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THE CLOSE CORPORATION AND THE LAW

CARLOS D. ISRAELS

Lawyers have long recognized, in practice if not in theory, a distinction between two types of corporations termed—for lack of more precise appellations—the “close corporation” and the “public issue corporation.” The terms are inaccurate because a “close corporation” is not necessarily a small enterprise nor even one having comparatively few stockholders and a “public issue corporation” has not necessarily been financed by public sale of its securities.

What then is the distinction? Arbitrary definitions based on financial size or number of investors have been suggested.¹ Obviously, however, the distinction cannot accurately be so expressed. A ten million dollar enterprise may as easily be a “family affair” as a ten thousand dollar enterprise.

Foreign statutes generally set up a special type of corporation, *e.g.*, the English “private company”, the French “Société à Responsabilité Limitée” and the German “G.m.b.H.” which are contrasted with the “public company,” the “Société Anonyme” and the “Aktiengesellschaft” respectively. It has been argued that the distinction made in the foreign statutes affords a useful analogy for American legislation. However, closer examination of those statutes clearly indicates the broad purpose merely to distinguish between publicly financed and privately financed enterprises, exempting the latter from the rather strict requirements for registration, publication of financial data, and the like, imposed upon the former.

In the economic sense in which the term is used in the United States, a “close corporation” is an enterprise in corporate form in which management and ownership are substantially identical. As a result of that identity the participants consider themselves “partners” and seek to conduct the corporate affairs to a greater or lesser extent in the manner of a partnership. Implementation or frustration of that desire has given rise to most of the litigated cases in the United States.

Litigation has centered about the attempts of participants in close corporations generally occupying not only the capacity of shareholder but also those of director and officer to induce the courts to recognize private agreements between them which are in derogation of the statutory scheme of corporate government. To say the least, the courts have not been consistent

¹*E.g.* Weiner, *Proposing a New York Close Corporation Law*, 28 CORNELL L. Q. 313 (1943).

in their attitudes. They have recognized or refused to recognize the validity of such agreements on varying grounds from case to case. The decision of the Court of Appeals in *Benintendi v. Kenton Hotel, Inc.*,² decided in 1945 by a majority of four judges to three, brought the problem to a head in New York. Two shareholders, one holding one-third and the other two-thirds of the outstanding shares of the corporation, agreed at the instance of the minority shareholder to the following four by-laws, each requiring unanimity:

1. for all shareholders' resolutions;
2. for all elections of directors;
3. for all directors' resolutions; and
4. for all amendments to the by-laws.

They also agreed not to vote their shares against each other and if they failed to reach accord, not to vote at all. A year later the majority shareholder called a special meeting to annul the four by-laws. The minority shareholder thereupon sued in equity to have the by-laws declared valid and to enjoin the corporation from doing anything inconsistent therewith. The majority of the Court of Appeals held the first three by-laws invalid as violative of the statutory scheme of corporate government, particularly Sections 27 and 28 of the General Corporation Law and Section 55 of the Stock Corporation Law. Only the fourth by-law was sustained. The dissenting judges argued vigorously for judicial recognition of the distinction between the close corporation and the public issue corporation, saying in fact that so long as no public or creditor interest would have been prejudiced by recognizing the validity of the agreement between the two shareholders as embodied in the by-laws, their contract should be enforced at least as between the individuals.

The decision aroused considerable comment because it could be interpreted as overruling an earlier important case,³ which had caused New York lawyers to believe that agreements between the participants of a close corporation, provided *all* shareholders were parties to them, would probably be sustained in the New York courts despite the fact that, strictly construed, they might violate the statutory scheme. The matter was studied by the New York Law Revision Commission and has now been clarified by the 1948 Legislature. Chapter 862 of the New York Laws of 1948, effective September 1, 1948, adds a new Section 9 to the Stock Corporation Law, reading as follows:

“Provisions of certificates of incorporation; requirement of greater

²224 N. Y. 112, 60 N. E. 2d 829 (1945).

³Clark v. Dodge, 269 N. Y. 410, 199 N. E. 641 (1936).

than majority or plurality vote of directors or shareholders; restrictions.

