the question as to the effect to be given to *ultra vires* corporate contracts. However, after their rendition and in 1869, we find a case decided in which the minority doctrine followed in the federal courts is enunciated.<sup>15</sup> It was there said that:

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<sup>13</sup> (1863), 22 Cal. 430.

<sup>14</sup> (1863), 22 Cal. 630.

<sup>15</sup> *Miners' Ditch Co. v. Zellerbach* (1869), 37 Cal. 543, 99 Am. Dec. 300. Although we have referred to the "federal doctrine" as if it were well settled in the federal courts, several of those courts and particularly the

"The term *ultra vires*, whether with strict propriety or not, is, also, used in different senses. An act is said to be *ultra vires* when it is not within the scope of the powers of the corporation to perform it under any circumstances, or for any purpose. An act is also, sometimes, said to be *ultra vires* with reference to the rights of certain parties, when the corporation is not authorized to perform it without their consent; or with reference to some specific purpose, when it is not authorized to perform it for that purpose, although fully within the scope of the general powers of the corporation, with the consent of the parties interested, or for some other purpose. And the rights of strangers dealing with corporations may vary, according as the act is *ultra vires* in one, or the other of these senses. All these distinctions must be constantly borne in mind in considering a question arising out of dealings with a corporation. When an act is *ultra vires* in the first sense mentioned, it is generally, if not always, void in toto, and the corporation may avail itself of the plea. But when it is *ultra vires* in the second sense, the right of the corporation to avail itself of the plea will depend upon the circumstances of the case."

The court said in another part of the opinion that in determining whether the defense of *ultra vires* may be maintained

"the test as between strangers having no knowledge of an unlawful purpose, and the corporation, is to compare the terms of the contract with the provisions of the law from which the corporation derives its powers, and if the Court can see that the act to be performed is necessarily beyond the powers of the corporation for any purpose, the contract cannot be enforced, otherwise it can."

The Court, in support of this doctrine, based its opinion upon the decision of Mr. Justice Selden in the case of *Bissell v. The Michigan Southern, etc., R. R.*<sup>18</sup> In that case opinions were rendered by Justices Selden and Comstock. Their opinions typify the two opposing doctrines referred to at the outset of our discussion. Thus, Mr. Justice Selden, whose opinion is extensively quoted from by our Supreme Court in the *Zellerbach* case, held that, "the real ground upon which the defense of *ultra vires* rests, and the only one upon which it has ever to any extent been judicially based, is that the contracts of corporations which

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ninth Circuit Court of Appeals, have evinced a tendency to break away from it. In this connection see *Kellogg-Mackay Co. v. Havre Hotel Co.* (1912), 199 Fed. 727 and *Baker v. Scofield* (1915), 221 Fed. 322, 136 C. C. A. 320.

<sup>18</sup> (1860), 22 N. Y. 262.

are unauthorized by their charters are to be regarded as illegal, and, therefore, void." He proceeded to point out that such contracts are illegal and void because they are made "in contravention of public policy." This position was also taken by Mr. Justice Gray in the leading federal case of *Central Transportation Co. v. Pullman's Palace Car Co.*<sup>17</sup> Mr. Justice Comstock doubted the proposition that all contracts of corporations for purposes not embraced in their charters are illegal, and therefore void. Said he:

"Undoubtedly, such engagements may have the vices which sometimes infect the contracts of individuals. They may involve a *malum in se* or a *malum prohibitum*, and may be void for any cause which would avoid the contract of a natural person. But where no such vices exist and the only defect is one of power, the contract cannot be void because it is illegal or immoral."

Under the doctrine of Mr. Justice Selden, followed as we have seen by our court in the *Zellerbach* case, it necessarily follows that an action could not be maintained on an *ultra vires* contract, although fully executed. Our Supreme Court seems to have had some doubt as to the soundness of its reasoning and granted a petition for re-hearing. In the opinion rendered after the re-hearing the court contented itself with holding that since the contract in question had been fully executed, the corporation could not recover possession of the property in question on the ground that the execution of the contract had been *ultra vires*.

