PROTECTION OF MINORITY INTERESTS THROUGH STOCKHOLDERS' AGREEMENTS: A COMMENTARY ON SECTION 9 OF THE NEW YORK STOCK CORPORATION LAW

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The usual machinery of corporate control functions through a board of directors as the governing body, aided by the executive group, the shareholders as such exercising very little control. Its working principle is that the will of the majority generally binds the minority.

From this general scheme, Section 9 of the New York Stock Corporation Law [1] authorizes major departures. Authorizing the insertion of provisions in the original or amendatory certificate of incorporation which would require for corporate acts the presence and/or vote of greater than majority or other statutory minimum,[2] it fur-

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[1] Added by L. 1948, Ch. 862 (Effective September 1, 1948; subsequently amended by L. 1949, Ch. 261; L. 1951, effective September 1, 1951.)

[2] Section 9 provides that the original or amendatory certificate of incorporation "may contain provisions specifying any or all of the following:

"(a) that the number of directors who shall be present at any meeting of the directors in order to constitute a quorum for the transaction of any business or of any specified item of business shall be such number greater than a majority as may be specified in such certificate;

"(b) that the number of votes of directors that shall be necessary for the transaction of any business or of any specified item of business at any meeting of directors shall be such number greater than a majority as may be specifed in such certificate;

"(c) that the number of shares of the corporation, or the number of shares of any class having voting power, the holders of which shall be present in person or represented by proxy at any meeting in order to constitute a quorum for the transaction of any business or of any specified item of business at a meeting of the stockholders shall be a number greater than the majority or plurality prescribed by law in the absence of such provision.

"(d) that the number of votes or consents of the holders of shares of the corporation, or of the holders of shares of any class of stock having voting power that shall be necessary for the transaction of any business or of any specified item of business at a meeting of the stockholders, including amendments to the certificate of incorporation, or the giving of any consent, shall be a number greater than the proportion prescribed by law in the absence of such provision."

The statutes of eight other states and of Hawaii authorize similar provisions either in the articles of incorporation or in the by-laws. See Note, 44 *Yale L. J.* 873 (1935). For instance, The Illinois Business Corporation Act, s. 33, *Ill. Rev. Stat.* (1949) c. 32, s. 157.37, provides:

"Quorum of directors. A majority of the board of directors shall constitute a quorum for the transaction of business unless a greater number is required by the articles or incorporation or the by-laws. The act of the majority of the directors

nishes a means by which an individual director or a minority stockholder may veto the decision of the majority of the directors constituting a quorum or of the shareholders representing the majority of the shares entitled to vote. By making it possible for a member of a corporation to exercise a veto, it allows him a measure of control which ordinarily is enjoyed by a member of a partnership [3] but not by a member of a corporation. The section thereby recognizes the need for greater protection of minority interests. It permits shareholders to freeze the corporate set-up upon the terms agreed upon on its incorporation by making changes difficult to effect. It is a recognition of the close corporation as an entity midway between a partnership and a corporation.

I. MINORITY INTERESTS IN CONTROL AND MANAGEMENT

The New York General Corporation Law vests management and control in a board of directors. "The business of a corporation shall be managed by its board of directors," [4] "acting by a majority of a quorum," [5] so the statute provides. This scheme or formula—as you wish—is the starting point in the solution of conflicts between directors, as one group, and shareholders, as another, and between majority and minority interests in each group over management and control. And in the application of this formula, courts are more or less guided by the public policy said to be crystallized by the formula.[6]

The theory of corporate fiction is carried through. The assets of the corporation are said to be owned by the corporation as a person distinct from the shareholders who compose it. This being so, a line is drawn between directors and shareholders, as such, in mat-

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present at a meeting shall be the act of the board of directors, unless the act of a greater number is required by the articles of incorporation or the by-laws."

Delaware Rev. Code (1935), c. 65, s. 17, last paragraph provides:

"Subject to the provisions of this chapter in respect of the vote that shall be required for a specified action, the Certificate of Incorporation or by-laws of any corporation may specify the number of shares and/or the amount of other securities having voting power the holders of which (or in the case of a corporation with no capital stock, the number of the members thereof having voting powers who) shall be present or represented by proxy at any meeting that shall be necessary for, the transaction of any business."

And in subdivision 11 of s. 5, the Delaware statute provides:

"11. The Certificate of Incorporation may also contain provisions requiring for any corporate action the vote of a larger proportion of the stock or any class thereof than is required by this Chapter."

[3] See N. Y. Partnership Law, section 40, subdivision 8; Uniform Partnership Act, section 18, subdivision 28.

[4] See N. Y. General Corporation Law, section 27.

[5] See N. Y. General Corporation Law, section 28.

[6] See *Benintendi v. Kenton Hotel, Inc.*, 294 N.Y. 112, 60 N.E. 2d 829 (1945).

ters of management and control. Within its jurisdiction, the board of directors exercises managerial functions with which, in the absence of fraud, negligence, or bad faith, the shareholders as such may not interfere.[7] The direct participation of the shareholders in management and control is limited to certain specified acts,[8] and in this the participation of the shareholders is mainly permissive, confirmatory, and confined to corporate acts of extraordinary nature. The shareholders may, of course, propose or request certain board actions, but the board is under no legal obligation to follow the proposal or to grant the request.[9]

Indirectly the shareholders participate in management and control through their power to make by-laws[10] and their right to vote at the election of directors.[11] But, if a shareholder's stockholding is a minority interest, his vote alone may not be sufficient to elect even a single director; unless cumulative voting[12] is provided for in the certificate of incorporation or other certificate filed pursuant to law and his stockholding is at least equivalent to the smallest unit of representation. Nor is the right to vote at the election of directors or in connection with other business proper for stockholders' meetings inseparable from stock ownership. The shares may be so classified as to grant one or some classes the right to vote and deny it to the rest.[13] It is possible also for an existing right to vote to be separated from the shareholder through proxy and voting trust devices.[14]

A shareholder may, of course, run for a seat on the board if he wants greater participation in management and control. But this

[7] In *Abrams v. Allen*, 113 N.Y.S. 2d 181 (1951), the court said: "Questions of policy of management, expediency of contracts or action, adequacy of consideration, lawful appropriation of corporate funds to advance corporate interests are left solely to their honest and unselfish decision, for their powers therein are without limitation and free from restraint, and the exercise of them for the common and general interests of the corporation may not be questioned, even though the results show that what they did was unwise or inexpedient *** " (at 189).

[8] Thus the assent of stockholders to the issue of stock to employees (N.Y. Stock Corporation Law, sec. 14), sale of franchise and property (ibid, sec. 20), merger (ibid, sec. 85), consolidation (ibid, secs. 86, 89), amendment of certificate of incorporation (ibid secs. 35-38), dissolution without judicial proceedings (ibid, sec. 105), petition for dissolution in case of deadlock (N.Y. General Corporation Law, sec. 103) is required.

[9] See *Continental Securities Co. v. Belmont*, 206 N.Y. 7, 99 N.E. 138 (1912).

[10] See N.Y. General Corporation Law, sections 23 and 27.

[11] See N.Y. Stock Corporation Law, section 55 and General Corporation Law, section 23.

[12] Authorization for adoption of cumulative voting is given by section 49 of the N.Y. Stock Corporation Law.

[13] See N.Y. Stock Corporation Law, sections 11 and 51.

[14] Section 19 of the N.Y. General Corporation Law deals with proxies; and section 50 of the N.Y. Stock Corporation Law, with voting trusts. See also sec. 47, N.Y. S.C.L.

is a question of having the votes, and, the number of seats being limited, not all the shareholders may be elected to the board. If he is lucky enough to be elected a director, he will find out that his voting position may, without his consent and over his objection, be reduced by an increase in the number of directors.[15] He can only be sure that he may not, without cause, be removed during the term for which he is elected and until his successor is elected and qualified; unless the articles or the by-laws contain a provision for the removal of directors without cause.[16]

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[15] Under section 5, paragraph 7, N.Y. S.C.L., the certificate of incorporation shall state the number of directors, or that the number of directors shall be not less than a stated minimum. In any case the number may be increased or decreased (to not less than three) by an amendment to the certificate. See N.Y. S.C.L., sec. 35.

May the right of the holders of a majority of the shares entitled to vote to amend the certificate of incorporation so as to increase the number of directors be restricted by agreement? In *Christal v. Petry*, 275 App. Div. 550, 90 N.Y.S. 2d 620 (1949), the court held that "the statutory right to holders of a majority of voting stock to amend the certificate of incorporation so as to increase the number of directors is absolute unless restricted by some contrary provision in the certificate of incorporation or unless prohibited by some unanimous written agreement of all the stockholders. Any by-laws attempting to restrict such right is ineffectual and invalid. The stock corporation Law of this state, Section 5 (7), provides that the certificate of incorporation must state the number of directors. There is no such requirement with respect to the by-laws. As between the certificate of incorporation and the by-laws, the certificate must control. 'The by-laws of course cannot override the statutes and hence if the by-laws conflict with the charter, the charter prevails.'" In *Katz v. H. M. Manufacturing Co.*, 109 App. Div., 49, 95 N.Y.S. 663 (1905) affirmed without opinion, 183 N.Y. 578, the court declared invalid a by-law which provided that the board of directors shall consist of five and that the stockholders, by a vote of 90% of the stock issued and outstanding, may alter or amend the by-laws. The court said in this case that a person purchasing stock has a right to assume that the directorate may be increased or reduced by a majority vote and that he is not called upon to examine the by-laws. (at p. 665) In *Ripin v. U. S. Woven Label Co.*, 205 N.Y. 442, 98 N.E. 855 (1912), the court said that no public policy "requires that in all cases a majority should be allowed to increase the number of directors." (at p. 856). But it is to be noted in connection with this case that the certificate of incorporation provided that the number of directors shall not be changed, except by the unanimous consent of all the stockholders. It would seem then that a restriction which is not ctontained in the certificate of incorporation will not be binding on subsequent purchasers of stock in good faith and without notice. See also *Bond v. Atlantic Terra Cotta Co.*, 137 App. Div. 671, 122 N.Y.S. 425 (1910).

[16] In part, section 55, N.Y. S.C.L., provides that the directors of a stock corporation shall be chosen at the time and place fixed by the by-laws of the corporation; and section 21, N.Y. G.C.L., provides that: "If the directors shall not be elected on the day designated by law or fixed in the by-laws, the corporation shall not for that reason be dissolved; but every director shall continue to hold his office and discharge his duties until his successor has been elected."

See *Manice v. Paul*, 201 N.Y. 194, affirming 140 App. Div. 912 (194); *In re Singer*, 70 N.Y.S. 2d 550 (1947); and *Matter of Korff*, 198 App. Div. 553 (1921).

A shareholder, instead of or in addition to running for a directorship, may aspire for appointment or election by the board to an executive position in the corporation. But to land such a position he must have the support of the management where the mangement dominates the board or of the board where it is not controlled by the executive group; and there may not be enough positions for all aspirants. Assuming, however, that he lands an executive position, he may be removed at any time by a majority of the board of directors even without cause.[17] And, if his employment contract does not specify a period, then he may not even recover damages for wrongful discharge.[18]

Thus by a combination of circumstances, the interests of a shareholder may become, within the framework of the law, limited to (1) the right to vote at the election of directors and at stockholders' meetings; (2) the expectation of sharing in the dividends, if and when declared by the board,[19] and in the assets, upon liquidation of the corporation, after the creditors of the corporation shall have been paid; and (3) the chance of making money on a sale of the securities

[17] The N.Y. S.C.L., section 60 states that the directors may remove any officer, agent, or employee "at pleasure."

[18] When an employment contract specifies a period, a distinction is to be made between the power of the directors to remove the officer or employee "at pleasure" and the right to discharge him before the expiration of the contract. The contract will not prevent the exercise of the power of removal under section 60, but section 60 will not relieve the corporation from the obligation to pay damages for breach of contract. The purpose of section 60, said the court in *In re Paramount Publix Corporation*, 90 F. 2d 441, 111 A.L.R. 889 (2d Cir. 1937), "was to declare that a corporation, through its directors, should have the same power to revoke an agency an individual principal has. In the case of an individual the agency and the contract of hiring are distinct."