1. The certificate of incorporation as originally filed, or as amended by certificate filed pursuant to law, may contain provisions specifying any or all of the following:

(a) that the number of directors who shall be present at any meeting 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 specified in such certificate;

(c) that 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 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 any class of stock having voting power that shall be necessary for the transaction of any business or of any specified item of business, including amendments to the certificate of incorporation, or the giving of any consent, shall be a number greater than the majority or plurality prescribed by law in the absence of such provision;

2. (a) A requirement for a quorum, vote or consent of directors or shareholders, which is invalid except for the authorization therefor granted by this section, shall not be valid hereunder unless (i) it appears in the certificate of incorporation as originally filed or as amended by certificate filed pursuant to law; (ii) notice of its existence appears plainly on the face of all stock certificates; and (iii) it specifies a period no longer than ten years for its duration.

(b) A certificate filed pursuant to law containing a requirement authorized by this section shall be subscribed and acknowledged by every subscriber of the certificate of incorporation and every subscriber to stock if no stock has been issued, or in person or by proxy by the holders of record of all outstanding shares of the corporation. Such certificate may be amended at any time in the same manner or in such manner as may be provided in the certificate.

3. At the expiration of any requirements specified pursuant to subdivision one of this section, such requirements may be renewed from time to time for further periods, not exceeding ten years each upon compliance with the provisions of this section.

4. Nothing herein contained shall be construed to limit the power of a court of equity to decree a dissolution in a proper case."

The purpose of this article is to survey the problem of the governance of

the close corporation from the standpoint of the participants in the enterprise, as it existed under the leading cases in New York and in other states prior to the new statute; to discuss the theory of the new statute; and to essay some prognostication as to how some of the practical problems which confront counsel for such an enterprise have been and may now be dealt with.⁴

It will be seen at once that the statute does not speak in terms of close corporations. It sets forth no definition but is applicable to any stock corporation. This was done in recognition of the historical fact that no satisfactory all-purpose definition of a close corporation appears ever to have been worked out, a fact which itself has led to some of the confusion in the cases, springing from the willingness or unwillingness of particular courts to grant legal recognition to the clearly separate economic concept of the close corporation. The conflict is nowhere better illustrated than in the two *Benintendi* opinions; the majority opinion refusing to let the facts dictate a modification of the statutory scheme of corporate government; the minority arguing for a pragmatic flexibility which would clearly indicate a different result because *Kenton Hotel, Inc.* was actually a close corporation.⁵

Therefore the Law Revision Commission rejected the idea of arbitrary definition of a close corporation and sought to meet the problem in pragmatic terms, adopting a solution which while theoretically applicable to any corporation would not as a practical matter be resorted to by any except a genuine close corporation.

Against this background, we seek first to analyze the objective of the participants in a close corporation with respect to its scheme of government.

The Objective

The objective of the participants in a close corporation is to equate the scheme of governance of their enterprise to that of a partnership. The extent to which that objective has been attained or has failed of attainment in particular instances has depended often on the court's view as to the existence or non-existence of a basic public policy; viz., limited liability is a privilege granted by the state, for which the participants must pay the price, that price being submission to the statutory scheme of majority or

⁴No attempt will be made to analyze or even to cite all of the cases; those discussed have been selected because they present problems which, in the writer's view, are typical.

⁵This and many other observations here made find their origin in the ACT, RECOMMENDATION AND STUDY OF THE LAW REVISION COMMISSION WITH RESPECT TO CLOSE CORPORATIONS, LEGISLATIVE DOCUMENT (1948) No. 65 K, on which the writer served as Research Consultant.

representative corporate government. Thus the court in the *Benintendi* case held by-law number 3 (requiring unanimity for all directors' action) "intrinsicly unlawful because it contravenes an essential part of state policy as expressed in the Stock Corporation Law";⁶ while the dissenting judges thought "There is here no question of public policy."⁷

Existence of the policy is rationalized on the basis of legislative (or perhaps judicial) abhorrence of a deadlock, the Court of Appeals majority quoting an English decision to the effect that "prima facie in all acts done by a corporation, the major number must bind the lesser, or else differences could never be determined."⁸

As we shall see below, this argument is somewhat of an overstatement.

The Equation

Apart from the new statute, let us line up the elements of the equation between the partnership and corporate schemes of government. Under either form the participants in a "family" enterprise seek:

- I. Veto powers as to admission of a new participant;
- II. Veto powers in matters of day to day administration;
- III. Veto powers as to basic structural changes;
- IV. The ability to freeze particular individuals into jobs or other emoluments; and perhaps
- V. A way out in the event of deadlock.

