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Power of Corporations to Guarantee an Obligation to Pay Money

COMMENT

POWER OF CORPORATIONS TO GUARANTEE AN OBLIGATION TO PAY MONEY

The New York legislature has once again taken cognizance of the gradually increasing liberality of the common law with reference to the power of a corporation to guarantee obligations to pay money.[1] Chapter 695 of the Laws of 1944 not only has added two subdivisions to Section 19 of the Stock Corporation Law which enumerate additional instances in which exception is taken to the general prohibition against the power of a corporation to guarantee but has also greatly enlarged the type of obligations to which the statute previously applied.[2] Prior to these changes the statute recognized guaranties only of the bonds of another corporation (and not obligations to pay money generally) upon the affirmative vote of at least two-thirds of its outstanding shares entitled to vote at a meeting called in accordance with statutory procedure, or in the absence of a meeting, by the unanimous written consent of all outstanding shares entitled to vote. In the event that the guarantor corporation owned directly or indirectly a majority of the voting shares of the other corporation such guaranty could be given when approved by a resolution of the board of directors, so authorizing.[3] The amendment to the statute broadens the scope of the power to guarantee by permitting it to be exercised generally, i.e., with reference to *any* obligation to pay money. In addition, apart from incorporating the existing circumstances under which the guaranty may issue, it provides that the power may be exercised when in connection with and incidental to the corporate functions for which it was created or when made in connection with the negotiation by sale or otherwise of an obligation owned by it.[4] It should be noted, however, that with the exception of the provision that enlarges the scope of the guaranty to all obligations to pay money, the amendment introduces no novel principles of law. In effect it is no more than a statement of the common law holdings on the subject.

The history of this statute is characterized by cautious legislative acceptance

1. N. Y. Laws 1944, c. 695 effective April 9, 1944, amending N. Y. Laws 1940, c. 464 which amended N. Y. Laws 1923, c. 787 and N. Y. Laws 1909, c. 61, § 19.

2. N. Y. Laws 1944, c. 695 provides in effect that any stock corporation may guarantee *any obligation* for the payment of the money (a) when made in connection with the exercise of its rights and purposes or (b) when made in connection with the negotiation of an obligation owned by it or (c) when the guarantor corporation owns directly or indirectly a majority of the voting shares of the other corporation and the guaranty is authorized by the board of directors of the guarantor corporation or (d) when authorized by the affirmative resolution of two-thirds of the voting shares of the guarantor corporation at a meeting called pursuant to statutory regulation or in the absence of a meeting by the unanimous written consent of the voting shares.

3. N. Y. Laws 1940, c. 464.

4. See note 2 *supra*.

of the common law tendency to liberalize what was once considered in nearly all instances to be an *ultra vires* action of a corporation. A corporation has always been considered to possess as much as and no more than the aggregate of powers[5] which were expressly or impliedly conferred upon it by its charter.[6] Thus it followed that a corporation could not contract unless the subject of the contract was one expressly authorized or was one strictly necessary or incidental to the express purposes for which the corporation was created.[7]

It has been vigorously contended by many that (with the obvious exception of those institutions expressly created to act as surety or guarantor) corporations engaged in ordinary commercial pursuits are not empowered to become surety in the absence of express authority and that all such acts are on their face *ultra vires*.[8] The reason why the power is generally denied follows from the obvious fact that a business corporation is formed to further the financial interests of its stockholders and not to lend money and credit gratuitously.[9] Accordingly the earliest views on the topic demonstrate a readiness to permit corporations to guarantee only under such situations of fact that clearly show the act to be strictly necessary to the financial well-being of the guarantor. However, the courts have held quite consistently that gainfulness or expediency cannot stand as the sole test of the power to guarantee. The fact that it enables a corporation to reap a profit is not enough to make a presumptively *ultra vires* act permissible.[10] To establish that lending of credit would be profitable to the corporation would not, in the eyes of the common law, establish the right to do so.[11] Indeed, even if a substantial consideration were given

5. The use of the word "powers" in reference to corporations conveys the notion of *authority and right* to act as distinguished from the mere *ability* to act. See Freligh v. Saugerties, 70 Hun 589, 24 N. Y. Supp. 182, 185 (3d Dept. 1893).