[19] Section 58, N.Y. S.C.L., governs the discretion of the board of directors in the matter of declaring dividends.

With respect to contracts to declare dividends, the court in *Lindgrove v. Shulter & Co., Inc.*, 256 N.Y. 439, 176 N.E. 832 (1931) said: "The directors of a corporation owe a duty to their shareholders to exercise an impartial judgment in reference to the declaration of dividends, and to declare them only when, under existing circumstances, a declaration will seem best to serve the corporate interests, and no contract, engaging unrestrictedly to declare dividends, can have any legal force." (256 N.Y. 439, at 444) But with respect to a corporation which is a family affair, the court in *Groh v. Groh*, 80 App. Div. 85, 80 N.Y.S. 438, reversed on other grounds 177 N.Y. 8, 68 N.E. 992 (1903), said: "As between the owners and holders of all the stock of a corporation, it must in principle follow that the members of such corporation entitled to receive dividends may agree among themselves, either by conversation or otherwise, to appropriate of the funds of the corporation a specified sum, as agreed upon, and distribute the same, and the stockholder, upon the receipt of it, will acquire good title thereto as against the other members of the corporation. It amounts to a mere division of the property by agreement of all the parties in interest, and as between them it is perfectly good and may not be attacked where the act does not impair the rights of third parties." (80 N.Y.S. 438 at 443.)

and, perhaps, of using his shares as collaterals for the payment of his obligations.

At that, he may find at any time his voting position, his share in the dividends and in the assets, and the market value of his shares impaired by corporate acts over which he may have no control. The capital stock may be increased or decreased, the shares reclassified, an indebtedness incurred, the assets of the corporation sold, or the corporation even dissolved—all this may be done against his will provided that in each case there is a sufficient number of votes linêd up against him.[20] In many situations, his remedy is limited to the payment by the corporation of the appraised value of his shares.[21] When capital stock is increased, he may preserve his relative voting position and the size of his share in the dividends and the assets by exercising his pre-emptive right; unless the original or amendatory certificate of incorporation does not provide for any pre-emptive right.[22]

The board of directors, as the manager of the corporate affairs, acts by the vote of the majority of the quorum; and a majority of the members is sufficient to constitute a quorum; and it may be provided in the by-laws that a number less than a majority but not less than one-third of the number of directors shall constitute a quorum.[23] He may also discover that some or all of his colleagues on the board are not even stockholders of the corporation, for it may be provided in the certificate of incorporation or in the by-laws that the directors need not be shareholders.[24] So even if a shareholder finds himself on the board, his vote might be overriden by a few of his colleagues all of whom may not even be nominal shareholders.

Control and management are to be exercised by the board, aided by executive officers and other employees selected by it and acting under its direction. But, while control is thus given to the board, it may in fact be exercised by the executive group through its control of the board, such that for all practical purposes the corporation is run by the executive group, the board's function being limited to ratification of the policies and acts of the executives and to giving the latter advice.[25] Such a dominant position the executive group may

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[20] See N.Y. S.C.L., sections 35-38, 16, 20, 105; N.Y.G.C.L., sections 101-03.

[21] See N.Y. S.C.L., section 21.

[22] See N.Y. S.C.L., sections 39 and 35.

[23] See N.Y. G.C.L., sections 27 and 28.

[24] See N.Y. S.C.L., section 55.

[25] At least in large corporations, this seems to be the typical situation. See Temporary National Economic Committee Monograph 11, pp. 23, 25, 26 (1940); GORDON, BUSINESS LEADERSHIP IN THE LARGE CORPORATION, Chapter VI (1945). It may happen, however, that the dominant forces within the corporation are neither the directors nor ordinary officers but individuals or groups constituting the "control." See

attain by means of vote-getting devices at the disposal of the management with the objective of having at its command a number of votes sufficient to elect a board of their own choice. It may also happen that some of the directors may not have been elected for the purpose of representation of stockholding interests.[26] Some of them may be executive officers at the same time that they are directors of the corporation. Some of them may not be familiar with the details and intricacies of the particular business of the corporation. These and other factors may combine to produce a board which neither has the time, nor the interest, nor the capacity to keep a sharp and knowing eye on the activities of the executive group, let alone actively manage the business.

This, by no means, is the usual situation. But the point is that under the law, a large degree of separation of control from ownership is possible. And, where diffusion of stock ownership is considerable, as seems to be typical of publicly held corporations, the statutory formula exhibits sufficient elasticity to cover a marked degree of separation of control from ownership. To be sure, where shareholders are few such that all or most of them can be directors, executive officers or employees, they may in fact with the intention of preventing separation of control from ownership so organize and elect themselves directors and officers. Then fusion between control and ownership takes place, and the statutory scheme is visible only to the extent that the members should preserve the form and formalities and go through the ceremonies attendant to corporate management. Acts required by law to be done by directors or officers are to be done by them in their capacity as such, and acts required to be done by the shareholders are to be performed by them as such.

Where fusion of control and ownership is attained, the interests of the shareholders in the business are naturally two-fold. Their interests are not only those of shareholders but also of directors and officers. As directors and officers they participate actively and fully in the management and control of the business in matters which the

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BERLE AND MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY, Chapter VI (1932).

[26] In a survey of some 500 corporations in all fields, ranging in size from those with assets of less than 1 million to very large ones, the National Industrial Conference Board found the reasons for inclusion of individual directors to include (other than stock ownership or representation of important stockholdings) knowledge of technical details of business, sound executive judgment, representation of banks or financial interests, financial counsel, marketing counsel, legal counsel, knowledge of external business conditions, knowledge of labor relations, knowledge of foreign markets, representation of customers, representation of allied manufacturing or commercial interest, retired or former official of company, and executive officer. See GORDON, *op. cit. supra* note 25, at 126-127.

law under the statutory scheme puts beyond the power of shareholders as such. And as directors and officers they ordinarily draw salaries or other compensation. Their interests extend to office-holding for purposes of control and for the income which is derived from office-holding. Their interests as directors, officers, and shareholders the minority may wish to protect and preserve against the normalcy of change to which the minority is constantly subject under the rule that the majority or a greater number but less than all may, short of breach of fiduciary relations, impose their will on the minority. This purpose the minority may seek to achieve by means of agreements.

II. PROTECTION AND ENHANCEMENT OF MINORITY INTERESTS THROUGH AGREEMENTS

Several courses are open to stockholders for enlarging their capacity to control corporate affairs beyond that which pertains to them as shareholders and beyond the voting power corresponding to the size of stock ownership. They may embody their agreements in the articles of incorporation or amendments thereto, in the by-laws, or in ordinary contracts.

A. CLASSIFICATION OF SHARES

In the original or amendatory certificate of incorporation, provisions may be made classifying shares into voting and non-voting.[27] Although in relation to the aggregate capital the voting shares may in fact be but a minority, by the disenfranchisement of the other shares, a minority may control stockholders' actions and, through their power to elect directors, influence the board's actions or, if they so desire, elect themselves directors and officers. The weakness of this set-up is that the certificate of incorporation may, by a majority vote of the shares entitled to vote, be amended so as to reclassify the shares. An existing majority may also be wiped out by an increase in the capital calling for an additional issue of voting shares, subject only to their right to maintain their relative voting power by exercising their pre-emptive right, if any is provided for in the certificate of incorporation which, at any rate, may be amended so as to change or strike out any provision with respect to pre-emptive right. And any existing preemptive right is to no avail if the additional issue is that of unissued, authorized shares.[28]

So far as classification of shares is designed to secure power or control in a group of shareholders, it may not be employed so as to deprive the board of directors of their powers and functions. In

[27] See *supra* note 13.

[28] See *supra* note 22.

Abbey v. Meyerson,[29] the incorporator's agreement called for the organization of a corporation with a special stock divided into Class "A" and Class "B". By the terms of the agreement, holders of Class "A" were required to "nominate, vote for and elect for officers of the corporation, stockholders of Class "B" only." It was further provided that:

> "4. The corporation and each of the parties hereto shall enter into contracts of employment for a period of ten years from and after the date hereof at the following salaries: * * *
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> "7. The management and operation of the corporation shall be administered exclusively by the holders of the class 'B' stock, the parties hereto agreeing that Class 'A' stockholders shall not interfere in said management and operation in their capacity as individuals, stockholders or directors."

The court held that such an agreement violates the provisions of section 27 of the General Corporation Law and the public policy of the state and therefore void and unenforceable. Said the court: "The effect of the provisions of the agreement is to deprive the board of directors of their powers and functions and to vest control in the holders of Class 'B' stock."[30]

B. CUMULATIVE VOTING

Cumulative voting[31] may be provided so as to give minority shareholders representation in the board. This will not be sufficient to give the minority control of the board, but, by permitting a shareholder to vote the number of his shares multiplied by the number of directors to be elected for one candidate or distributively among various candidates, he is in a position to elect at least one candidate.

The weakness of this device is that ordinarily the privilege may, by a majority vote of the shares entitled to vote, be written off or otherwise altered by amendment of the certificate of incorporation.[32] Just as effectively, the power of the minority to elect its representatives to the board may be reduced by an amendment of the certificate of incorporation decreasing the number of directors.[33]

Provisions for cumulative voting should be made in the original or amendatory certificate of incorporation. Would a by-law be sufficient? In the *Matter of American Fibre Chair Corporation,*[34] the ori-

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[29] 83 N.Y.S. 2d 503, affirmed 299 N.Y. 557, 85 N.E. 2d 789 (1948).
[30] 83 N.Y.S. 2d at 505.
[31] See *supra* note 12.
[32] See N.Y. S.C.L., section 35.
[33] See *supra* note 15.
[34] 265 N.Y. 416, 193 N.E. 253 (1934).

ginal certificate of incorporation contained no provisions for cumulative voting. Subsequently, however, the stockholders, by a unanimous vote, adopted new by-laws which provided for cumulative voting and at the same time adopted a resolution directing the president and the secretary of the corporation to execute and file the proper certificate amending the original certificate of incorporation by adding a provision for cumulative voting. The officers failed to do so. Thirteen years later, dissension arose in the ranks of the stockholders, and at the election of directors one of the stockholders attempted to vote cumulatively; but his right to do so was challenged by the other stockholders. Hence the action to confirm the election of the directors voted for by him. The court confirmed the election on the theory that all the stockholders agreed on the provision for cumulative voting and that they exhausted their powers when they authorized the officers to file the necessary certificate.[35] It is to be stressed, however, that this is an exceptional case. The corporation was a close corporation; the entire capital stock was owned by only three persons who jointly directed the affairs of the corporation; all of them voted for the provision; and at the time of the controversy they were still the only stockholders of the corporation. As the court said no rights of third parties were involved and no public policy was violated; hence, it was proper to give effect to the agreement of the stockholders and their resolution.