I. Veto Powers as to Admission of a New Partner

The right to veto the admission of a new member of the firm is basic to the partnership concept. No one may become a partner without the consent of the existing partners, and a partner cannot convey his interest in the firm to another and give his assignee any of the rights of partnership except the right to receive his assignor's share of the profits.⁹

By contrast, the purchaser of corporate shares, whether from the corporation itself or from others, immediately becomes a participant in more than the profits of the enterprise. The very status of shareholder carries

⁶294 N. Y. 112, 117, 60 N. E. 2d 829, 830 (1945); *accord*, Jackson v. Hooper, 76 N. J. Eq. 185, 74 Atl. 130 (1909); Kaplan v. Block, 183 Va. 327, 31 S. E. 2d 893 (1944).

⁷294 N. Y. 112, 129, 60 N. E. 2d 829, 837 (1945); *accord*, Kantzler v. Bensinger, 214 Ill. 589, 73 N. E. 874 (1905); Fitzgerald v. Christy, 242 Ill. App. 343 (1926).

⁸294 N. Y. 112, 119, 60 N. E. 2d 829, 831 (1945).

⁹N. Y. PARTNERSHIP LAW § 53. Nor does the assignment relieve the assignor of liability for federal income taxes on subsequently accruing profits. *Rossmore v. Anderson*, 1 F. Supp. 35 (S.D.N.Y. 1932).

with it not only an interest in the earnings but almost without exception a right to participate in the distribution of assets on dissolution and some voice in management through the exercise of voting power. While the holders of a particular class of shares may be excluded from voting for the election of directors and even on most of the extraordinary matters which under the statutory scheme require shareholders' votes or consents, practically all of the statutes in some manner preserve the right of each shareholder to vote on a proposal which would adversely affect his vital property interests.¹⁰ The extent to which a new participant becomes a "partner" is of course dependent primarily upon the proportion of the voting power which he can purchase. Assuming that he has purchased shares entitled to vote for the election of directors, he still cannot assure himself of election to the board under ordinary voting, unless he purchases the majority of the shares; under cumulative voting, unless he purchases at least the electoral quotient;¹¹ or where voting is by classes, unless he has purchased a majority of the shares of a particular class. As to extraordinary matters, the situation is the same.

In New York, for instance, the new participant cannot control the decision to sell all or substantially all of the assets unless he purchases two-thirds of the shares,¹² but with one share more than one-third he acquires a veto power over the decision to sell or not to sell. Possibly, also, the new participant's objective to assure himself a place on a five man board under cumulative voting by the purchase of 21% of the outstanding shares might be defeated by a majority shareholder's decision to reduce the number of the board from five to four or three; and his objective to obtain a veto power over a sale of assets by purchase of 34% of the outstanding shares might be defeated by the sale of new shares to others unless he is protected by preemptive rights and can afford to exercise them.

Certainly under the conventional corporate scheme no individual shareholder may forbid another to convey his shares, no matter how unfriendly he may believe the intended conveyee to be. An agreement not to convey one's holdings for a given period is invalid as a restraint on the power of alienation, but from this has come the conventional restriction on transfer and cross-option agreement, giving the corporation, the other participants, or both, the option to purchase any shares at a calculated or arbitrated price prior to their offer to a stranger.¹³

¹⁰See N. Y. STOCK CORPORATION LAW § 51.

¹¹E.g., where there is a three-member board of directors, more than a 33 1/3% of the shares entitled to vote.

¹²N. Y. STOCK CORPORATION LAW § 20.

¹³The validity of such arrangements is unquestioned. *Bloomington v. Bloomington*,

Obviously, however, the restriction on transfer does not accomplish the complete equation. Nor does the new statute in any way change this situation.

If the newcomer can purchase a sufficient weight of shares after the cross-option agreement has been complied with, he may become *pro tanto* a "partner," unless the scheme of corporate governance set up by the certificate of incorporation and the by-laws permits the cutting down of his effectiveness in some such manner as above indicated.

Once the purchase has been accomplished, the new participant is in the same position toward his co-participants as he would have been had he joined with them in organizing the corporation in the first instance.