6. Weckler v. First National Bank of Hagerstown, 42 Md. 581, 20 Am. Rep. 95 (1875); People *ex rel.* Nelson v. Wiersema State Bk., 361 Ill. 75, 197 N. E. 537, affirming 276 Ill. App. 21 (1934); Wagg v. Toler, 80 Cal. App. 501, 251 Pac. 973 (1926).

7. Woods Lumber Co. v. Moore, 183 Cal. 497, 191 Pac. 905 (1920), 19 MICH. L. REV. 216.

8. Limerick Mills v. Royal Textile Co., 228 Mass. 479, 193 N. E. 9 (1934); Strauss v. W. H. Strauss and Co., 330 Pa. 317, 199 Atl. 195 (1938); Norfolk Mattress Co. v. Royal Mfg. Co., 160 Va. 623, 169 S. E. 586 (1933); Nowell v. Equitable Trust Co., 249 Mass. 585, 144 N.E. 749 (1924).

9. Harms Co. v. Michel Brewing Co., 228 N. Y. 118, 126 N. E. 710 (1920); M. V. Monarch Co. v. Farmers and T. Bank, 105 Ky. 430, 49 S. W. 317, 88 Am. St. Rep. 310 (1899); Fox. v. Rural Home Co., 90 Hun. 365, 35 N. Y. Supp. 896 (1st Dept. 1895), *aff'd without opinion* 157 N. Y. 684, 51 N. E. 1090 (1898); McClellan v. Detroit File Works, 56 Mich. 579, 23 N. W. 321 (1885).

10. Gulf Yellow Pine Lumber Co. v. Chapman, 159 Ala. 444, 48 So. 662 (1909); Globe Indemnity Co. v. McCullom, 313 Pa. 135, 169 Atl. 76 (1933).

11. Germania Safety Vault and Trust Co. v. Boynton, 71 Fed. 797 (C. C. A. 6th, 1896); Rogers v. Jewell Belting Co., 184 Ill. 574, 56 N. E. 1017 (1900); Ward v. Joslin, 105 Fed. 224 (C. C. A. 1st, 1900).

in return for an act of guaranty, a presumption of capacity to act would not be adduced.[12] *A fortiori*, it cannot be assumed that authority to extend credit exists because benefit is to be derived from a contract made with the corporation whose obligation is guaranteed.[13] Almost without exception the courts have held that the test for determining whether an act of a corporation is *ultra vires* is not to consider whether the transaction is a source of profit or advantage but whether it can be classified as one within the scope or purpose of the corporate aims.[14]

Nevertheless, the factual situations in which the power has been sanctioned indicate that the rule has a reasonably broad application. Thus it has been held that, when a manufacturing corporation advanced funds to a manufacturer in order that the latter might supply raw materials for the reason that the former could not have operated with the same efficiency without them, it was acting *intra vires*.[15] In addition, a charitable institution may give bonds or undertakings to insure and facilitate the admission of refugee children into the United States, when the facts establish that the corporation was founded with that as one of its general purposes.[16] Further facts incidental to the issuance of the guaranty may exist which may influence the courts to construe the use of the power more readily. The cases indicate that this willingness to relax the strict construction is applied in situations where the act falls generally into the regular line of corporate business and where (a) a contract

12. National Park Bank v. German American Mutual Warehouse and Security Co., 116 N. Y. 281, 22 N. E. 567 (1889); Carlaftes v. Goldmeyer Co., 72 Misc. 75, 129 N. Y. Supp. 396 (Sup. Ct. 1911).