The doctrine enunciated in the original opinion in the *Zellerbach* case that an action may not be based upon the contract when the execution of such contract was wholly beyond the powers of the corporation, has not been followed, and may be regarded as a sporadic reversion to the minority doctrine adhered to in the federal courts. Instead, the doctrine of estoppel has been generally relied upon by the Supreme Court of California since that time without inquiry as to whether the act questioned was or was not wholly without the powers of the corporation. Thus in the case of *Grangers' Ass'n. v. Clark*,<sup>18</sup> decided in 1885, it appears that the plaintiff corporation had lent a sum of money to the defendant, and taken a mortgage to secure its repayment. Upon suit being brought to foreclose the mortgage, the defendant

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<sup>17</sup> (1890), 139 U. S. 24, 35 L. Ed. 55, 11 Sup. Ct. Rep. 478.

<sup>18</sup> (1885), 67 Cal. 634, 8 Pac. 445.

set up the defense of irregularities in the organization of the plaintiff corporation, and a lack of power on plaintiff's part to enter into the contract. The Supreme Court curtly disposed of the plea with the remark that "upon established principles of equity appellant's mouth is closed in respect to both points." In numerous cases since that time the doctrine of estoppel has been relied upon in disposing of the plea of *ultra vires*, where the party interposing it has had the benefit of the contract.<sup>19</sup>

This doctrine of estoppel as used in this connection has, however, been criticized by a number of courts outside of California. The basis of the criticism is that the elements of estoppel are not ordinarily present in cases involving *ultra vires* corporate acts. To constitute an estoppel in pais "the party claiming the benefit of it must be destitute of knowledge of his own legal rights and of the means of acquiring such knowledge."<sup>20</sup> Obviously, the corporation is not in a position to assert such ignorance. Nor can the other contracting party claim an estoppel if the act be performed was absolutely in excess of the powers of the corporation since, in the language of Mr. Justice Selden, quoted in *Miners' Ditch Co. v. Zellerbach*,<sup>21</sup> he "is presumed to have knowledge of the defect." But as has been suggested by the Kansas Supreme Court in answer to this objection:

"This, however, is a mere question of terminology. The requirement that one shall be consistent in conduct—shall not occupy contradictory positions—shall not retain the advantages of a transaction and reject its burdens—is often spoken of as a form of estoppel. The term is convenient and if inaccurate is not misleading."<sup>22</sup>

In many of the cases passed upon by our Supreme Court it has been recognized in accordance with the general rule that a plaintiff may not successfully maintain an action when the *ultra vires* contract is wholly executory. This was recognized in the case of *Pixley v. W. P. R. R. Co.*,<sup>23</sup> in which the court, in referring to *ultra vires* contracts, said:

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<sup>19</sup> See *Bank of Shasta v. Boyd* (1893), 99 Cal. 604, 34 Pac. 337; *Camp v. Land* (1898), 122 Cal. 167, 54 Pac. 839; *Raphael Weill and Co. v. Crittenden* (1903), 139 Cal. 488, 73 Pac. 238; *McQuaide v. Enterprise Brewing Co.* (1910), 14 Cal. App. 315, 111 Pac. 927.

<sup>20</sup> *Lux v. Haggin* (1886), 69 Cal. 255, 266, 4 Pac. 919, 10 Pac. 674.

<sup>21</sup> *Supra*, n. 15.

<sup>22</sup> *Harris v. Independence Gas Co.*, *supra*, n. 7.

<sup>23</sup> (1867), 33 Cal. 183, 95 Am. Dec. 623.