C. PROXY AND VOTING TRUST

So long as voting of shares by proxy is permitted, a stockholder may improve his relative voting power by obtaining authorization from other stockholders to vote their shares under a proxy or voting trust arrangement. Both types are good only for a limited period of time. [36]

Unless coupled with an interest, a proxy is revocable. A pledge or an executory contract of sale is expressly recognized by statute as such an interest. And it has been held that a situation "analogous to a partnership arrangement" confers an interest. In *Hey v. Dolphin,* [37]plaintiff and defendant were joint owners of certain inventions and they were partners in the business of developing and patenting these inventions. They sold those inventions to a corporation in exchange for shares of its stock. Pursuant to the contract of sale between Hey, Dolphin and the corporation, a single certificate of stock was issued jointly to Hey and Dolphin. The contract further provided that Hey and Dolphin was each to own an undivided one-half

[35] 265 N.Y. at 421-22.
[36] See *supra* note 14.
[37] 92 Hun 230, 36 N.Y.S. 626 (1896).

interest in the said stock; that, for the purpose of preventing control and management from passing to persons who might not be qualified nor disposed to make the business of the corporation a success, the certificate should not be surrendered for dividing said stock, nor should it be sold, pledged, or otherwise disposed of for the period of ten years. It was also provided that the shares should be voted by Dolphin as attorney-in-fact, the power of attorney to remain "unrevoked and irrevocable" for the said period of ten years. The court held the proxy agreement good for the entire period. Said the court:

> "It is to be borne in mind that plaintiff and Dolphin * * * were joint owners of the inventions * * * and were partners in the business and developing and patenting those inventions. Evidently their relation existed when the contracts in question were made and they were related to a part of that business. The relation between Hey and Dolphin was not terminated but changed. The common property assumed another form, and its management for a definite period * * * was entrusted to one of the parties. This was the effect of the power of attorney. The consideration for this was ample, as it was a part of the sale of the inventions and the purchase of the stock."[38]

"The test of validity (of a voting trust) is the statute." No voting trust not within the terms of the statute is valid. But any voting trust, if constituted according to the terms of the statute, is legal so long as its purpose is legitimate. There being a statute on the matter, voting trusts do not stand or fall on common-law theories of public policy.[39] Accordingly, the objection under the older case law that voting power can be transferred irrevocably to carry out a particular policy previously arrived at but not to enable the voting trustees to exercise their discretion in formulating corporate policy to be pursued cannot apply.[40] A voting trust created in accordance with the statute is presumed valid until it shall be made to appear that it contravenes an express charter or statutory provision or contemplates some fraud, oppression or wrong against other stockholders or creditors; and it is irrevocable during the period for which it is constituted.[41]

[38] 36 N.Y.S. at 631-32. Further the court said: "It was a power given for a consideration, and Dolphin had an interest in the property itself. The stock being issued to the two together, the power of attorney or proxy was necessary in order to carry out the arrangement." (at 632).

[39] *Matter of Morse* (*Bank of America*), 247 N.Y. 290, 160 N.E. 374 (1928), where the court gave retrospective effect to an amendment to section 50, S.C.L., prohibiting the transfer of stock of a banking corporation to a voting trustee or trustees. See also *Mannheimer v. Keehn*, 41 N.Y.S. 2d 542 (1943), modified 268 App. Div. 813, 49 N.Y.S. 2d 304, amended 268 App. Div. 845, 51 N.Y.S. 2d 304.

[40] *Mannheimer v. Keehn*, 41 N.Y.S. 2d at 547-48.

[41] *Id.* at 548, 556.

D. POOLING AGREEMENTS

By a pooling agreement, stockholders agree to combine their voting strength and vote as a unit with reference to certain policies or courses of action. The suggestion that such an agreement is necessarily bad, because the contracting parties bind themselves to exercise their judgment in a given way in advance of the time when they would be called upon to exercise that judgment in the course of their activities as stockholders, has not received sympathetic treatment from the courts. In *Miller v. Vanderlip*,[42] the Court of Appeals of New York quoted with approval *Brightman v. Bates* [43] where it was said that it "is as legitimate for a majority of stockholders to combine as for other people. The fact that they expect 'gain and advantages' * * * to accrue to them, does not make the combination unlawful." Indeed, the court said, "(if) stockholders want to make their power felt, they must unite." The question is not the legality of the combination *per se*. The question, according to the court, is what they might contract to do. What they may legally do singly, they may do in combination. But it would be unlawful, said the court, "if the gain (to the contracting parties) was to be at the expense of the corporation, or in some way was intended to work a wrong to the other stockholders." [44]

The stockholders may agree to elect themselves directors. But beyond this, considerable difficulty may be encountered. Where stockholders agree not only to vote themselves directors but also agree to employ one another, the agreement is open to attack as against public policy in that directors may not be divested of their discretion in the management of the corporation. The distinction between an agreement simply to elect themselves directors and an agreement to elect or appoint themselves as officers, perhaps, is sustainable on the ground that the former agreement affectes only the duty of the contracting parties to themselves; while the latter agreement affects the duty of the directors to act according to a disinterested judgment. Accordingly, it may be argued that the effect of an agreement among stockholders to employ themselves as officers is to control the board of directors in the free exercise of its power to select and remove officers and employees, to fix their salaries, and determine the tenure of their office; and generally that such an agreement is prejudicial to

[42] 285 N.Y. 116, 33 N.E. 2d 51 (1941).

[43] 175 Mass. 105, 55 N.E. 809, 810 (1900). In *Ringling Bros. Barnum and Bailey Combined Shows, Inc. v. Ringling*, 53 A. 2d. 441 (Del. 1947), the court sustained an agreement for a period of ten years unless sooner terminated by mutual consent that in exercising any voting rights each party will act jointly and that, if they fail to agree, the matter shall be submitted to an arbitrator.

[44] *Miller v. Vanderlip*, 33 N.E. 2d at 54-55.

stockholders not parties to the agreement, subsequent stockholders, or creditors of the corporation. In any case, much would depend on whether all the stockholders are parties to the agreement, whether the agreement precludes removal for cause, and whether the agreement is sought to be enforced against the corporation or only as among the parties.

In the *Miller* case, supra, the court held that the complaint for damages for breach of contract stated a sufficient cause of action against the defendants who were parties thereto. The plaintiff and the defendants bound themselves to form a stockholders' committee for the purpose of rehabilitating a corporation. As part of their plan, they agreed to seek an increase in the number of directors of the corporation; and it was also agreed that the committee would advocate before the new board the adoption of the plan and plaintiff's election as president and general manager for a term of three years and an annual salary of $9,000 plus options on a given price on 38,000 shares. None of the parties were alleged to be stockholders or directors. This the court did not consider important. The court saw no reason why any stockholder or "any outsider, for that matter, may not urge upon the board considerations in favor of or opposed to a proposed course of action in the interest of the company." To listen to arguments advanced by others, according to the court, was not to abandon discretion or judgment of the directors in the premises, but merely to weigh as many factors as possible. Further, the court said that even if it were to be assumed that the parties were stockholders, there was nothing in the complaint from which it could be inferred that the profits which would flow to the proponents of the plan would not equally flow to the other stockholders, except for the fact that the plaintiff would obtain the emoluments of an office, which was alleged to be fair and reasonable and which obviously could not accrue to more than one or, at most, to a very limited number.[45]

But would the directors have been bound to listen to the defendants? Probably not; but in this case, as a result of the work of the committee the number of directors was increased (according to the plan) and the stockholders elected directors who were acceptable to the committee and the parties to this action; and the defendants failed to advocate before the new board the adoption of the plan and the election of the plaintiff as president and general manager. That the contract might have proved illusory either because the plaintiff was not eligible for the position, or because he could not be employed for the full term of three years, or because the defendants did not have control over the actions of the board was no reason, according

[45] *Id.* at 54.

to the court, why the defendants should not be called upon to perform what they had agreed to do in accordance with their abilities and in good faith.[46]

However, in two earlier cases, the Court of Appeals of New York refused to enforce similar agreements or award damages for breach thereof, holding that the agreements exceeded the legitimate power of stockholders to unite upon a course of action or upon the officers whom they will elect and attempted to control the directors in the exercise of their judgment. From this the conclusion was made that the agreements were contrary to public policy. "Clearly the law does not permit the stockholders to create a sterilized board of directors," said the court in the earlier of these two cases, e.g., *Manson v. Curtis.*[47] The situation in the other case, *McQuade v. Stoneham,*[48] was narrower in scope. There was no general sterilization of the board; but there was, according to the court, an attempt to preclude the board of directors "from changing officers, salaries, or policies or retaining individuals in office, except by the consent of the contracting parties."[49] It should be mentioned, however, that in the *McQuade* case there was another ground for the invalidation of the agreement, namely, that the employment of the plaintiff was a prohibited transaction under a statute which prohibited a city magistrate from engaging in any other business, profession, or holding any other paid office.

The offending agreement in the *Manson* case provided:

> "1. That for one year thereafter there should be no change in the business management of the business of the corporation to that theretofore carried out by plaintiff, and that the management thereof should continue in the same manner that it had in the past, and plaintiff should continue as General Manager of the corporation and shape its policy.
>
> "2. That any President of the corporation to be thereafter elected should be only a nominal head as President, and be no more active in conducting the affairs of the corporation than the then President Abel I. Culver had been, and that such President should not change, alter, molest, or interfere with plaintiff's methods of managing the corporate business affairs nor interfere with plaintiff as such General Manager for said one year.
>
> "3. That out of defendant's stockholdings he would sell to plaintiff * * * 20 shares * * * after defendant had acquired Culver's said stock.

[46] *Id.* at 55-56. Said the court further. "The plaintiff's grievance is not simply his failure to receive from the company the offer of employment and its attendant emolument, but the failure of the defendants to keep their promise to urge plaintiff's employment upon the members of the board."

[47] 223 N.Y. 313, 323; 119 N.E. 559 (1918).

[48] 263 N.Y. 323, 189 N.E. 234 (1934).

[49] 263 N.Y. at 330.

> "4. That the defendant and the plaintiff should each name three directors * * * and that a seventh director to be elected should be a disinterested party to be mutually agreed upon by plaintiff and defendant."[50]

In the *McQuade* case, the parties agreed that they would "use their best endeavors" for the purpose of continuing themselves as directors and officers of the company at stated salaries so long as they were stockholders. It was also provided that:—

> "X. There should be no change in said salaries, no change in the amount of capital, or the number of shares, no change or amendment of the by-laws of the corporation or any matters regarding the policy of the business of the corporation or any matters which may in anywise affect, endanger or interfere with the rights of minority stockholders, excepting upon the mutual and unanimous consent of the parties hereto."[51]

It may be a good generalization to say that it is beyond the power of shareholders to control the directors in the exercise of judgment vested in them and that the law does not permit the shareholders to create a sterilized board of directors. It is, indeed, clear that the law places control and management of the business of the corporation in the board of directors and means plainly that in the exercise of their functions directors should be free from dictation by particular shareholders or group of shareholders. Any other arrangement might conflict with their duty to the entire body of shareholders. Much also may be said for the proposition that third persons, including shareholders not parties to the agreement, subsequent stockholders, and creditors of the corporation have a right to expect that a corporation is being run in the interest of the corporation rather than of particular shareholders or groups of shareholders bound by a private agreement among themselves.

But, while this is so, it may perhaps be argued that in the two cases under review (laying aside the second ground of the *McQuade* decision) the pronouncements of the court went beyond the necessities of the problems at hand. Both cases involved intramural squab-

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[50] 223 N.Y. at 316-17. It is to be noted that nothing is said in the agreement about the directors being passive. The court, however, said: "The fundamental and dominant purpose and intent of the parties which necessitated and provided for a passive president of the board of directors necessitated likewise passive directors." (at 322).

[51] 263 N.Y. at 326-327. Lehman, *J.* concurring: "A contract which merely provides for the election of fit officers and adhesion to particular policy determined in advance constitutes an agreement by which men in combination exercise a power which could be lawfully exercised if lodged in a single man. Individual, if designed to protect legitimate interests without wrongs to others *** The contract is unenforceable only because it resulted in an employment which was illegal." (at 340). Compare Lehman's statement in *Miller v. Vanderlip, supra.*

bles among the parties. In both cases, no prejudice to the other stockholders, nor to the creditors of the corporation, nor to the corporation itself was apparent. It was not alleged nor shown that either McQuade or Manson were inefficient, or guilty of any breach of duty to the corporation, or to any of the other stockholders, or of any breach of the contracts in question. As the court found, the "cause for dropping McQuade was due to the falling out of friends." "We will assume," said the court, "that Stoneham put him out when he might have retained him, merely in order to get rid of him." [52] Nor did the defendant in the *Manson* case demur to the complaint on any of these grounds.

In both cases, the defendants, had they chosen to do so, could have, like the defendants in the *Miller* case, done what they had agreed to do in accordance with their abilities and in good faith. In the case of McQuade, he was ousted as officer by the vote of the four directors selected by the defendant Stoneham and over whom he had complete control, the defendants abstaining from voting. And at the next stockholders' meeting he was dropped as director although the defendants as majority stockholders could have elected him. In the case of Manson, the complaint alleged that (after gaining controlling interest by virtue of the contract) the defendant, through dummy directors elected by his votes, deposed the plaintiff as manager.