13. Hayes v. State *ex rel.* Olroyd Mach. Co., 124 Ohio Stat. 485, 179 N. E. 402 (1931), where a bond given by one corporation to stay execution upon the property of another was held *ultra vires*, notwithstanding the fact that the guarantor, a manufacturer, had acted to protect its interest under a contract with the judgment debtor who was the designer, patentee and distributor of the manufacured articles.

14. *In re* German-Jewish Children's Aid, Inc., 151 Misc. 834, 272 N. Y. Supp. 540 (Sup. Ct. 1934); Koehler & Co. v. Reinheimer, 26 App. Div. 1, 49 N. Y. Supp. 755 (1st Dept. 1898); Fuld v. Burr Brewing Co., 18 N. Y. Supp. 456 (N. Y. City Ct. 1892).

15. Holmes, Booth & Haydens v. Willard, 125 N. Y. 75, 25 N. E. 1083 (1890); Mercantile Trust Co. v. Kiser, 18 S. E. 358, 91 Ga. 636 (1893); State *ex inf.* Gentry v. Long-Bell Lumber Co., 321 Mo. 461, 12 S. W. (2d) 64 (1928); *but cf.* Western Maryland R. Co. v. Blue Hotel Co., 102 Md. 307, 62 Atl. 351, 111 Am. St. Rep. 362 (1905), where the court refused to recognize the power of a railroading corporation to guarantee payment of interest and dividends on the bonds and stock of a hotel situated along the line; Lucas v. White Line Transfer Co., 70 Iowa 541, 30 N. W. 771, 59 Am. Rep. 449 (1886), where the underwriting of an independent ferry service by a railroad whose passengers utilized it as a connecting link was held *ultra vires*. Both of these decisions were based on the ground that the act of guaranty though beneficial to, was not strictly necessary to the carrying out of the corporate enterprise.

16. *In re* German-Jewish Children's Aid, Inc., 151 Misc. 834, 272 N. Y. Supp. 540 (Sup. Ct. 1934).

has been made and the guaranty forms part of the consideration or (b) the guaranty is given to secure the collection of a debt or to negotiate an obligation held by it or (c) where the guarantor is protecting its interest in a subsidiary corporation. Accordingly as an instance of situation (a) it was held that when a contract existed between a lumber company and a building contractor, the former had the power to become surety on the latter's bond when it was necessary in order to procure the contract and secure the contractor's business.[17] By identical reasoning a brewing corporation was held to be acting *intra vires* when guaranteeing the rent of a customer[18] and another brewing corporation was acting within its implicit authority in becoming surety on a liquor bond.[19] Rule (b) was applicable when a debt owed to a corporation and in order to protect itself from loss, the corporation issued a guaranty in an attempt to secure the solvency of the debtor. The court held that the defense of *ultra vires* was not available to the guarantor on the ground that the corporation had acted to protect its debt and thus had been implicitly empowered.[20] Thus, a railroad company without the express power of guaranty was within the scope of implied authority when it took the bonds of another corporation as payment of a debt and in order to facilitate their sale, guaranteed them.[21] The power to indorse, which is itself a form of guaranty, is generally acknowledged when a corporation has taken a note in satisfaction of an obligation.[22] In providing for the issuance of a corporation guaranty under such circumstances, the amendment under discussion is merely paraphrasing an established common law rule which recognized the fact that in obligating itself upon a chose in action already in its possession the corporation was not assuming a new liability but merely warranting an asset which it sold. The courts, in formulating rule (c), have decided that when the guarantor had pledged its credit in favor of another corporation, all of whose stock it owned, the defense

17. Wheeler, Osgood & Co. v. Everett Land Co., 14 Wash. 630, 45 Pac. 316 (1896); Wittmer Lumber Co. v. Rice, 23 Ind. App. 586, 55 N. E. 868 (1900); National Bank of Commerce v. Allen, 90 Fed. 545 (C. C. A. 8th, 1898). *Contra: In re* S. P. Smith Lumber Co., 132 Fed. 620 (N. D. Texas, 1904).