"They are voidable so long as unexecuted on both sides; but when executed by one of the parties by complete performance, the other becomes liable, and must render the consideration stipulated in advance, or a reasonable compensation to be ascertained as a matter of fact, if not fixed and agreed upon by the parties themselves."<sup>24</sup>

As has already been pointed out the defense of ultra vires may not be successfully invoked when the contract in question has been fully executed. An illogical exception to this rule may be seen in the case of *Knowles v. Sandercock*.<sup>25</sup> From the decision in that case it appears that the defendant, a corporation authorized to engage in the manufacture and sale of furniture, had subscribed and paid for certain shares of stock in a hotel corporation. An action was instituted against the furniture company to collect from its proportion of certain debts owing by the hotel company. The defendant set up the plea that it was not authorized under its articles to subscribe for the stock purchased by it. The plea was sustained, and the defendant held not liable. The court pointed out that under the California Constitution a corporation is forbidden to engage in any business other than that expressly authorized by its charter. This provision, said the court, "makes all acts, which are wholly without the business of the corporation, unlawful." The conclusion drawn was that the subscription of the defendant was "ultra vires and void."

It is submitted that the decision is unsound. The commission of a tort by a corporation is clearly without the scope of the authorized powers of a corporation, and yet it is held in California, as in all other states, that such fact does not exonerate the corporation from liability.<sup>26</sup>

The constitutional provision relied upon by the court in the case of *Knowles v. Sandercock*<sup>27</sup> is merely a restatement of the common law prohibition. As Mr. Morawetz has well said:

"Unauthorized corporate acts are said to be ultra vires, not because the power to do those acts has not been granted, but because the exercise of the power is forbidden by the common law. To deny that corporations are able to enter into con-

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<sup>24</sup> Also see *Foulke v. San Diego R. R. Co.* (1876), 51 Cal. 365; *Coleman v. S. R. T. R. Co.* (1875), 49 Cal. 517; *Main v. Casserly* (1885), 67 Cal. 127, 7 Pac. 426.

<sup>25</sup> (1895), 107 Cal. 629, 40 Pac. 1047.

<sup>26</sup> *Chamberlain v. So. California Edison Co.* (1914), 167 Cal. 500, 124 Pac. 25.

<sup>27</sup> *Supra*, n. 25.

tracts, and do frequently enter into contracts and do acts in excess of their chartered powers is to deny an unalterable and self-evident fact." And he adds, "It does not follow that because the exercise of corporate powers is prohibited by the common law, any corporate acts performed in violation of this prohibition will not be recognized by the law as corporate acts."<sup>28</sup>

A corporation may enter into an agreement that is not merely *ultra vires*, but also against public policy, and hence not actionable. Such a situation was presented in the case of *Visalia Gas and Electric Company v. Sims*.<sup>29</sup> It appears from that case that the plaintiff, a public service corporation, had agreed to lease its plant to an individual for the term of two years. The rent not having been paid, the corporation instituted suit. The Supreme Court held that there could be no recovery since the execution of the lease was against public policy. The court regarded the execution of the contract as "an attempt to do that which is unlawful without reference to the corporate franchise." The court also held that since the lessee had made no profit from the enterprise a recovery independent of the lease could not be allowed.

In New York, however, it has been held under similar circumstances that public policy is not involved to such an extent as to prohibit a recovery on the lease itself when the lessee has had the benefit of the contract. Said the court in that case:

"We think the demands of public policy are fully satisfied by holding that as to the public the lease was void, but that as between the parties, so long as the occupation under the lease continued, the lessee was bound to pay the rent, and that its recovery may be enforced by action on the covenant. Public policy is promoted by the discouragement of fraud, and the maintenance of the obligation of contracts, and to permit the lessee of a corporation to escape the payment of rent by pleading the incapacity of the corporation to make the lease, although he has had the undisturbed enjoyment of the property, would be, we think, most inequitable and unjust."<sup>30</sup>

The case of *Griffith v. Life Insurance Company*<sup>31</sup> involved the right of an insurance company to declare a policy forfeited for non-payment of a premium in the face of a statute expressly

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<sup>28</sup> Morawetz on Private Corporations (2d ed.), § 649.

<sup>29</sup> (1894), 104 Cal. 326, 37 Pac. 1042, 43 Am. St. Rep. 105.