II. *Veto Powers in Matters of Day to Day Administration*

As to the partnership, the law is clear. The partners by their agreement may provide for simple or qualified majority or for unanimity as they may please. In the corporate scheme the problem has more than one facet. The statutes contemplate a hierarchy under which decisions as to day to day administrative matters are to be made not by the participants as such, but by the directors and the officers. They contemplate majority control:

- (a) by the shareholders as to the personnel of the board;
- (b) by the board as to its own acts, including the personnel of the officers.

Various devices for restricting the power of the majority shareholders as to board personnel have been availed of, and are generally upheld. Cumulative voting is clearly effective if the holding of the individual participant meets the electoral quotient, subject only to the difficulties inherent in the power of the shareholders by majority action to change the number of directors or to issue new shares.

At least the first difficulty can be insured against in New York under *Ripin v. U. S. Woven Label Co.*¹⁴ which upheld the validity of a requirement of unanimous shareholders' consent to change the *number* of directors¹⁵ and was specifically distinguished by the court in the *Benintendi* case.¹⁶ On the other hand, where all of the existing shares are of a single class, it seems that the *Benintendi* case¹⁷ would condemn a requirement of unanimity or

107 Misc. 646, 177 N. Y. Supp. 872 (Sup. Ct. 1919). However the share certificates must be appropriately stamped as required by the UNIFORM STOCK TRANSFER ACT § 15 (N. Y. PERSONAL PROPERTY LAW § 176).

¹⁴205 N. Y. 442, 98 N. E. 855 (1912).

¹⁵As distinct from the personnel of the board. As to this last problem *cf. In re Boulevard Theatre Co.*, 231 N. Y. 615, 132 N. E. 910 (1921).

¹⁶294 N. Y. 112, 119, 60 N. E. 2d 829, 831 (1945).

¹⁷By its holding as to by-laws Number 1 and Number 3.

qualified majority for the creation of new shares or the sale of authorized but unissued shares. Thus, unless preemptive rights or the so-called "rule of equitable contribution" (which merely requires sale at a fair price)¹⁸ afford protection, there may be none.

Division of the shares into two or more classes may, however; produce a somewhat different result. This device is often resorted to, with the principal distinction between the classes being that each class of shares is entitled to elect a specified number of directors or a specified proportion of the board. Provided that the votes or consents of the holders of a majority of each class of shares are required for amendment of the certificate of incorporation or the by-laws, the number of directors could not be increased, nor could new shares be authorized except with such consents.¹⁹ Classification of shares appears to be the best method so far developed to assure continued representation of all interests on the board. The new statute by its terms does not affect this device.²⁰

Voting trusts also are recognized by the statutes, subject, in New York and Delaware for example, to a ten-year limitation. A single voting trustee may of course vote all the deposited shares, and two or more trustees may be required by the agreement to act unanimously or by simple or qualified majority. Possibly the agreement might require the trustees to vote for named individuals, and in the writer's view such a provision should be enforceable subject to the trustees' right to show that to so vote would be a breach of fiduciary duty (*e.g.*, that the named individual had become a lunatic or been convicted of a crime or had otherwise become disqualified).²¹

Several of the decided cases have involved agreements among the participants to elect each other as directors. Usually the validity of that particular agreement has not been a serious issue, but specific dicta seem to leave no doubt that it is valid.²²

¹⁸See *Israels, Problems of Par and No Par Shares: A Reappraisal*, 47 *Col. L. Rev.* 1279, 1281 (1947).

¹⁹*N. Y. Stock Corporation Law* § 51 would appear to authorize this type of "class voting" as well as the exclusion of any particular class from voting for directors or on any proposal except one which would further limit its own voting power or change its preferences or priorities.

²⁰For an example which carried this device to the extent of creating four separate classes of shares, primarily for the purpose of assuring to the holders of each class the right to elect one of four directors, see *Long Park, Inc. v. Trenton New Brunswick Theatres Co.*, 297 *N. Y.* 174, 77 *N.E. 2d* 633 (1948).

²¹*Cf. McQuade v. Stoneham*, 263 *N. Y.* 323, 189 *N.E. 2d* 234 (1934), discussed *infra*.