In both cases, the undertakings of the defendants under the agreements were promised by them in consideration of certain undertakings by the plaintiffs, which the latter performed. In *McQuade v. Stoneham,* the agreement was part of a transaction by which plaintiff and defendant McGraw each purchased shares of stock from the defendant Stoneham. In *Manson v. Curtis,* the complaint alleged that there was an agreement, known to the defendant, between plaintiff and Culver that they would act as a unit "to the end that such policy as the plaintiff might in his good judgment promulgate in the conduct and management of the said Company's affairs, would be acquiesced in and followed by said Culver; "that neither would dispose of his shares without first giving to the other a first option to buy all or any part of the shares; and that Culver would vote his shares as the plaintiff voted his." [53] It was, then, in consideration of the defendant's promise that the plaintiff acceded to the defendant's request for plaintiff's permission to purchase Culver's shares which, added to those already owned by the defendant, constituted the defendant owner of more than one-half of the outstanding shares.

[52] 263 N.Y. at 328.
[53] 223 N.Y. at 316.

Could not the court have sustained the agreements in accordance with its doctrine in the *Miller* case, namely, that the fact that an agreement may prove to be illusory, due to some legal or other impediment, does not excuse a party from performing what he has agreed to do in good faith and as may be within his ability to do? Laying aside the second ground of the *McQuade* decision, could not the agreements in the two cases have been held good as against the defendants in so far as the agreements called for action on the part of the defendants leading to the employment of the plaintiffs and their retention as long as they gave no cause for removal—and bad in so far as they precluded board action in the interest of the corporation?

In this connection it may be observed that a contract of employment to last for as long as the officer in question does not give cause for removal, or, stated negatively, that an officer shall not be removed except for cause has been upheld, notwithstanding the law to the effect that the board may remove any officer with or without cause. [54] The theory seems to be that on this premise directors do not bind themselves to something inconsistent with their duty of exercising an independent judgment in the interest of the corporation. Of course, where there is cause for removal, then an agreement not to remove is no bar to removal; [55] and even where there is no cause for removal an officer or employee, unlike a director, may be removed, inspite of a contract of employment for a fixed term, without prejudice to the right of the officer or employee to recover damages for breach of contract. [56]

One decision [57] has gone so far as to sustain an agreement for the retention of each stockholder as an officer and employee for life. The court was of the opinion that the agreement did not create "a sterilized set of officers and employees nor withdraw from the directors

[54] In *the Matter of Buckley*, 50 N.Y.S. 2d 54 (1944), the court said, "An agreement that directors are to continue a person as officer as long as he shall be faithful, efficent, and competent is legal and valid," and that a by-law that directors are not to remove a person from office without cause is likewise valid as an equally harmless and slight infringement upon section 27, Gen. Corp. Law, and section 60, Stock Corporation Law. (at 58.) See also *In re Roosevelt Leather Bag Co., Inc.*, 68 N.Y.S. 2d 735 (1947).

[55] In *Fells v. Katz*, 256 N.Y. 67, 175 N.E. 516, 517 (1933), it was held that an agreement among stockholders whereby directors are bereft of their power to discharge an unfaithful employee is illegal as against public policy; and that an agreement to continue a man in the directorate must be construed as an obligation to do so as long as he keeps the agreement on his part faithfully to act as a trustee for the stockholders.

See also *Tremsky v. Green*, 106 N.Y.S. 2d 572 (1951).

[56] See notes 16, 17, 18, *supra*.

[57] *Martocci v. Martocci*, 42 N.Y.S. 2d 222 (1943), affirmed 266 App. Div. 840, 43, N.Y.S. 2d 279, appeal denied 266 App. Div. 917, 43 N.Y.S. 2d 517.

that control of the corporate business and that freedom of choice and of removal of officers and employees that the statute preserved to them." It should be mentioned, however, that in this case the parties to the agreement comprised all the stockholders and directors; that the parties not only constituted the three persons who contributed all the capital of the corporation but they owned its shares in equal amounts; that the agreement was conditioned upon the faithful performance of duties; and that the court underlined the circumstances that the corporation was little more than a "chartered partnership" and that neither the rights of creditors nor other persons were involved. "Under such circumstances," the court said, "it has been held that the stockholders may do as they please with their corporate concerns and may agree to perpetuate themeselves as directors, officers, and employees. Under such circumstances, it has been held that an agreement to do so may be enforced." [58]

In *In re Feinson's Estate,* [59] the sole owner of the shares of stock of a corporation made a will among the conditions of which was that each of the legatees of the shares of stock

> "shall agree to vote for and elect my wife, Helene, during her lifetime, as a Director of American Dispenser Co., Inc., and they shall further agree that they will instruct and direct the corporation by their affirmative vote to elect, appoint, and employ my said wife, Helene, during her lifetime as an executive at a salary of $500 per month, said salary to be received by her for services as director and executive * * *" [60]

Holding that the condition was valid, the court said that there was no threatened harm to the state or to the public generally. According to the court's interpretation, the legatees would agree only that they would so instruct the board to employ the widow. "In any event," said the court, "the agreement would not be construed as one to retain her after she proved unfaithful to the duties of her office." Whether it would require a single initial act or a succession of acts to effect the employment of the widow during her lifetime, the stockholders, according to the court, would be required to carry out their agreement in good faith; and the directors may carry out the instructions of the shareholders unless such course of action would conflict with their fiduciary obligations as directors. [61]

Trimming the broad dicta of *McQuade v. Stoneham,* [62] the court in *Clark v. Dodge* [63] enforced an agreement which provided that

[58] 42 N.Y.S. 2d 225.
[59] 196 Misc. 590, 92 N.Y.S. 2d 87 (1949).
[60] 92 N.Y.S. 2d. at 89.
[61] *Id.* at 90-91.
[62] See note 48, *supra*
[63] 269 N.Y. 410, 199 N.E. 641 (1936).

Dodge would so vote his stock and so vote as director that Clark should continue as a director and general manager so long as Clark should continue to be faithful, efficient, and competent; that Clark should during his life receive one-fourth of the net income of the corporations either as salaries or dividends; and that no unreasonable or incommensurate salaries should be paid to other officers or agents which would so reduce the net income as to materially affect Clark's profit. On his part, Clark agreed to disclose to Dodge's son a specified formula for the manufacture of medicinal preparations in which the corporations were engaged; and to bequeath his stock, if no issue survived him, to the wife and children of Dodge. Subsequently, Clark was removed as director and general manager. Ordering the reinstatement of Clark the court said:

> "If the enforcement of a particular contract damages nobody * * * one sees no reason for holding it illegal, even though it impinges slightly upon the broad provision of section 27. Damage suffered or threatened is a logical and practical test, and has come to be the one generally adopted by the courts."[64]

It should, perhaps, be pointed out that the situation in this case is distinguishable from those in the *McQuade* and *Manson* cases in that all the stockholders in this case were parties to the agreement, there being no other shareholders outside of Clark and Dodge; while in the two preceding cases the agreements were entered into by the owners of the majority stock but not by all of the stockholders.[65] Be that as it may, the court in the *Clark* case said:

> "Public policy, the intention of the Legislature, detriment to the corporation, are phrases which in this connection mean little. Possible harm to *bona fide* purchasers of stock or to creditors or to stockholding minorities have more substance; but such harms are absent in many instances."[66]

Of course, where all the stockholders are parties to the agreement, no rights of third persons are involved, and no cause for removal is present, an agreement for employment stands on firm ground. An agreement that the shareholders would vote their shares so as to elect themeselves directors and officers of the corporation was upheld in *Wernick v. Gulkin*,[67] because the corporation was a "closed corporation in which no rights of third persons are involved and no charges of misconduct or breach of duty have been levelled against

[64] 199 N.E. at 642.

[65] The same distinction may be made with respect to the *McQuade* and *Manson* cases, on the one hand, and the *Martocci* and *Feinson* cases, on the other.

[66] See note 64, *supra*.

[67] 172 N.Y.S. 2d 871 (1947).

the plaintiff."[68] In Illinois, the court in *Fitzgerald v. Christy*[69] upheld an agreement which went farther than the agreement in the *Wernick* case. In addition, the agreement provided that so long as the parties owned the stock there would be no change in the salary of any officer except by the unanimous consent of all of them.[70] It was a provision similiar to this which the court in the *McQuade* case found offensive. While the court in the *McQuade* case held that the provision was against public policy, the court in the *Fitzgerald* case pointed out that "the mere fact that the property came to be represented by corporate stock did not interfere with the fact that, being the sole owners of all the property, they were in a position to enter into any contract they saw fit, concerning the use of the property and its management so long as they did not violate any law or interfere with public policy and the public good."[71] On the same theory, the Illinois court earlier held valid in *Kantzler v. Bensinger*[72] a stockholders' agreement, for and in consideration of the sale of 60% of the stock made by plaintiffs, who owned all the stock, to the defendants that the plaintiffs would hold the offices of president, secretary, and treasurer of the corporation for five years at fixed salaries.[73] It may be recalled that a similar situation was involved in *Manson v. Curtis.* The court in the *Kantzler* case said that the owners of the shares had the right to determine the price to be paid for the shares, and added that "it will be time enough to consider the rights of subsequent stockholders and creditors of the corporations when they are before us complaining."[74]

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[68] *Ibid.*

[69] 242 Ill. Ann. 343 (1926).

[70] *Id.* at 346.

[71] *Id.* at 353.

[72] 214 Ill. 589, 73 N.E. 874 (1905).

[73] 73 N.E. at 875-876.

[74] *Id.* at 878.

Other cases along the same line as the *Clark* decision: *Eisenberg v. Rodless Decorations*, 106 N.Y.S. 2d 822 (1951) where the court said that stockholders by their unanimous consent may do as they choose with the corporate assets, provided creditors are not affected; *Lorillard v. Clyde*, 86 N.Y. 384 (1881) where the court held valid an agreement that one of the parties would have the management of the business at the usual commission; that the other party would be guaranteed a dividend not less than 7% per annum for seven years; that the dividends, when earned, shall be declared and paid quarterly; that the manager shall be in good faith and as economical as possible, consistent with the interest of the business; and that no change in the management shall be made, inconsistent with the terms of the agreement, without the assent of the majority of shareholders;—*Kassel v. Empire Tinware Co.* et al. 164 N.Y.S. 1033 (1917) where the court declared valid an agreement that in case of the death of one of the parties his share shall become the absolute property of the others, the latter to pay for the value thereof in installments, and that pending the payment of the price the personal representative of the deceased shall share in

E. AGREEMENTS AS TO QUORUM AND VOTE

As pointed out earlier, one feature of the statutory scheme of management and control is that actions by directors and stockholders are to be made by the vote of a majority, unless the statute requires a different vote. Indeed, it has been said that the corporate form has been invented to get away from the unanimity rule in partnerships. [75] And the rule that the will of the majority binds the minority to a corporate act has been more or less shielded from agreements calling for a greater number or proportion of vote by an encrustment of arguments ranging from intrinsic reasonableness of the rule to common law principles and from republican principles of government to public policy. [76]

Thus in *Benintendi v. Kenton Hotel, Inc.*, [77] the Court of appeals of New York declared void a by-law which provided that no action shall be taken by the stockholders except by the unanimous vote of all of them. The court was of the opinion that this by-law was "obnoxious to the statutory scheme of stock corporation management." Every corporation must have, according to the court, "a representative government, with voting conducted conformably to statutes, and the power of decision lodged in certain fractions, always more than half, of the stock." "That whole concept," continued the court, "is destroyed when the stockholders, by agreement, by-law, or certificate of incorporation provision as to unanimous action, give the minority interest an absolute, permanent, all-inclusive power to veto." This

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the profits of the business—the court saying that as the parties are "the complete owners of the corporation, there is no reason why the exercise of the power and discretion of the directors cannot be controlled by valid agreement between themselves, provided that the interests of creditors are not affected;" See also *Glonim v. Brodie*, 109 N.Y.S. 440 (1952).

[75] *Kaplan v. Block*, 183 Va. 327, 31 S. E. 2d 893, 896 (1944).

[76] Thus run the testimonials for the majority rule:

"It is the theory of the law that the holders of the majority of the shares of stock in a corporation may control its management, and every person who becomes an owner of stock therein has a right to believe that the corporation will, and to insist that it shall, be managed by the majority." *Morel v. Hoge*, 130 Ga. 625, 632 (1908).