18. Holm v. Claus Lipsius Brewing Co., 21 App. Div. 204, 47 N. Y. Supp. 518 (2d Dept. 1897); Winterfield v. Beam City Brewing Co., 96 Wis. 239, 71 N. W. 101 (1897).

19. Horst v. Lewis, 71 Neb. 365, 98 N. W. 1046, 103 N. W. 460 (1905); Kraft v. West Side Brewery Co., 219 Ill. 205, 76 N. E. 372 (1905); *accord,* Garrison Canning Co. v. Stanley, 133 Iowa 57, 110 N. W. 171 (1907); Frese v. Mutual Life Ins. Co. of New York, 11 Cal. App. 387, 105 Pac. 265 (1909).

20. North Texas State Bk. v. Crowley Southerland Commission Co., 145 S. W. 1027 (1912); *see* American Surety Co. v. Philippine National Bk., 245 N. Y. 116, 156 N. E. 634 (1927).

21. Rogers Locomotive Works v. So. R.R. Ass'n, 34 Fed. 278 (1888); Arnot v. Erie R.R., 67 N. Y. 315 (1876); *accord,* Broadway Nat'l Bk. v. Baker, 176 Mass. 294, 57 N. E. 603 (1900).

22. Bank of Genesee v. Patchin Bank, 13 N. Y. 309 (1855).

of *ultra vires* is not available against a surety company to which the defendant had given an agreement of indemnity.[23] The reason given for the rejection of the defense was that, although the court recognized that the main business of the corporation was encompassed by those acts performed in direct furtherance of the corporate aim, it would also permit, under certain circumstances, the issuance of guaranties necessary to contracts and transactions incidental or auxiliary to its main business. The ownership of all or a majority of shares in another corporation was considered such a circumstance.[24] Most jurisdictions are in accord on this point and New York common law recognized that, where the defendant had in good faith guaranteed bonds of another corporation, the fact that the guarantor corporation had a majority interest in the other would except the guarantor from the general prohibition against *ultra vires* guaranties.[25] The power of a corporation, by a resolution of its board of directors, to pledge credit in favor of another, a majority of whose stock is either directly or indirectly owned by the guarantor, is recognized in New York by the statute under discussion.

It appears, therefore, that the recently adopted provisions of the statute to a great extent merely codify the recognized common-law on the subject of corporation guaranties. The one departure that is of any appreciable consequence is the extension of the subject matter of the guaranty of a subsidiary's debts, or those of another corporation where the stockholders consent, to include obligations to pay money generally and not merely bonds, as had been hitherto permitted. When viewed in connection with the enumerated instances under which a guaranty may now be given, this clause contemplates a leniency which was not enjoyed prior to this amendment. If the statute is given a purely literal interpretation, in the case of a subsidiary of the guarantor or when at least two-thirds of the guarantor's stockholders consent, the guaranty may be issued upon *any* money obligation incurred by any other person, firm or corporation, even though the guaranty is patently inconsistent with the corporate powers and entirely without benefit to its stockholders. Would the courts countenance a pledge of credit in an instance where the president of a corporation, in control of two-thirds of the voting shares, guaranteed in the name of the corporation the payment of jewelry purchased by his wife? Judicial conservativeness may well refuse to recognize such a liberal use of the corporate power to guarantee even though the literal interpretation of the amended statute might permit such non-corporate use.

23. American Surety Co. of N. Y. v. 14 Canal St., Inc., 276 Mass. 119, 176 N. E. 785 (1931).

24. Jesselsohn v. Boorstein, 111 N. J. Eq. 310, 162 Atl. 254 (1932).

25. Nurick v. Baker, — Misc. —, 14 N. Y. S. (2d) 503 (Sup. Ct. 1939).