²²The whole line of leading New York cases contains such dicta, *e.g.*, *Manson v. Curtis*, 223 *N. Y.* 313, 119 *N.E.* 559 (1918); *McQuade v. Stoneham*, 263 *N. Y.* 323, 189 *N.E. 2d* 234 (1934), *supra* note 21; *Clark v. Dodge*, 269 *N. Y.* 410, 199 *N.E.*

Why then is not such an agreement the simplest solution? Obviously it would be if it were clear that it is binding on the corporation and that an election at which votes were cast in breach of it would be set aside. That issue arose directly in the important case of *Ringling v. Ringling Bros. B. & B. Combined Shows*.²³ Here two sisters whose combined votes could elect five out of seven directors under cumulative voting had agreed to vote their shares alike or, if they failed to agree, as a named individual should direct. They consulted the individual. One sister followed his instructions. The other did not. As a result, the brother named four directors and the sisters three. The Chancery Court ordered a new election. On appeal the Supreme Court cancelled the effectiveness of the votes of the disobedient sister, but otherwise upheld the validity of the election, with the result that the corporation had only six directors for the year 1946, three named by the sisters and three by the brother. The case had many technical aspects under Delaware law, *e.g.*, whether the agreement contemplated the separation of voting power from the shareholding, an agreement to agree, or an agreement to arbitrate.²⁴ But in the writer's view its most important feature is that it allowed the actual election, the personnel of the board itself, to be affected by a private agreement between shareholders to which the corporation was not a party. Contrast this with the *Benintendi* case where the court struck down by-law number 2 (requiring unanimity for the election of directors), and an earlier case cited as authority for that holding,²⁵ both of which go on the theory that such a by-law is repugnant to Section 55 of the Stock Corporation Law, providing that directors shall be chosen "by a plurality of the votes at such election." How would the *Ringling* case have been decided in New York after an election under Sections 47 and 49 of the Stock Corporation Law? The only right to challenge a shareholder's vote under these statutes is based on his not being a shareholder of record or his duly authorized proxy. Granted that the agreement—construed as an agreement to arbitrate—would be specifically enforceable in New York, and that its breach might be enjoined in advance of the casting of the vote, the writer suggests that the case would again pose for a New York court the question of whether or not to recognize that this was a close corporation and thus hold

641 (1936), *supra* note 2. Nor does the majority opinion in the *Benintendi* case appear inconsistent on this point. The Illinois and New Jersey cases, cited *supra* notes 6 and 7, are in accord. The point is not discussed in *Kaplan v. Block*, 183 Va. 327, 31 S.E. 2d 893 (1944).

²³49 A. 2d 603 (Del. Ch. 1946), *aff'd*, 53 A. 2d 141 (Del. 1947).

²⁴This would be unenforceable specifically in Delaware.

²⁵*In re Boulevard Theatre Co.*, 231 N. Y. 612, 132 N. E. 909 (1921).

that the shareholders and the corporation should be bound by the agreement regardless of the letter of the statute, or to refuse to set aside the election or modify its results.

Agreements among participants in close corporations whereby they seek veto powers over matters of day to day administration clearly within the statutory competence of the board of directors have been almost universally struck down by the courts. The one exception is with respect to the removal of individuals from particular jobs (discussed under IV below). By-law number 3 in the *Benintendi* case required unanimity for all directors' action. The court condemned it as inconsistent with Sections 27 and 28 of the General Corporation Law, construing those sections as requiring that a quorum of the board be not more than a majority and possibly also that the act of a majority of a quorum should be the act of the board. Where the earlier New York cases infringe on this area their results are entirely consistent. Under a dictum in *Manson v. Curtis*²⁶ an agreement among shareholders to elect particular officers is not objectionable. However, the result of the case was to strike down a contract under which the corporation's affairs were to be administered by a named individual without supervision by the board of directors or the president. A dictum in the majority opinion in *McQuade v. Stoneham* would hold an agreement to elect particular officers invalid.²⁷ Lehman, J. dissented, referring *inter alia* to *Manson v. Curtis* on this point.

*Clark v. Dodge*²⁸ again contains a dictum to the effect that the shareholders may agree as to officer personnel, but the office in question was that of "general manager" and the court emphasized that the job was to be retained only during good behavior. It was said that the restraint, if any, on directors' discretion was "harmless." The most recent New York case, *Long Park, Inc. v. Trenton New Brunswick Theatres Co.*,²⁹ involved a contract whereby B. F. Keith Co., holding Class A-1 and Class A-2 shares entitled to elect one director each, was to designate the management and control the policies of the corporation, despite the fact that others held Class B and Class C shares, each also entitled to elect one director. It was further provided that if the majority of the Class B and Class C shareholders wanted a change of management, the question must be arbitrated. The Court of Appeals struck down the agreement as an attempt to sterilize the board of directors, and refused to uphold it as a management contract

²⁶223 N. Y. 313, 119 N. E. 559 (1918).

