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THE *DE FACTO* CORPORATION DOCTRINE IN MONTANA

Mark E. Noennig

I. *De Jure* CORPORATIONS

A. *Conditions Precedent*

Corporation statutes traditionally prescribe mandatory conditions precedent to incorporation.¹ One or more incorporators must sign and acknowledge a document called the articles of incorporation and file it with the secretary of state. These statutes require various specific information such as the name, address, nature of business, and the number of authorized shares of the corporation to be set forth in the articles.²

B. *Compliance*

A corporation which substantially complies with all of these mandatory conditions precedent to incorporation is a *de jure* corporation (a lawful corporation).³ It is a separate legal entity possessing all of the attributes or powers incident to a corporation: limited liability; continuity of life; the power to sue and be sued; the power to hold and convey property; the capacity to contract; and the right to exercise corporate powers.⁴ Since the mandatory conditions precedent have been substantially complied with, the right of a *de jure* corporation to exist and act cannot be collaterally attacked by any party, nor can it be successfully attacked directly by the state in a *quo warranto* proceeding.⁵ In other words, the law will always recognize the corporate character of a *de jure* corporation.⁶

II. DEFECTIVELY FORMED CORPORATIONS

A. *The Nullity Theory*

It follows, then, that a corporation which fails to comply with

1. For general discussions of conditions precedent, see H. HENN, *LAW OF CORPORATIONS* 238-39 (2d ed. 1970) (hereinafter cited as HENN); N. LATTIN, *LATTIN ON CORPORATIONS* 179-80 (2d ed. 1971) (hereinafter cited as LATTIN).

2. See *Revised Codes of Montana* (1947) (hereinafter cited as R.C.M. 1947), §§ 15-2247 to 15-2249.

3. 8 W. FLETCHER, *CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS* § 3760 (rev. perm. ed. 1966) (hereinafter cited as FLETCHER); HENN at 238-39; LATTIN at 181.

4. HENN at 109-10; LATTIN at 184.

5. FLETCHER at § 3760; HENN at 238; R. STEVENS, *PRIVATE CORPORATIONS* 136 (2d ed. 1949) (hereinafter cited as STEVENS).

6. Failure to perform a condition subsequent to incorporation, such as compliance with a minimum paid-in capital requirement or filing of certain reports, may result in revocation of a *de jure* corporation's corporate status. HENN at 238-39.

mandatory conditions precedent to incorporation is not a *de jure* corporation.⁷ Since it is inevitable that the statutory formalities for formation of a corporation will not always be met, courts are faced with the problem of how to treat defectively organized corporations. One approach is to treat the corporation as a nullity, that is, as though no corporation has been formed.⁸ Thus the "corporation" has none of the corporate attributes. For example, suits by parties on contractual obligations purportedly assumed by corporations or for torts committed by purported corporations can be defended on the basis that no corporation existed. Suits brought by the "corporation" can be defended by other parties on the same grounds. Conveyances may also be invalidated. Parties can sue the associates, shareholders, incorporators, or officers of what was purported to be a corporation and hold them personally liable on "corporate" obligations.

The soundness of the nullity theory is questionable. In some instances, there may have been an intentional failure to comply with the requirements by those responsible, hoping to successfully avoid liability. A court's disregard of corporateness in these circumstances would be just if the responsible parties are held personally liable. Unfortunately, the proper parties may not be held responsible. Instead, the result may be to penalize investors, employees, customers and creditors without harming the promoters who have long since departed.

In other instances, the failure to comply may be due to the negligence of the attorney or an innocent mistake of people who tried to form a corporation without legal help. Then the harsh results of disregarding corporateness may not be justified.

Another problem with the nullity approach is that it may deny corporate attributes on the basis of omitted formalities which bear no relation to corporate existence. Further, creditors, who are concerned only that an enterprise was organized and business was done in good faith, may profit from defects in formalities that do not affect them.

Compliance with statutory formalities is the appropriate concern of the state, since it gives a corporation its powers and prescribes the method for its formation. Therefore, it is the state which should bring the action directly attacking the corporation when statutory formalities have not been met.

7. FLETCHER at § 3760; HENN at 240-41.

8. For a general discussion of the nullity theory, see A. CONRAD, CORPORATIONS IN PERSPECTIVE 245-250 (1976) (hereinafter cited as CONRAD). See also H. BALLANTINE, BALLANTINE ON CORPORATIONS 68-71 (rev. ed. 1946) (hereinafter cited as BALLANTINE); LATTIN at 183; STEVENS at 173-80.