"*** in share holdings plaintiffs in error are predominant. It conforms to the philosophy of free government, therefore, and the justice which such a government guarantees and protects, to determine that plaintiffs in error may not equitably be denied the rights and privileges due those whose chorus swells from preponderating voices." *Kullgren v. Navy Gas and Supply Co.*, 110 Colo. 454, 466 (143).

"*** it seems to be the first suggestion of reason, that an act done by a simple majority should be binding on the whole: this is the principle of the rule adopted by the common law of England with respect to aggregate corporation ***" 1 KYD, CORPORATIONS, 308; STEVENS ON CORPORATIONS, note 1, at 308 (1949).

[77] 294 N.Y. 112, 60 N.E. 2d 829 (1945); noted, 45 *Col. L. Rev.* 960; 20 *N.Y. U.L. Rev.* 513; 19 *St. John's L. Rev.* 144 (1945).

the court could not permit, because the state, "granting to individuals the privilege of limiting their individual liabilities for business debts by forming themselves into an entity separate and distinct from the persons who own it, demands in turn that the entity take a prescribed form and conduct itself, procedurally according to fixed rules." [78]

With respect to a by-law which provided that the directors of the corporation shall be elected by the unanimous vote of all the stockholders, the court took the position that such device, whether incorporated in the certificate of incorporation or in a by-law, was "intrinsically unlawful because it contravenes an essential part of the State policy," meaning that it violated section 55 of the New York Stock Corporation Law which provides that directors shall be chosen "by a plurality of the votes at such election." [79]

A by-law providing that no action shall be taken by the directors except by the unanimous vote of all of them was likewise declared void by the court. To the court such a provision was "unworkable and unenforceable for the reason given by the Court of King's Bench in *Hascard v. Somany*, 1 Freeman 504, in 1993: 'prima facie' in all acts done by the corporation, the major number must bind the lesser, or else differences could never be determined." The court found that at common law only a majority of the board was needed for a quorum and a majority of the quorum was all that was necessary for the transaction of its business. Taking note of Section 27 of the New York General Corporation Law, which provides that a by-law may fix the quorum "at a number *less* than a majority of the board, but *not less* than one-third of its number," the court interpreted the section as permitting a by-law which fixes the quorum "at any fraction not less than one-third, *nor more* than a majority of its directors." "But," said the court, "the very idea of a quorum is that when that required number

[78] 60 N.E. 2d at 830, 831. The court made it clear that stockholders may "individually bind themselves in advance to vote in a certain way or for certain persons," and that it was not holding that "an arrangement would be necessarily invalid, which, for particular decisions, would require unanimous consent of all stockholders." (at 831).

See also *Christal v. Petry*, note 15, *supra*, where the court declared void a by-law requiring 75% of voting stock to amend certificate of incorporation so as to increase the number of directors; *Eisenstadt Bros. v. Eisenstadt*, 89 N.Y.S. 2d 12 (1949) where the court sustained the discharge of employees by a majority of stockholders and directors, notwithstanding a by-law requiring action by 90% of the stockholders.

[79] 60 N.E. 2d at 830.

In the Matter of Boulevard Theater and Realty Co., (CANY), 132 N.E. 910 (1921), the court held that a similar provision in the certificate of incorporation was null and void, because of the mandatory language of the law, the common law rule, and because of public policy "since it may work a fraud upon the public who may purchase such shares in ignorance of the certificate provisions in question." (at 843 N.Y.S. 430, 433).

of persons goes into session as a body, the votes of the majority thereof are sufficient for compelling action." The court conceded that the by-law in question was not expressly forbidden by section 27, nevertheless to the court "it seems to flout the plain purpose of the Legislature." Reading together sections 27 and 28 of the General Corporation Law, the court concluded that "there never was a legislative intent so to change the common law rule as to quorum as to authorize a by-law like the one under scrutiny." [80]

On the other hand, the court saw no invalidity in a by-law requiring unanimity of action of all stockholders in order to amend the by-laws. Said the court:

> "The State has an interest in seeing to it that such 'private laws' or by-laws as the corporation adopts are not inconsistent with the public law and not such as will turn the corporation into some other kind of entity. But, once proper by-laws have been adopted, the matter of amending them is, we think, no concern of the State." [81]

Invocation of public policy is all very well. But it is to be remembered that public policy is in its nature ordinarily difficult to fix, uncertain, and fluctuating. Care must be taken that recourse to public policy does not trespass upon the freedom to contract so long as the exercise of that freedom does not violate some definite policy of the law and so long as it causes or threatens no injury to the public. To maintain a finding of public policy, and thereby abridge freedom to contract, the statute must leave no room for doubt that it was the intention of the legislature to require one thing and to leave no right to anyone to do another thing. And in the absence of a clear mandate the circumstances must be such that to sanction a different course would be to threaten or cause a public harm.

At least, with respect to sections 27 and 28 of the General Corporation Law, the language of the statute was equally susceptable of being interpreted as permissive, rather than prohibitive, of a by-law

[80] 60 N.E. 2d at 831-32. Conway, dissenting, stressing that the owners of 100% of the stock may do as they will provided rights of third persons are not involved and the public policy of the state is not violated. (at 834, 835-36.)

[81] 60 N.E. 2d at 832. In *Prigerson v. White Cap Sea Foods, Inc.*, 100 N.Y.S. 2d 881 (1950), the court voided a by-law provision requiring a quorum and vote of 65% at stockholders' meetings, a by-law requiring a quorum of 85% and a vote of 70% at directors' meetings; and declared valid a by-law requiring a vote of 65% to amend the by-laws. (at 884-85); In *Goldfarb v. Dorset Products*; 82 N.Y.S. 2d 42 (1948), the court voided a stockholders' agreement requiring concurrence of more than a majority of the quorum of the board of directors, but declared that a majority of the stockholders may amend or repeal the by-laws in the absence of a stockholders' agreement restricting the right of a majority to do so. (at 44-45.) See also *Katz v. H. & H. Mfg.*, note 15, *supra*.

prescribing unanimity for directors' action. Indeed, the majority opinion of the court conceded that the third by-law was not expressly forbidden by section 27. And the dissenting opinion underscored the clause "Unless otherwise provided" which qualified the language of section 27, and the clause "except when otherwise expressly required by law or the by-laws" which qualified the language of section 28. It is not quite clear how the third by-law was "utterly inconsistent," in the opinion of the court, with these sections of the law. It must be said, however, that with respect to the second by-law the holding of the court rested on firmer ground. Section 14 (5) of the General Corporation Law provides that a corporation has power to make by-laws "not inconsistent with law," and section 55 of the Stock Corporation Law states that directors "shall be chosen . . . by a plurality of the votes."

It may be that public policy demands that corporate action be taken conformably to statutory provisions relating to quorums and votes, for persons dealing with a corporation have a right to assume that it is so. It may be that ordinarily unanimity would be unattainable and thus likely to paralyze the corporation. It may be that shareholders ordinarily have the right to expect that the will of a majority of them or other number or proportion established by law could bind the corporation in matters reserved by statute for their action. It may be that the shareholders have a right to expect also that the majority of the board of directors shall be sufficient to take action.

But in this case it is to be noted that all the capital stock of the corporation was owned by only two persons in unequal shares, both of whom voted for and adopted the by-laws in question. Having done so, did any one of them have the right to expect that action by shareholders or directors shall be by a vote less than that which they themselves provided? The case involved a question which affected them only. In no way involved in the controversy were third parties, whether other shareholders or creditors of the corporation. Under these circumstances, it seems that to invoke public policy to avoid a contract between the parties would be to carry it far beyond what it is designed to protect, namely, the public good. As well said by the dissenting opinion, after observing that rights of creditors were not involved:

> "A totality of stockholders may agree among themselves as to how they shall or shall not vote shares of stock owned by them. They may by agreement waive or relinquish as between themselves statutory rights where such waiver or abandonment is not contrary to the public interest." [82]

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[82] See note 80, *supra*.

To be sure, the court did not hold, as the court said so itself, "that an arrangement would necessarily be invalid, which, for particular decisions, would require unanimous consent of all stockholders." What it found objectionable was such provision as would give the minority "an absolute, permanent, all-inclusive veto." [83] The court thus drew a line between the case immediately before it and that which was involved in *Ripin v. U.S. Woven Label Co.* In the latter case the court did not find objectionable a provision in a certificate of incorporation that:

> "The number of its directors is to be four (4); said directors shall not be required to be stockholders of said corporation; and said number shall not be changed, except by the unanimous consent of all the stockholders of said corporation." [84]

It is rather surprising that the court in the *Benintendi* case should, as it did, express approval of specific provisions requiring unanimity for particular decisions and in the same breath reject all-inclusive provisions. It would seem that any difference between these two types of provisions would be but a matter of degree. The principle involved in either type seems to be the same. It is strange that with respect to particular decisions, the court should find that public policy is not offended, as it so found in the *Ripin* case where the court said:

> "When the statute provided for the organization and internal regulation and management of corporations it was necessary to prescribe many details which did not involve public policy or the relation of the corporations with the public. It was necessary simply because there had to be some rules or regulations on the subject. Appreciating this, the lawmakers, while prescribing general rules in default of agreement to the contrary, permitted the incorporators, by agreement at the inception of the corporation and embodied in the certificate by which the corporation got life, to regulate these unessential matters in such manner as they might agree." [85]

Of major significance is the departure of the *Benintendi* decision from earlier decisions, particularly *Clark v. Dodge.* [86] in which the

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[83] See note 78, *supra.*

[84] 205 N.Y. 442, 98 N.E. 855 (1912).

[85] 93 N.E. at 856. The court suggested that, in veiw of the possibility of abuse of power by a majority, the law permits the parties by their original agreement of incorporation to limit their respective rights and powers in respects that did not affect the public. The court also said that a limitation, which, "if found in the certificate of a mere trading company, would have no relation to the public or public policy might, in the case of a quasi-public corporation, present a different question." Finally, the court distinguished between a provision found in the certificate of incorporation and a by-law—a distinction which the *Benintendi* decision abandoned. (at 856-57.)

[86] See notes 63 and 74, *supra.* See also *Matter of American Fibre Chair Corporation*, note 34, *supra; Matter of Buckley*, note 54, *supra; Fitzgerald v. Christy*, note 69,

courts, employing the test of damage, held that where all stockholders consent they may as owners of the corporate stock provide for its management in the manner they desire so long as the rights of third parties are not prejudiced thereby. This deviation is probably explainable in the light of the recurring theme in the court's decision, namely, that the law imposes the corporate form as the price which persons seeking limited liability through incorporation have to pay. If that be the price, should it not be exacted in a manner which bears some relation to the rights of creditors? But here there was no question of liability of the corporation or anyone else for the debts of the corporation. The litigation was between the parties to the contract and no other. Obviously, the decision rests on a dry consideration of public policy. Under the court's thesis, the law establishes a scheme of management of corporate affairs which does not admit of the exercise of an "absolute, permanent, and all-inclusive" veto by an individual director or a stockholder representing a minority interest. Parties may not, according to the court, be permitted to transform a corporation into some other form of entity. What the court probably meant by this was that persons may not be a corporation to the whole world and a partnership among themselves.

This idea is, by no means, novel. Thirty-five years earlier, the New Jersey court in *Jackson v. Hooper* [67] said:

> "The law never contemplated that persons engaged in business as partners may incorporate, with intent to obtain the advantages and immunities of a corporate form and then, Proteus-like, become at will a copartnership or a corporation, as the exigencies or purpose of their joint enterprise may from time to time require.
>
> "The policy of the law is to the contrary. If the parties have the rights of partners they have the duties and liabilities imposed by law and are responsible *in solido* to all creditors.
>
> "If they adopt the corporate form, with the corporate shield extended over them to protect them against personal liability, they cease to be partners and have only the rigbts, duties, and obligations of stockholders. They cannot be partners *inter sese* and a corporation as to the rest of the world." [88]

On this theory, the court held that the parties were as a matter of law shareholders and not partners, notwithstanding an alleged agreement

supra; Martocci v. Martocci, note 57, *supra; Kassel v. Empire Tinware*, note 74, *supra; Kantzler v. Bansinger*, note 72, *supra;* Decisions subsequent to the *Benintendi* opinion, which adhere to the *Clark* line: *In re Feinson's Estate*, note 59, *supra; Eisenberg. v. Rodless Decorations*, note 74, *supra; Slonim v. Brodie*, note 74, *supra; In re Block's Will*, 60 N.Y.S. 2d 639 (1946.)