²⁷*McQuade v. Stoneham*, 263 N. Y. 323, 189 N. E. 2d 234 (1934).

²⁸294 N. Y. 112, 60 N. E. 2d 829 (1945).

²⁹*Supra* note 20.

binding on the corporation. Pragmatically the decision is a particularly interesting one since it creates, not breaks, a potential deadlock, but the theory is completely consistent with that of the earlier cases.

The cases in other states are all of the same tenor. In *Jackson v. Hooper*³⁰ a New Jersey court refused to interfere with corporate administration by directors who were intended to be dummies but who, when the two shareholders quarreled, chose sides between them. In *Kaplan v. Block*³¹ a Virginia court struck down an agreement requiring ratification by shareholders for the validity of directors' action.

Under some statutes, it seems clear that unanimity or qualified majority may be required for directors' action. The Illinois Business Corporation Act³² specifically permits such a requirement to be inserted in the certificate of incorporation. So also does the new New York statute which, within the limitations it contains, has clearly overruled the *Benintendi* decision as to by-law number 3 and opened the way for imposing a type of veto power over day to day administrative matters which was not available in New York before its enactment.

III. *Veto Powers as to Basic Structural Changes*

Here again the partnership scheme is simple and uncomplicated. Decisions rest with the partners who act or fail to act with whatever consequences their agreement dictates. The corporate problem is much more complex. The statutes provide for shareholders' action in specific respects, *e.g.*, for amendment of the certificate of incorporation, including the authorization of additional shares, reclassification of shares, reduction of capital, etc., and also under many statutes (those of New York included) for the mortgage or sale of any substantial property. The origin of these provisions is relevant. Historically such steps could not be taken without the consent of all parties to the corporate contract, *i.e.*, the holders of 100% of the shares.³³

The various statutory provisions are thus, in effect, permissive, granting to the majority a power it did not previously have, *e.g.*, the power to bind the minority to an amendment of the certificate of incorporation. Logically, therefore, it might be argued that a particular corporation or group of shareholders could validly reject the proffered freedom of action. The Delaware

³⁰6 N. J. Eq. 185, 74 Atl. 130 (1909). A New Jersey corporation was involved here, but the controlling statute was similar to § 27 of the General Corporations Law.

³¹183 Va. 327, 31 S. E. 2d 893 (1944).

³²ILL. BUS. CORP. ACT § 6.37.

³³See *Breslav v. N. Y. & Queens Elec. L. & P. Co.*, 249 App. Div. 181, 291 N. Y. Supp. 932 (2d Dep't 1936); *aff'd*, 273 N. Y. 593, 7 N. E. 2d 708 (1937).

Corporation Law³⁴ seems to proceed on this theory in permitting the certificate of incorporation to require a greater majority for shareholders' action than the statute specifies. Presumably a requirement of unanimity would be valid under these provisions. In New York, however, the courts appear to have rejected this line of reasoning. True, by-law number 4 in the *Benintendi* case (requiring unanimity for amendment of the by-laws) was sustained, but the statute does not specifically provide how by-laws may be amended. The *Ripin* and *Boulevard Theatre* cases sustained limitations on the power of the majority to amend the certificate of incorporation as to the number of directors as valid under Section 13 of the General Corporation Law. However, the decision as to by-law number 1 in the *Benintendi* case (unanimity required for all shareholders' resolutions) makes clear that at least where the restriction on the power of the statutory majority is phrased in all-inclusive terms, it is invalid.

Where there is more than one class of shares, the situation may be different. We have referred above to Section 51 of the Stock Corporation Law and its authorization of class voting. The purpose of this statute was obviously to permit the creation of one or more classes of shares which could be denied any voting power in the election of directors and in various types of extraordinary action. The exclusion is effective except in the cases specified in Section 51 where the proposed action would adversely affect the preferences, priorities or voting powers of the excluded class of shares. Under these or similar provisions in other statutes it has become common practice in public issue corporations having senior security issues such as preferred shares, to give the senior issues some form of veto power not only over extraordinary action which under the statute is within the shareholders' orbit (*e.g.*, the placing of a mortgage) but also over matters ordinarily within the purview of board action, *e.g.*, the declaration of dividends out of paid-in or capital surplus as distinct from earned surplus. In some instances percentages higher than the statutory majorities are specified. No such case has yet been tested in the courts. However, at least so far as such provisions require class voting by statutory majorities on matters within the statutory sphere of shareholders' action, Section 51 would seem clearly to validate them in New York. Where qualified majorities are required, or where the matters to be passed on are ordinarily within the competence of the directors there may be some doubt.³⁵

³⁴DEL. CORP. LAW §§ 2 (5) and 17.