Because of the harsh results which accompany the nullity theory, American courts have been reluctant to apply it.⁹

B. *The De Facto Doctrine*

Rather than finding that a defectively formed corporation (one that is not *de jure*) is a nullity, courts tend to treat it as a corporation in fact—a *de facto* corporation.¹⁰ In order to be fair to innocent parties who have attempted to organize a corporation or who have dealt with a purported corporation, and at the same time prevent unauthorized use of corporateness, courts have developed standards for recognition of a *de facto* corporation. The traditional elements are (1) the existence of a statute under which the corporation might have been validly incorporated; (2) colorable attempt in good faith to comply with such statute; and (3) some user or exercise of corporate privileges. If these elements are established, a *de facto* corporation exists.¹¹

Like a *de jure* corporation, a *de facto* corporation cannot be attacked by any private party.¹² It is subject to the same liabilities, duties, and responsibilities as a *de jure* corporation.¹³ Unlike a *de jure* corporation, however, it can be successfully attacked by the state in a *quo warranto* proceeding.¹⁴

The concept of *de facto* corporations has been sharply criticized. Although courts purport to apply the elements of the doctrine, these requirements have not been interpreted consistently. The doctrine is characterized as “a discouraging and baffling maze,”¹⁵ “legal conceptionalism at its worst,”¹⁶ and “inaccurate and confusing.”¹⁷ After an exhaustive review of cases purporting to apply the doctrine, Professor Frey of the University of Pennsylvania Law School found the doctrine ineffective. He criticized the *de facto-de jure* distinction because it fails to reveal what acts of incomplete compliance are sufficient to constitute “substantial” compliance,

9. CONRAD at 249-50.

10. FLETCHER at §§ 3736-3888; HENN at 240-41; LATTIN at 184.

11. FLETCHER at § 3761; HENN at 239; STEVENS at 139. Montana has recognized the doctrine in *Sun River Stock and Land Co. v. Montana Trust and Savings Bank*, 81 Mont. 222, 262 P. 1039 (1928). In that case, the court applied the traditional elements and found a *de facto* corporation rather than a partnership, even though there were only two incorporators rather than the three required (citing *Daily v. Marshall*, 47 Mont. 377, 133 P. 681 (1913)). *Id.*, 81 Mont. at 235-6.

12. BALLANTINE at 74; FLETCHER at § 3761; HENN at 239.

13. FLETCHER at § 3856.

14. BALLANTINE at 74; FLETCHER at § 3771; HENN at 240.

15. BALLANTINE at 71.

16. Frey, *Legal Analysis and the "De Facto" Doctrine*, U. PA. L. REV. 1153, 1180 (1952) (hereinafter cited as Frey).

17. STEVENS at 135.

and what acts, insufficient for "substantial" compliance, are nevertheless enough for a "colorable" attempt to comply.¹⁸

It appears that the court decisions do not *apply* the doctrine, but recite it to justify the result the court deems to be fair. "[I]f the decision is adverse to the defendants, the court is quite likely to assign as a reason that the association is not a '*de facto*' corporation, but . . . this is not a reason but a mere reiteration of the ultimate judgment."¹⁹ Frey concluded "that the traditional doctrine of '*de facto*' corporation is just so much jargon and ought to be abandoned."²⁰

As mentioned, one of the reasons for the creation of the *de facto* doctrine is to be fair to those who deal with a purported corporation. The existence of specific elements which must be met before a *de facto* corporation exists assures predictability and finality in business dealings. But as a result of the inconsistent application of the doctrine, this purpose is thwarted. There are no uniform criteria which will be applied to determine whether or not a corporation is formed and will be recognized.

III. THE ACT

As a result of the criticism of the *de facto* doctrine, the drafters of the Model Business Corporations Act (hereinafter cited as the Model Act) provided for the elimination of the concept.²¹ The statutory pattern chosen provides that the issuance of the certificate of incorporation by the secretary of state "shall be conclusive evidence

18. Frey at 1156.

19. *Id.* at 1179.

20. *Id.* at 1178.

21. Prior to 1969, the comment to section 50 of the Model Act stated (after noting that *de jure* corporation is complete when the certificate is issued): "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." See *Robertson v. Levy*, 197 A.2d 443, 446 (D.C. Cir. 1964). In 1969, section 50 was renumbered section 56. At the same time, the comment was also changed: "Under the unequivocal provisions of the Model Act, any steps short of securing a certificate of incorporation would not constitute apparent compliance. Therefore a *de facto* corporation cannot exist under the Model Act." Comment, 2 Model Bus. Corp. Act Ann. 2d § 56 (1971). The comment to section 146 of the Model Act states:

This section is designed to prohibit the application of any theory of *de facto* incorporation. The only authority to act as a corporation under the Model Act arises from completion of the procedures prescribed in sections 53 to 55 inclusive. The consequences of those procedures are specified in section 56 as being the creation of a corporation. No other means being authorized, the effect of section 146 is to negate the possibility of a *de facto* corporation.