<sup>30</sup> *Bath Gas Light Co. v. Claffy* (1896), 151 N. Y. 24, 45 N. E. 390.

<sup>31</sup> (1894), 101 Cal. 627, 36 Pac. 113, 40 Am. St. Rep. 96.

forbidding forfeiture under the circumstances shown in the case. The court held the attempted forfeiture void, saying: "The statute is a limitation on the power of the company to do a specified thing except under prescribed conditions." The court also made use of the following misleading language: "That which a corporation has not the power to do, if attempted to be done by it is *ultra vires* and void." Under the circumstances of the case it is true that the attempted forfeiture in the face of the statute was void. This was true, however, not because the corporation had no express power to enforce the forfeiture under the circumstances, but because such attempted action was in the face of a prohibitory statute, which statute was admittedly based on sound public policy.

It is true that there are a few cases holding that a contract executed by a corporation in the face of an expressly prohibitory statute is not actionable regardless of the question of the policy underlying the statute. Thus in the case of *Foulke v. San Diego R. R. Company*,<sup>32</sup> the court held that an action would not lie upon an oral contract, although fully executed by one of the parties, in view of the provisions of a statute providing that "no contract shall be binding on the company unless made in writing." The court held that the only remedy available was an action in quantum meruit. The court had, a few years before, expressed the view in an action affected by the same statute, that a recovery based on the contract itself might be had where the party suing had fully performed.<sup>33</sup>

"It may be," said the court in the latter case, "that while such contract remains executory on both sides an action could not be maintained by either party, to enforce it, but where one of the contracting parties has completely performed it on its part, and thereby rendered to the other the consideration stipulated, the party having received the consideration promised, cannot be permitted to escape liability on the naked letter of the statute, because the meaning of the law is not such as to afford immunity from liability in such a case."

This language was regarded by the court in the *Foulke* case<sup>34</sup> as mere dictum.

The court might, with considerable reason, have based its

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<sup>32</sup> (1876), 51 Cal. 365.

<sup>33</sup> *Pixley v. W. P. R. R. Co.*, *supra*, n. 23.

<sup>34</sup> *Supra*, n. 32.

decision upon the provisions of the Civil Code. The Code provides, it will be remembered, that "that is not lawful which is (1) contrary to an express provision of law."<sup>35</sup>

Although the language of this provision makes no distinction as to the nature of the provision of law involved, such distinction was recently made by the Supreme Court in the case of Blochman Commercial and Savings Bank v. F. G. Investment Company, et al., decided in March, 1918.<sup>36</sup> The plaintiff sued to foreclose two mortgages executed by the defendant company. At the time of the execution of the notes the banking act provided, in so far as its terms are here material, that: "No commercial bank shall make any loans to any person, company, corporation or firm to an amount exceeding one-tenth part of the capital stock of such bank actually paid in and surplus." The defendants contended that the loans were in excess of the amount permitted by law, and that hence the obligations based thereon were void, and unenforcible, citing Section 1667 of the Civil Code above set forth. The court upheld a judgment for the plaintiff saying that:

"There is a vital distinction between contracts based upon fraud or made in violation of laws passed for the benefit of one of the contracting parties, and those made in violation of statutes designed to aid the sovereign power in the regulation of certain kinds of business. The act which, according to the contention of appellants, was violated by plaintiff's assignor in making the loan does not declare such a loan a void obligation. A penalty for the violation may be inflicted under certain circumstances by the superintendent of banks, but no part of the penalty in any way inures to the borrower of the excess."

The court referred to several cases which, it held, "support the general rule that the doctrine of want of power to contract may not be invoked to aid any one in the perpetration of wrong and injustice."

Thus, the law in this state upon this particular subject is brought in accord with the doctrine which obtains generally in this country.

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<sup>35</sup> Cal. Civ. Code, § 1667.

<sup>36</sup> (March 19, 1918), 55 Cal. Dec. 528, 171 Pac. 943.