³⁵*Cf.* Kaplan v. Block, 183 Va. 327, 31 S.E. 2d 893 (1944), where the court struck down a requirement of shareholder ratification for the validity of directors' action.

As to close corporations, Section 51 would seem to afford some latitude to produce the desired veto powers by the rather complicated method of classification of shares without resort to the new statute or subjection to its technical requirements.

IV. *Freezing Individuals into Jobs or Other Emoluments*

As to this also, clearly partners may agree, and in the corporate scheme the courts have been more sympathetic toward the individual whose status is sought to be changed than in paying strict adherence to the hierarchy of corporate government.

While the *Kaplan*, *Manson* and *McQuade* cases each sustained removals from office in breach of shareholders' agreements for retention, the two Illinois cases³⁶ and, in New York, *Clark v. Dodge*³⁷ and *Matter of Buckley*³⁸ appear to sustain agreements not to remove officers. In the *McQuade* case the actual result was dictated largely if not entirely by the fact that *McQuade*, having become a city magistrate, was probably disqualified by statute from continuing to serve as paid treasurer of the New York Giants. By the same token, the defendants, being merely majority shareholders, would have risked personal liability at the suit of the minority who were not parties to the agreement by continuing *McQuade* in office. This risk the court declined to put them to.

The extent to which the *Benintendi* decision as to by-law number 3 and the *Long Park* case³⁹ overrule *Clark v. Dodge* or *Matter of Buckley* is difficult to determine. Here again the court struck down restrictions on the powers of the board phrased in general and all-inclusive terms.

Apart from the new statute then, it may still be possible for *all* the shareholders of a close corporation to contract as in *Clark v. Dodge* against the removal of a named official during the continuance of their shareholding and during his good behavior. However, the conventional employment contract is probably a more useful tool. It is not necessary to confuse corporate office with executive function. It is entirely unobjectionable to have the corporation (particularly when all shareholders specifically consent) enter into a five to ten year agreement to employ *X* at a stated salary, providing that *X* shall serve "subject to the control of the board of directors"⁴⁰ and, if elected to

³⁶*Supra* note 7. *Kantler v. Bensinger*, 214 Ill. 589, 73 N.E. 874 (1905); *Fitzgerald v. Christy*, 142 Ill. App. 343 (1926).

³⁷294 N. Y. 112, 60 N.E. 2d 829 (1945).

³⁸183 Misc. 189, 50 N.Y.S. 2d 54 (Sup. Ct. 1944).

³⁹297 N. Y. 174, 77 N.E. 2d 633 (1948).

⁴⁰N. Y. STOCK CORPORATION LAW § 60.

that office, shall also serve as president or vice president, as the case may be, without additional compensation. To make assurance doubly sure it can be provided that even though X should not be elected to office in any year during the term of his employment, his compensation shall not therefore be reduced.

Under the new statute it can be provided during the ten-year period that the removal, change of salary, or election of any officer shall require unanimity or qualified majority.

V. *The Way Out of a Deadlock*

Article 6 of the Uniform Partnership Law⁴¹ clearly contemplates that dissolution of the firm may be the consequence of deadlock regardless of the fact that the term of the partnership agreement may not have expired. Dissolution may ensue by mutual agreement,⁴² by the will of a single partner⁴³ or by the court at the suit of any partner on the grounds, *inter alia*, that another partner has been guilty of "such conduct as tends to affect prejudicially the carrying on of the business"⁴⁴ or "so conducts himself in matters relating to the partnership business that it is not reasonably practicable to carry on the business in partnership with him."⁴⁵

The procedure for dissolution of a New York corporation is governed by Article 9 of the General Corporation Law. Section 103 specifically contemplates dissolution when the shareholders or directors are deadlocked "unless the certificate of incorporation otherwise provides." The majority shareholders may direct dissolution, without judicial proceedings, and the directors may apply for dissolution under judicial supervision regardless of shareholders' wishes. Indeed, in a proper case the courts will entertain an action by a minority shareholder to compel the directors to apply for dissolution.⁴⁶

The law as to what occurs once the court takes jurisdiction is well defined in both situations. Thus, in the writer's view, the emphasis of the majority in the *Benintendi* case on the possibility of deadlock, as an objection to sustaining by-law number 1 because it might prevent dissolution when that was appropriate, is overdrawn.