Abolition of the concept of *de facto* incorporation, which at best was fuzzy, is a sound result. No reason exists for its continuance under general corporate laws, where the process of acquiring *de jure* incorporation is both simple and clear. The vestigial appendage should be removed.

Comment, 2 Model Bus. Corp. Act Ann. 2d § 146 (1971).

that all conditions precedent . . . have been complied with"²² and "[a]ll persons who assume to act as a corporation without authority so to do shall be jointly and severally liable for all debts and liabilities incurred or arising as a result thereof."²³

The Model Act has been widely construed as abolishing the *de facto* doctrine.²⁴ The leading case is *Robertson v. Levy*.²⁵ There, the District of Columbia Court of Appeals held the president of a purported corporation personally liable on a lease obligation entered into after the articles of incorporation had been submitted, but prior to their acceptance and filing. The articles were then rejected and no certificate was issued. Although the articles were later refiled and accepted, the president had assumed to act as a corporation before acceptance of the articles, with no authority to do so.²⁶ The court held that "the impact of these sections (sections 56 and 146 of the Model Act), when considered together, is to eliminate the concepts of estoppel and de facto corporations. . . . The certificate of incorporation provides the cut off point; before it is issued, the individuals and not the corporation, are liable."²⁷

It appears that this construction of the Model Act gives rise to some of the problems associated with the nullity theory. In the *Robertson* case, for example, the president was held liable as a result of a defect which may have been insignificant. Similarly, an attorney's failure to file the articles before his corporate client transacts business may result in a malpractice suit against the attorney.²⁸ Under the nullity theory, however, associates and outside parties must transact business without legal assurance of the corporate status or their own personal liability.

The statutory scheme has advantages over both the *de facto* doctrine and the nullity theory. It provides that the state (the secretary of state), which is the entity most concerned with corporate existence, shall determine whether or not the statutory formalities have been satisfied. The courts will seldom be faced with that question. It also provides a clear cut off point which denotes corporate existence—the issuance of the certificate of incorporation. Thus, parties can rely on the certificate as conclusive evidence of compli-

22. 2 Model Bus. Corp. Act Ann. 2d § 56 (1971); R.C.M. 1947, § 2250.

23. 2 Model Bus. Corp. Act Ann. 2d § 146 (1971); R.C.M. 1947, § 15-22-135.

24. *E.g.*, *Timberline Equip. Co. v. Davenport*, 267 Or. 64, 69, 514 P.2d 1109, 1111 (1973); *Swindel v. Kelly*, 499 P.2d 291, 299 (Alaska 1972); *Robertson v. Levy*, 197 A.2d 443, 447 (D.C. Cir. 1964); *CONRAD* at 248; *FLETCHER* at § 3762.1; *HENN* at 245. It appears that Utah retains the *de facto* doctrine in spite of the Model Act provisions. *Vincent Drug Co. v. Utah State Tax Comm'n*, 17 Utah 2d 202, 407 P.2d 683 (1965).

25. *Robertson v. Levy*, 197 A.2d 443 (D.C. Cir. 1964).

26. *Id.* at 447.

27. *Id.*

28. *Conway v. Samet*, 300 N.Y.S. 2d 243, 246 (1969).

ance. Corporate members and parties dealing with the corporation have notice that business transactions before issuance of the certificate will be entered without the consequences of corporate attributes and powers. The result is the desired uniformity and predictability in business dealings which is absent with the *de facto* concept and the nullity theory.

IV. THE CASE

A. Introduction

Montana enacted the Montana Business Corporation Act, a modified version of the Model Act, in 1967.²⁹ But recently, in *Montana Ass'n of Underwriters v. State*,³⁰ the Montana supreme court purportedly applied the *de facto* doctrine. Ignoring the Model Act precedent, the court held that Montana Benefits, Inc. (MBI) was, in effect, a *de facto* corporation at the time it contracted with the state, although it had not yet filed its articles with the secretary of state.³¹

B. The Opinion

On September 17, 1975, the State Department of Administration (DOA), pursuant to Montana statute,³² entered into a written agreement with Montana Public Benefit Services Co., Inc., the predecessor of MBI, giving it the right to establish and administer a plan of deferred compensation for public employees. On October 8, 1975, Montana Public Employees Benefit Services Co., Inc., was incorporated. It later changed its name to MBI. The DOA entered into an identical contract with MBI.