[87] N.J. Eq. 592 (1910).

[88] 76 N.J. Eq. at 599.

to the effect that the general policy of the corporation "should be determined by mutual assent, each to have and exercise the authority and control of equal partners," the other directors to be merely dummies.

The pronouncements of the New Jersey court should be understood in relation to the remedy sought and the theory of the complainant. The complaint prayed for receivership, injunction, and dissolution of going corporations on the theory that they were in fact partnerships and that the defendant had breached the alleged partnership agreements. None of the grounds on which the corporations could possibly have been placed under receivership for the purpose of dissolution were alleged. The remedy prayed for could perhaps have been granted only on the theory that the associations were partnerships and not corporations. The complainant was not only asking for the enforcement of a stockholders' agreement within the corporate norm—he was seeking to avoid the corporate form in order to enforce alleged partnership agreements. So, perhaps, the opinion of the court —or so much of it to the effect that shareholders "cannot be partners *inter sese* and a corporation to the rest of the world"—should not be taken as barring, in general, stockholders' agreements as to control which vary the corporate norm and, in particular, agreements vesting an individual director or minority stockholder with a veto power.

On the other hand, in *Little v. Garabrandt*,[89] the stockholders treated the assets of the corporation "as if it were a partnership." It was a family corporation; and all of the family expenses, rent, fire insurance, taxes, contributions to charity and religious organizations, and the insurance on the life of a stockholder payable to his wife or to his legal heirs were paid out of the corporate funds. The Supreme Court of New York, proceeding on the theory that stockholders are the equitable owners of the corporate property dismissed the action instituted by the receiver of the corporation to recover the insurance policy, there being no evidence that the corporation was insolvent at the time of the making of the payments for the premiums, nor that the indebtedness of the corporation to any of its creditors arose prior to such payments, and all the stockholders having assented to the way in which the corporation was run.[90] Obviously referring to this case, the dissenting judges in *Benintendi v. Kenton Hotel* argued: "Clearly nothing could be more against public policy or the public interest than larceny or conversion and yet unanimous consent or ratification validates even such acts."[91]

[89] 97 N.Y. (90 Hun), 404 (1895).
[90] *Id.* at 409.
[91] 60 N.E. 2d at 835.

At any rate, the *Benintendi* decision prompted the law revision commission of New York to study the necessity and desirability of some statutory recognition of the special problems of close corporations. The failure of the court in the *Benintendi* case to treat a close corporation differently from a publicly held corporation, led the commission to believe that there was a need for making the statutory scheme "more directly analogous to the partnership and thus more suited to the economic needs of the close corporation." [92] Section 9 of the New York Stock Corporation Law is the product of the commission's study. It is far from being a complete close corporation law, for, indeed, the commission decided to defer the general revision of the statutes to simplify the structure and functioning of close corporations.[93] But it is a beginning in that direction.

III. PROTECTION AND ENHANCEMENT OF MINORITY INTERESTS UNDER SEC. 9, N.Y.S.C.L.[94]

A. APPLICABILITY LIMITED TO CLOSE CORPORATIONS

For all practical purposes, the provisions of Section 9 are available only to closely held corporations as distinguished from publicly held corporations. In this respect, the New York statute differs from similar statutes in other states. [95] This limitation on its applicability has not been achieved by means of defining what a close corporation is and making the statute applicable only to such corporations as fit the defination. The commission did not think it desirable. [96] Instead, the statute requires a unanimous vote or nearly unanimous vote for the adoption, amendment, or repeal of a provision authorized by it. [97] This requirement makes it hardly conceivable that one would, for the purpose of adopting a provision authorized by section 9, undertake the task of marshaling the votes of the stockholders of a public-issue corporation who very likely are numerous and

[92] See *N.Y. Law Rev. Comm'n Rep.*, 385, 387 (1948).

[93] *Id.* at 386.

[94] See note 1, *supra*.

[95] *Ibid.*

[96] ". . . No satisfactory way of defining the genuine close corporation for purposes of a statute has been found. Economically, the distinction between a close corporation and any other is that in the close corporation management and ownership are substantially identical, but the only way in which it appeared to the commission could be embodied in a statute would be to limit the amendment to corporations having not more than a stated number of shareholders, or not more than a stated amount of capital. This would necessarily be arbitrary, might not provide an adequate answer to the economic problem, and would possibly permit a single shareholder by splitting up his shareholding to break up the arrangement at will unless the remaining shareholders or the corporation bought him out." See note 92, *supra*, at 386.

[97] See par. 2, section 9, N.Y. S.C.L.; L 1951, Ch. 717.

scattered. And, if he suceeds in doing so, the problem of amendment or repeal of the provision would present the same difficulties.

It may then be asked if the limitation of its applicability to close corporations is reasonable. Stated differently, it may be asked if it is advisable to grant an individual director or a minority stockholder in a close corporation, while denying the same to a director or shareholder in a publicly held corporation. Certain differences between these two types of corporations suggest the need for the difference in treatment.

The capital stock of a public-issue corporation ordinarilly is diffused among a large number of shareholders. With the number of stockholders in the hundreds and even thousands, it would be too optimistic to expect the presence or representation or assent of all or nearly all of them at stockholders' meetings. The average stockholder does not own a substantial portion of the capital stock.[98] Usually not holding an office or employment in the corporation, his interests are limited to hanging on to his shares with an eye fixed on the fluctuations of the stock market for a chance to make money on the sale of his shares, and to receiving dividends. Diffusion of capital stock also makes possible the concentration of control and management among a few, leaving the average stockholder in the dark about the details of the problems of management.[99] As for directors, it is not unusual to find one who is not even a nominal stockholder of the corporation. And he might have been chosen for reasons other than to give representation to certain stockholding interests. It is indeed, a practice among large, publicy held corporations, to have on their boards representatives of outside interests, experts, professional and technical men, chosen for the value to the corporations of their connections or judgment.[100] Ordinarily, the size[101] of the board of directors is sufficiently large to make a unanimous or nearly unanimous vote difficult to reach. Again, the diffusion of capital stock which makes it possible to concentrate control and management among a few augments the position of executive officers and reduces the board to an advisory group.[102]

All of this make the possession of the veto power by an individual director or minority stockholder of a publicly held corporation out of proportion to his interests and functions and quite risky besides. It might, indeed, be an invitation to paralyzation of the corporation.

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[98] See BERLE AND MEANS, *op cit.* note 25 *supra*, Chapter V.

[99] *Id.* Chapter VIII.

[100] See note 26, *supra.*

[101] In 155 large corporations in 1935, the smallest board had 6 members and some had 21 or more. Gordon, *op. cit.* note 25 *supra*, at 117-18.

[102] See note 25, *supra.*

On the other hand, a close corporation is, as it has been described, a corporation *de jure* and a partnership *de facto*. It might be a corporation to the whole world; but in expectations and interests the shareholders are in fact partners.[103] Their interests do not consist mainly in the expectation of sharing in the dividends or of profiting on the sale of their shares. While a stockholder in a publicly held corporation may very well regard his contribution to the capital as a mere investment supplementing his other sources of income, the participation of a shareholder in a close corporation may be his main, if not sole, means of income. In a closely held corporation, the stockholders are usually directors, officers, and employees of the corporation. The market for the securities of a close corporation being limited, the stockholders look to their salaries as directors, officers, and employees as a return on their capital investment. Being intimately and directly affected by acts of management and control, the actions of the board and the body of stockholders are of major concern to them. More like partners than shareholders, they choose their associates; and it is important to them that a person elected or appointed to a corporate office be one acceptable to the greatest number possible.

It is for the protection of these interests that an individual director or stockholder should be permitted to have a voice in corporate affairs larger than that which comes with the right to cast a lonely minority vote against a majority. Actively participating in the running of the corporation and thus situated as to know and understand the problems of the corporation, the veto power should be safe with him. The stockholders and directors being usually few in number and closely associated, the probability of irremediable dissensions among them should be small.

Indeed, the differences between the close corporation and the publicly held corporation have inspired suggestions for reform of corporation statutes.[104] It has been pointed out that the typical American corporation statute treats these two types without distinction, and attention has been drawn to foreign laws dealing with the close

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[103] Describing the close corporation, Israels wrote: " *** A corporation which management and ownership are substantially identical to the extent that the independent judgment of directors is, in fact, a fiction, typically organized by an individual, or a group of individuals, seeking the recognized advantages of incorporation, limited liability, perpetual existence and easy transferability of interests—but regarding themselves much more akin to the partnership relation than to the statutory scheme of representative corporate government." Israels, "The Sacred Cow of Corporate Existence; Problems of Deadlock and Dissolution," 19 *U. Chi. L. Rev.* 778 ('52)

[104] See, e.g., ROHRLICH, LAW AND PRACTICE IN CORPORATE CONTROL, 215 (1933); Winer, "Proposing a New York's Close Corporation Law," 28 *Corn. L. Q.* 313 (1943).

corporation. Section 9 is a recognition of the differences between these two types of corporations.

B. VOTE NECESSARY FOR THE ADOPTION, AMENDMENT, OR REPEAL OF A PROVISION AUTHORIZED BY SECTION 9

Care has been taken to make the requirement for consent necessary for the adoption, amendment, or repeal of a provision authorized by section 9 commensurate with the nature of the provision to be adopted, amended, or stricken out.[105] Thus, if the provision adopted, changed, or stricken out by an amendatory certificate specifies, either before or after the change, that all the directors shall be present at any meeting of the directors to consitute a quorum, or that the votes of all directors shall be necessary for the transaction of any business at any meeting of directors, or that the votes or consents of holders of all shares shall be necessary for the transaction of any business at a meeting of the stockholders, then the filing of the certificate shall be authorized by the votes of the holders of all the outstanding shares of each class entitled to vote. For the adoption, amendment, or repeal of any other provision authorized by section 9, i.e., a provision requiring less than unanimity but greater than the minimum proportion of votes required by statute, it is sufficient if the filing of the certificate is authorized by the holders of record of two-thirds of the outstanding shares of each class entitled to vote, unless the certificate of incorporation or other certificate filed pursuant to law requires a larger proportion of votes.

Care also has been taken to make the rules uniform for adoption, amendment, and repeal. A distinction in the minimum consents between adoption and subsequent change or abrogation might be unduly confusing and might not protect those to whom the veto power is an inducement for investing in the corporation. If for the adoption of a provision authorized by section 9 it is required that all must consent, but nothing is said about the proportion of votes necessary to amend or repeal the provision, then the votes of the majority would be sufficient to impair the veto power of the minority. Further, unanimity is required for the adoption of a provision for unanimity in order to ensure due consideration of the hazards involved in departing from the majority rule.[106]

So that purchasers of shares of stock of the corporation (as well as those dealing with the corporation) might be informed of the existence of a provision authorized by section 9, certain safeguards are established by law. Firstly, it is required that the provision for una-

[105] See note 97, *supra.*

[106] 1951 Leg. Doc. No. 65 (H); McKinney's 1951 Sess. Laws of N.Y., 1431-32.

nimity or qualified majority be contained in the original or amendatory certificate of incorporation, rather than in the by-laws or other agreement.[107] This is to make certain that there will be a public record of the requirement. Secondly, it is required that notice of the existence of such a provision appear plainly on the face or back of every certificate of stock issued by the corporation.[108]

C. DURATION

As originally enacted, section 9 provided that a requirement for a quorum or vote of directors or shareholders authorized by the section shall not be valid unless the certificate of incorporation or other certificate filed pursuant to law specified a period no longer than ten years for the duration of the effectivity of the provision.[109] This restriction has been deleted upon the recommendation of the law revision commission. The commission was of the opinion that:

> "* * * The effect of automatic expiration of such a provision, however, may be to withdraw the special safeguards for protection of interests of minority stockholders which were a primary condition of the participation of those stockholders in the venture. The present statutory rule that such a provision may be made effective only for a ten-year period may force prudent investors who rely on the provision to insist that the corporate life itself must be limited to the same period."[110]

Nevertheless, this result does not appear to be unfair to minority stockholders, for the termination of the effectivity of the provision is merely the consequence of an agreement to which they are a party. If such investors insist that the corporate life be limited to a like period and the others agree, then, what is wrong with such an agreement? If the others do not give in to their insistence, then the prudent investors should not join the enterprise. If nevertheless they join the venture, then they should not insist later that the corporation be dissolved.

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[107] This was the distinction made by the court in *Ripin v. U.S. Woven Label Co.* notes 84 and 85, *supra.*

[108] Before the 1951 amendment (L. 1951, Ch. 717), subdivision 2(b) of section 9 required that an amendatory certificate containing a provision authorized by the section must be subscribed and acknowledged by every subscriber of the certificate of incorporation. Notwithstanding this requirement, however, the court in *Boornazian v. Sarkisian,* 110 N.Y.S. 2d 350 (1952), held that it was sufficient that the parties by their action and conduct had ratified and confirmed the amendatory certificate.

The requirement of notice is found in sec. 65, S.C.L.

[109] See subdivision 3, section 9, L. 1948, Ch. 862. The ten-year period was selected in analogy to voting trusts under section 50, S.C.L. and to a partnership agreement. *N.Y. Law Rev. Comm'n Rep.,* 387 (1948).

[110] 1951 Leg. Doc. No. 65 (H); *McKinney's 1951 Sess. Laws of N.Y.,* 1432.

It should be said, however, that the removal of the restriction is probably desirable. The parties are free to stipulate a period. They may stipulate a period for as long as they wish, or they may not stipulate a period at all. The parties may stipulate as they deem necessary in view of the needs of their organization. It is probably advisable to stipulate a period for such length of time as will give the provision a fair trial. If the trial proves successful, then the parties may amend the provision to extend its effectivity for a definite period, or, by not providing for a definite period of extension, they may continue its effectivity indefinitely. If the trial proves unsuccessful in the opinion of all or such proportion of votes as may be necessary, then it is no problem to strike it out or change it. If the trial proves successful in the opinion of the majority but not of all, then the provision should stand in the interest of the greater number; and the minority should be prepared to wait for the expiration of the period to which they have agreed after all. If the provision does not prove to be to the liking of the majority, the provision should stand for the protection of those who, upon the existence of the veto power for the period stipulated, joined the venture; in the meantime the majority should wait for its automatic expiration upon the termination of the period to which, after all, they have agreed. At any rate, with a period fixed, the stockholders, who later on change their minds about the desirability of the provision, might let things ride and smooth themselves out. On the other hand, if no period is stipulated, then the provision might not get a fair trial because a deadlock might lead to dissolution of the corporation, since dissolution might appear to be the only remedy.

D. TYPES OF PROVISIONS AUTHORIZED

The authorization contained in section 9 refers both to directors' meetings and stockholders' meetings, to quorum as well as to the number or proportion of votes, and to all business or items of business of any meeting. [111]

It is then possible to provide in the original or amendatory certificate of incorporation for a number or proportion of votes greater than majority or other statutory minimum for directors' meetings and/or stockholders' meetings for purposes of a quorum and/or vote. It may be provided that a number greater than majority shall be necessary to constitute a quorum but leaving the number or proportion of votes at majority or other statutory minimum. This would have the beneficial effect of compelling shareholders and directors to attend meetings, at the same time making it easier to arrive at a decision

[111] See note 2, *supra*.

than if a greater vote is also required. It may be provided that the quorum shall remain at majority but requiring a vote greater than majority of the quorum or other statutory minimum. Compared to the first one, this provision will serve as an insurance against adjournment for lack of attendance and at the same time give greater assurance that an action taken and passed is advisable than if a majority of the quorum is sufficient to carry a resolution. It may be provided that, for purposes of a quorum as well as for the approval of a proposal, a number or proportion greater than majority or other statutory minimum be in attendance and voting affirmatively. This would have the advantages of the first and the second provisions, but it would have the disadvantage of making decision more difficult to reach. A provision of this kind would give the greatest measure of protection to minority interests. To reduce the possibility of deadlocks, shares may be classified into voting and non-voting, and the number of directors necessary to constitute a quorum may be placed at the minimum number allowed by law.

Since the likelihood of a stalemate or deadlock bears some relation to the size of the deliberating body, the number of directors and stockholders entitled to vote, as well as the relative importance of an item of business, should be considered in adopting a provision authorized by section 9. Where there are only three directors or stockholders entitled to vote, requiring the attendance or votes of all of them, instead of a simple majority, would mean one more member will have to be in attendance or voting affirmatively. On the other hand, where there are, say, seven members constituting a body, it would mean that three members more will have to be present and four members more will have to vote affirmatively than if a simple majority is sufficient. With regard to the relative importance of an item of business and the probability of deadlock, it might be advisable to reserve the provision for unanimity or qualified majority for important matters, a vote greater than majority or other statutory minimum but less than unanimous vote for less important items, and a simple majority for the rest.

E. PROVISIONS FOR DISSOLUTION IN CASE OF DEADLOCK

With reference to a provision of the kind authorized by section 9, the fear has been expressed that it would invite deadlock and would permit a dissenting director or stockholder, in the words of *Kaplan v. Block*, to "embalm his corporation and to hold it helpless *** in a state of suspended animation." [112]

To meet this contingency, subdivision 4 of section 9 provides that nothing contained in section 9 shall be construed to limit the power

[112] 183 VA. 327, 31 S.E. 2d 893, 896 (1944).

of a court of equity to decree a dissolution in a proper case. Elsewhere, the General Corporation Law, section 103, 2d paragraph, enumerates two causes for judicial dissolution, to wit: (1) where the directors are divided respecting the mangement of the corporation's affairs in such a way that the requisite number of votes for action by the board or directors cannot be obtained and (2) where the votes of the stockholders are so divided that the requisite number of votes for election of directors cannot be obtained.

While the second paragraph of section 103 is a new addition to the section,[113] and has not received judicial interpretation, there is no indication in its language nor in its history [114] that it sets up causes for dissolution inconsistent in content with those established by the first paragraph. It is fair to say, then, that problems which might arise under the second paragraph of section 103 would call for solutions in harmony with the interpretation which the courts have given to the first paragraph.

Accordingly, it would seem that the mere failure of the board of directors, respecting the management of the corporate affairs, or of the stockholders, respecting the election of directors, to arrive at a decision by a unanimous vote or by a vote of a qualified majority, whichever may be required, may not standing alone constitute sufficient cause for dissolution. A petition for dissolution addresses itself to the exercise of sound discretion by the court. In the exercise of discretion, the courts are guided by certain considerations. Proof of irreconcilable division seems to be a primary consideration. Mere difference of opinion or judgment, or a division at a particular time which is only temporary or remediable are not sufficient. Necessity is also a factor—dissolution must appear to be beneficial to the stockholders or to the creditors of the corporation, as where the division prevents efficient management or renders the attainment of the objects of corporate existence impossible or places the creditors in jeopardy.

In *Application of Cantelmo*, [115] petitioner and respondent each owned 50% of the stock of the corporation. Alleging their failure to agree on the third impartial director, petitioner sought dissolution on the ground of failure to elect a board of directors. The court dismissed the petition in view of the circumstances, namely, that the petitioner had not made a *bona fide* attempt to agree with the respondent upon a third director, his purpose being obviously to force the respondent out of the business and keep for himself the business built

[113] Added by L. 1951, Ch. 717, sec. 3, effective September 1, 1951.
[114] See note 110, *supra*, at 1432-33.
[115] 88 N.Y.S. 2d 604 (1949). Noted, 50 *Col. L. Rev.* 100 (1950).

up over the years by their joint effort;[116] the business was functioning actively and profitably; and there was no real difference in opinion between the parties as to management.[117] "We see no reason," said the court, "why the courts should, under the circumstances here presented, lend themselves to the accomplishment of the purpose sought by the petitioner . . .," a purpose personal to him and certainly not for the benefit of either himself or respondent as stockholders. The sole desire of a stockholder to get control of the business was not, according to the court, one of the purposes for which the section on dissolution was enacted.[118]

In *Application of Anderson, Inc.*,[119] the basis of the petition was that the stockholders were so divided that they were unable to elect directors. The entire capital stocks of the two going corporations were owned equally by petitioner and respondent, husband and wife. The corporations were managed by respondent, and the petitioner had no active part in the management. For years, the petitioner, the respondent, and an employee of the corporations served as the board of directors. Then the employee resigned. At a meeting of stockholders, which was called upon the request of the petitioner for the purpose of electing directors, the petitioner insisted that her father, herself, and an employee of her father constitute the board, and she rejected respondent's suggestion that a board of directors consisting of himself, the petitioner, and an employee of the corporation familiar with the business be elected. It was this impassé which the petitioner claimed as basis for dissolution. It seemed that the difficulties between the two stockholders stemmed from marital differences, although the parties still resided under the same roof with their children. The corporations were neither insolvent, nor were the rights of creditors in jeopardy or in any way involved. Allegations of mismanagement were made but they were made simply upon information and belief. And no facts were alleged indicating that the deadlock had affected the corporate functions because of a paralyzing failure of management. In view of these circumstances the court could not perceive how dissolution of the two going concerns could be beneficial to the interests of the stockholders.[120] It should be noted that apparently the court could not bring itself to believe that the

[116] *Id.* at 605.

[117] *Id.* at 606.

[118] *Ibid.* The dissenting opinion stressed the fact that the respondent himself threatened dissolution and argues that the situation of a close corporation with two 50% stockholders, "in irreconcilable dissension and engaged in constant legal warfare under circumstances where corporate success and efficiency imperatively demand co-operation, is one calling for the relief provided by statute." (at 608.)

[119] 104 N.Y.S. 2d 184, affirmed 107 N.Y.S. 2d 556 (1951).

[120] 104 N.Y.S. 2d at 186-87.

parties were irreconcilably split over questions of management, viewing as it did the differences to be the result of marital difficulties, and that it would be equitable to order the dissolution of the two going concerns as a result of an attempt by the petitioner to exclude from the board the respondent, an equal owner, who had been managing the corporations from their inception.

And even where the stockholders are evenly divided and in disagreement as to the conduct of the business, if there is no showing of failure to elect directors and, if, in fact, there is no showing of an attempt to elect a board of directors, dissolution is not proper. So, in *Application of Landau,* [121] the court rejected as insufficient the allegation that an attempt to elect a board of directors would be futile because of the division which existed between the stockholders. The statute contemplates, according to the court, a condition "not less than the inability of the corporation to function because of a paralyzing failure of management." The first paragraph of section 103, the court said, is "aimed at an actual existing managerial incapacity, due either to an equal division and disagreement in the management, meaning the directors, or due to an absence of management because of an inability to elect directors." [122]

But where the situation is such that, notwithstanding the solvency of the corporation, it is quite evident that the interests and the rights of creditors would be placed in jeopardy if the corporation is permitted to function as constituted because the stockholders and directors are equally divided and efforts to bring about a settlement of the differences are to no avail—dissolution is proper. [123]

So also would dissolution be proper where the opposing interests are so discordant as to prevent efficient management and such that the objects of the corporation cannot be attained. [124] Thus in *Petition of Lynch* [125] there were present circumstances which took the case outside of the scope of the *Landau* decision, *supra.* As in the *Landau*

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[121] 183 Misc. 876, 51 N.Y.S. 2d 651 (1944).

[122] 51 N.Y.S. 2d at 653. The fact that the two stockowning directors are in disagreement and the third director is claimed to be a dummy does not bring the case within the ground of managerial incapacity due to an equal division in the management. *See Petition of Binders,* 15 N.Y.S. 2d 4 (1939) where the court said that no custom or practice can make a directorship a mere position of honor devoid of responsibility. (at 6). See also *In re Fiedlieb,* 184 N.Y.S. 753 where the court held insufficient the fact that the 5th director in a five-man board had "withdrawn from all participation in the company and neither considers himself, or is he considered any further as a director."

[123] In *re Bob's Fashion Furriers, Inc.,* 52 N.Y.S. 2d 279 (1944).

[124] *In re Kaufman Circle Express C., Inc.,* 177 Misc. 106, 29 N.Y.S. 2d 264, 265 (1941).