The plaintiff, Montana Association of Life Underwriters, an association whose members are involved in employee pension plans, filed an action in district court to block implementation of the deferred compensation plan.³³ After the suit was filed (and after the incorporation date), the DOA entered into a third contract with MBI identical to the previous contracts. The district court granted summary judgment to the defendants. The supreme court affirmed

29. R.C.M. 1947, §§ 15-2201 to 15-22-140. For a discussion of the Montana modifications of the Model Act, see Schaefer, *The Status of the Adoption of the Model Business Corporation Act in Montana—A Commentary*, 36 MONT. L. REV. 29 (1975). Professor Schaefer recommends abolition of the *de facto* doctrine under Montana's act. 36 MONT. L. REV. at 58.

30. *Montana Ass'n of Underwriters v. State*, ___ Mont. ___, 563 P.2d 577 (1977) (hereinafter cited as *Montana Underwriters*).

31. *Id.* at ___, 563 P.2d at 581.

32. R.C.M. 1947, §§ 68-2701 to 2709.

33. *Montana Underwriters*, ___ Mont. at ___, 563 P.2d at 578.

on appeal, responding, *inter alia*,³⁴ to the plaintiff's contention that MBI lacked contractual capacity by stating that MBI was a *de facto* corporation. The court found that "[a]lthough . . . (MBI) . . . was defective in its creation and not a *de jure* corporation, this was the result of a bona fide attempt to incorporate under the existing statutory authority, coupled with the exercise of corporate powers."³⁵ Citing neither case authority nor the Montana Business Corporation Act, and relying solely on 8 Fletcher Cyc. Corp. (Perm. Ed.), Chap. 45, §3862, and cases cited therein, the court held that MBI, being in effect a *de facto* corporation, had the same capacity to contract as a *de jure* corporation.³⁶ Thus, the contract with the DOA was not void, but merely voidable at the state's option. Since the state took no later action to void it, and in fact ratified it, the contract was valid.³⁷

C. Analysis

If the Montana court had construed the Model Act as abolishing the *de facto* doctrine in this case, it should have found the first contract between MBI void and not voidable, because that corporation had not yet filed its articles of incorporation and received its certificate. Therefore, MBI was not a corporation and had no power to contract as a corporation. In the absence of the *de facto* doctrine, MBI could not have been found a "private corporation or institution"—the only entities capable of entering such a contract under the deferred compensation statute.³⁸

In this case, however, it was unnecessary for the court to have considered whether or not MBI was a *de facto* corporation at the time of the first contract. Regardless of whether or not the first contract was valid, the subsequent contract was valid. It was an identical contract entered into after MBI was incorporated. Therefore, the challenge to MBI's capacity to contract before incorporation was moot. Since the court found the MBI plan complied with the statutory language, it properly held that implementation of the plan could not be blocked.

Thus the court properly affirmed the district court but unnecessarily purported to apply the *de facto* doctrine. In doing so, it unfor-

34. The court held that the language of the statute, R.C.M. 1947, §§ 68-2701 through 68-2709, permitted implementation of the deferred compensation plan involved. *Montana Underwriters*, ___ Mont. at ___, 563 P.2d at 580. The court refused to review the question of whether the DOA had the power to grant an exclusive contract to MBI, because that issue had not been previously raised. *Id.* at ___, 563 P.2d at 581.

35. *Montana Underwriters*, ___ Mont. at ___, 563 P.2d at 581.

36. *Id.*

37. *Id.*

38. R.C.M. 1947, § 68-2703.

tunately did not consider the impact of the Model Act. Although the court relied on Fletcher's *Cyclopedia of Corporations*, upon further investigation it would have found that Fletcher recognizes abolition of the *de facto* doctrine by the Model Act.³⁹

V. CONCLUSION

By discussing the *de facto* doctrine after the Model Act has been adopted and not clearly resolving the question of whether or not the doctrine has been abolished, the Montana supreme court added to the existing confusion in the law regarding defectively formed corporations. When the issue is properly raised in a future case, the Montana court should consider the intent of the drafters of the Model Act and the Montana legislature, the potential harshness in abolishing the doctrine, the need for uniformity in application of the requirements for incorporation, and the confusion in applying the *de facto-de jure* distinction. It should then establish a clear, definitive holding which will determine whether Montana courts will continue to apply the *de facto* doctrine, with all its shortcomings, or whether the adoption of the Model Act precludes its application.

39. "[P]rovisions of the Model Business Corporation Act . . . have been construed as eliminating the concepts of *de facto* corporations and corporations by estoppel." FLETCHER at § 3762.1.