[125] 54 N.Y.S. 2d 111 (1945).

case, it was alleged that the stockholders were deadlocked concerning the management and conduct of the affairs of the corporation and that it would be futile to attempt an election of directors. However, unlike in the *Landau* case, there were the further allegations that a deadlock existed in that the only two remaining and functioning directors were in irreconcilable conflict respecting the management of the business and affairs of the corporation and irreconcilable differences and discordant interests existed between its two sole and evenly divided stockholders, so that it was impossible to efficiently and advantageously conduct the business and affairs of the corporation or to attain the objects for which it was incorporated.[126] It was further alleged that the corporation was operating at a loss.

It is to be noted that, where there is a failure to elect directors, the fact that the incumbent directors hold over is not a bar to dissolution under section 103. The situation is to be distinguished from the one where no attempt to hold an election is made and the directors simply continue in their posts. The incumbent board of directors may not be deadlocked, but the failure of the stockholders to elect a board is a separate ground for dissolution.[127] It would still be a case of managerial incapacity.[128]

As to what vote is necessary for dissolution under 2d paragraph of section 103, it is provided that the petition shall be presented —

> "by the holders of such number of shares as, in accordance with the provisions of the certificate of incorporation or other certificate filed pursuant to law, represent more than the difference between the total number of outstanding shares the holders of which are entitled to vote on the question of dissolution of the corporation without judicial proceedings and the number of such shares, the votes of the holders of which are necessary to authorize filing of a certificate without judicial proceedings."[129]

Turning now to the provisions of the Stock Corporation Law on dissolution without judicial proceedings, we find that section 105 requires that a certificate of dissolution shall be consented to either by (a) every subscriber to stock, or their successors in interest where no stock has been issued, or (b) the holders or record of all of the outstanding shares entitled to vote, or (c) the holders of record of two-thirds of the outstanding shares entitled to vote thereon. Thus, the least number of votes necessary to effect a dissolution without judicial proceedings is two-thirds of the outstanding shares entitled to vote thereon. Taking the two sections together, it would seem that

[126] *Id.* at 114.
[127] See *Petition of Wiliamson et al*, 85 N.Y.S. 2d 93 (1948).
[128] See note 122, *supra.*
[129] See note 113, *supra.*

dissolution must be consented to by such vote representing the total number of shares which, in accordance with the certificate of incorporation, are entitled to vote on dissolution minus two-thirds of such shares.

Suppose that the required number of votes for dissolution cannot be obtained, may the corporation nevertheless be dissolved? There is, of course, subdivision 4 of section 9 which provides that nothing contained in section 9 shall be construed to limit the power of a court of equity to decree dissolution in a "proper" case. What would be a "proper" case? If the stockholders are so divided that they fail to elect a board of directors, then the incumbent board shall hold over.[130] Unless the deadlock among the stockholders leads to a deadlock among the directors, then the corporation will not be paralyzed. True, this would not bar dissolution under section 103—if dissolution is consented to by the required number of votes. But, if the required number of votes cannot be obtained and the corporation is not suffering from the management by the hold-over board, it would seem that the corporation should not be dissolved. Of course, it would be a different matter if dissolution would be beneficial to the stockholders as a whole. In such a case, it becomes the duty of the board of directors to petition for dissolution under section 101 of the General Corporation Law. If the directors fail to do so, then[131] a stockholder or director may invoke the power of a court of equity to decree dissolution.

Thus in *Kroger v. Jaburg*,[132] an action was instituted by a director and minority stockholders to compel the board of directors to file the necessary petition for dissolution of the corporation. The complaint alleged that, since the organization of the corporation ten years before, the corporation had been unprofitable and unsuccessful, the capital was being impaired, the property, wasted and dissipated, dividends had not been declared because of losses, the business was obsolete and could not possibly be operated profitably; but that, the directors, knowing all this, refused to file a petition for dissolution with the purpose of continuing to receive salaries. The court held that:

> "If it can be shown upon a trial that this refusal to dissolve is for the purpose and plan of giving to these officers and majority stockholders the assets of the corporation by way of salaries rather than through dis-

[130] See note 16, *supra*.

[131] Under section 102 stockholders constituting a majority in interest may direct the directors to petition for dissolution under section 102; but this article has no practical application to the problem, because where the required number of votes for dissolution under the second paragraph of section 103 cannot be obtained that means that the majority in interest opposes dissolution.

[132] 231 App. Div. 641 (1931).

solution dividing these assets among all stockholders, obviously it becomes the duty of the directors to institute appropriate proceedings." [133]

Equity, according to the court, will under such circumstances afford redress to minority stockholders. "Bad faith and fraud in refraining from dissolving a corporation may be shown," said the court, "to be as much a breach of duty as bad faith and fraud in seeking wrongfully to dissolve a corporation." "It being proper," the court continued, "for the court to act in one instance, it is proper, also, that it should act in the other * * *" [131]

IV. A CHOICE OF MEANS—SECTION 9 OR OTHER AGREEMENTS

A. RELATIVE MERITS AND DEMERITS

That the types of provisions authorized by section 9 cannot completely answer the need for stockholders' agreements for control is quite obvious. So far as it is desired to secure affirmative action, the provisions authorized by section 9 are ineffectual. Such provisions do achieve the positive results of requiring unanimity or a qualified majority for any or all items of corporate business, but this is merely equivalent to freezing the relation among the parties on the term *already* agreed upon. The provisions are intrinsically negative in operation, vesting the individual director or stockholder with a veto power.

Not alone is a provision authorized by section 9 negative in quality, the germ of deadlock which it carries is a factor which cannot be overlooked. It is no argument, of course, that provisions for dissolution are ample to protect the stockholders from loss as a result of a crippling deadlock embalming the corporation and holding it helpless in a state of suspended animation. On the other hand, it might be this thought— "agree or dissolve"—which might make the parties work hard on securing agreement among themselves. Again, the parties might by means of a provision authorized by section 9 require unanimous consent for dissolution. Barring a deadlock in the board of directors or among the stockholders with respect to the election of directors, this provision will secure for the minority the continuance of the corporate life. At any rate, the probability of deadlock might be a risk worth taking in relation to matters which the parties consider as indispensable conditions to the continuance of their relation.

Affirmatively, a veto provision may be approximated by classification of shares into voting and non-voting, supplemented by classification of directors, proxy and voting trust agreements, or by pooling

[133] 231 App. Div. at 644.
[134] *Id.* at 645.

agreements. Classification of shares may not even be necessary where it is possible without resorting to classification to bring together a controlling number of shares under a proxy or voting trust arrangement, or pooling agreements. It has been noted, however, that a classification of shares may be upset by an amendment of the certificate of incorporation; but here, again, a provision that the certificate of incorporation may not be amended except by the unanimous vote of the shares entitled to vote may be resorted to. Pooling agreements which attempt to do more than just bind in advance the stockholders to vote in a certain way, or which attempt to bind the judgment of directors may be assailed, as we have seen, as an abdication by the directors of their duty to exercise a disinterested judgment for the good of the corporation. With regard to proxy and voting trust, it has been shown, that they are good only for a limited period, and a proxy is revocable unless coupled with an interest. And proxy agreements are valid only with respect to voting at stockholders' meeting, for directors may not vote by proxy.

However, with regard to the veto aspect of stockholders' agreements, section 9 seems exclusive of agreements not conforming to the requirements of section 9, save possibly as such agreements are enforceable against those with actual knowledge of such provisions. An agreement as to veto must be surrounded with the safeguards thought to be necessary. It must appear in the original or amendatory certificate of incorporation (not merely in the by-laws), acknowledged by the persons designated, and authorized by the vote required, by the statute. Notice of the existence of such a provision must appear plainly on the face or back of the certificates of stock. Such requirements—termed "safeguards" by the law revision commission—spell "public policy." And, if only because of the demonstrated uncertainty in judicial views on policy imports of provisions of corporation statutes and the degree of observance of the dividing line between a corporation and a partnership even where a threatened injury to the public good is not apparent—it would be to risk invalidation to embody without the necessary formalities a provision authorized by section 9 whether the provision be an "absolute, permanent, all-inclusive power of veto" or a "provision requiring for particular decisions" unanimity or a qualified majority.[135] And if the provision refers to election of directors, though of the "particular decisions" type, then its fate in the hands of the court is foreclosed. Not even the dissenting opinion in the ill-starred *Benintendi* case went to its rescue in the face of the provision of the law stating that directors shall be elected by a plurality.

[135] The quoted words are from *Benintendi v. Kenton Hotel, supra* note 83.

B. A CHANGING PUBLIC POLICY?

With the enactment of section 9, which confessedly is designed to accommodate the peculiar "economic needs of the close corporation," [136] it might be argued that it is a recognition of the necessity for affording separate treatment to the close corporation such that agreements, which if the corporation is a publicly held one would be void as against public policy, would be valid where the corporation is a close corporation. It might fairly be expected that the courts will in the future exhibit greater sympathy towards attempts of members of a close corporation to approximate a partnership agreement and will be more inclined to recognize that, where rights of creditors are not involved, the desire to limit personal liability through incorporation, on the one hand, and the desire to protect minority interests, on the other, may legitimately be pursued at the same time. But then it might be argued with some force that the legislature, having as it did failed to make a general revision of the corporation laws, has for the present decided to let matters stand with respect to stockholders' agreement not covered by or not conforming to the requirements of section 9. Much then would still depend on judicial interpretation of the peculiar needs of the close corporation in connection with the provisions of the corporation laws untouched by section 9.

C. A MATTER OF DRAFTSMANSHIP

Since a decision may well hang on the phraseology of the agreements, drafting is a fateful task. A few unfortunate phrases might be all that is necessary to evoke a judicial pronouncement of invalidity of a stockholder on the ground of public policy.

Take the case of *Abbey v. Meyerson,* [137] *supra.* Had the agreement simply provided that Class "A" stock shall not have voting privileges and that Class "B" shall be voting, the result desired, that is, concentration of management in the hands of holders of Class "B" stock would have been achieved without exposing the agreement to invalidation.

Take the case of *McQuade v. Stoneham,*[138] *supra.* Was clause "X" of the agreement necessary? With his vote and those of the other four directors selected by him, Stoneham could have always out-voted McQuade and McGraw—a capacity which he demonstrated by having McQuade removed. In stockholders' meetings, Stoneham's dominant position was assured by his ownership of the majority shares. Was it necessary for the protection of the interests of the other parties to the agreement? In view of the smallness of the interests of the

[136] See *supra* note 92.
[137] See *supra* notes 29 and 30.

other parties, the protection accorded to them by clause "X" in terms of restrictions on changes of policy of management, changes in the amount of capital, number of shares, and amendment of by-laws, seemed rather extravagant. If it served any useful purpose at all it was to ensure to the parties salaries at stated sums and tenure of office. But even here it would seem that this result could have been effected even in the absence of cause "X", since the parties in the other clauses of the agreement bound themselves to use their best endeavors to retain each other as officers at stated salaries so long as they were stockholders of the corporation. As it was, the court made capital of clause "X".

Take the case of *Manson v. Curtis*,[139] *supra*. The court might have been disposed to declare the agreement valid, if the second paragraph was omitted. Without the second paragraph, the contract might have been interpreted as simply giving the manager a position paramount to that of the president—a valid agreement. As it was, the second paragraph loomed large in the estimation of the court as indicating that the manifest intention of the parties was to create a passive board of directors. As the court said (although the agreement was silent as to a passive board): "The fundamental and dominant purpose and intent of the parties which necessitated and provided for a passive president of the board of directors necessitated likewise passive directors."[140]

It is not suggested that the decisions in the *McQuade* and *Manson* cases would surely have gone the other way were the agreements phrased in the manner indicated. There were, of course, other factors not the least important of which was that there were minority interests not represented in the agreements. But the point is that phraseology occupies an important place in the determination of the validity of stockholders' agreements as in any agreement, for that matter. And a language which is a little more restrained and a little less apparent that the intention of the parties is to tie the hands of the directors might tilt the scale in case of doubt in favor of validity.

A final word. In the choice of means, efforts at effective combinations of the several ways available should not be spared.

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[138] See supra note 48.
[139] See *supra* note 47.
[140] 119 N.E. 561-62.