⁴¹N. Y. PARTNERSHIP LAW §§ 60 *et seq.*

⁴²*Id.* at § 62 (d).

⁴³*Id.* at § 62 (2).

⁴⁴*Id.* at § 63 (c).

⁴⁵*Id.* at § 63 (d).

⁴⁶*Kroger v. Jaburg*, 231 App. Div. 641, 248 N. Y. Supp. 387 (1931); *Gottfried v. Gottfried*, 50 N. Y. S. 2d 951 (Sup. Ct. 1944); and *see Jameson v. Hartford Fire Ins. Co.*, 14 App. Div. 380, 385, 44 N. Y. Supp. 15, 17 (1879).

The new statute will not substantially affect this situation. It will now be possible to require unanimity or qualified majority for shareholders' or directors' action to dissolve, but as the Law Revision Commission points out in its Recommendation⁴⁷ the right of the minority shareholder to seek to compel the board to act will not be affected. Thus as to either the partnership of the close corporation a court of equity remains in the position to apply the drastic remedy of dissolution when in its judgment a deadlock is causing injury to the enterprise.

The Scope of the New Statute

The new statute in effect writes into the New York scheme the provision of the Illinois Business Corporation Act permitting requirements of unanimity or qualified majority for directors' action,⁴⁸ and that of the Delaware Corporation Law permitting such requirements for shareholders' action,⁴⁹ subject to four safeguards;

1. The requirements must appear in the certificate of incorporation;
2. Notice of the existence of the requirements must appear plainly on the face or back of all share certificates;
3. The requirements can be imposed only by unanimous consent; and
4. They are valid only for a specified period not exceeding ten years, with rights of renewal.

The Commission's comments on its reasons for these safeguards are illuminating. Thus as to 1 and 3, the Commission says:

"This makes certain that there will be a public record of the requirement and of its terms, and implements (through operation of the existing provisions for amendment of a certificate of incorporation) the method by which it may be changed."⁵⁰

As to 2:

"Presumably this would be done in the manner in which a restriction on transfer of shares is now noted on the certificate as required by Personal Property Law, section 176 (Uniform Stock Transfer Act, § 15)."⁵¹

And as to 4:

"Thus, the participants in a close corporation who may wish to take

⁴⁷LEG. DOC. (1948) No. 65K, pp. 7-8.

⁴⁸ILL. BUS. CORP. ACT § 6.37.

⁴⁹DEL. CORP. LAW §§ 2 (5) and 17.

⁵⁰LEG. DOC. (1948) No. 65K, p. 7.

⁵¹*Ibid.*

advantage of the amendment would not be permitted to bind themselves irrevocably and in perpetuity. The ten-year maximum was selected in analogy to section 50 of the Stock Corporation Law, which limits a voting trust to ten years. The analogy to a partnership agreement, which almost uniformly has a limited term of years but may carry on thereafter from year to year until a partner serves notice of termination, is obvious."⁵²

The Present Status

A review of our discussion in the light of the safeguards of the new statute, and the Commission's comments on them, may be useful. How will existing practise, particularly the provisions of shareholders' agreements, be affected? How far does the new statute go toward balancing the equation between partnership and close corporation?

The typical shareholders' agreement has three purposes:

- I. To embody the shareholders' arrangements as to the capital structure, investments and distribution of shares. Often it serves as an agreement to subscribe for shares when issued. When organization is complete and the shares issued and paid for, this function of the agreement is executed. In this aspect, the new statute does not impinge upon the agreement.
- II. To embody the restriction on transfer and cross-option agreement. This can be done as well by provision of the certificate of incorporation or by by-law, but it has more usually been included in the shareholders' agreement for fear that otherwise a simple majority would be able to amend it. Indeed under the cases discussed above such fears would seem well founded.⁵³

Where the unanimity requirement of the new statute can be met, the sole issue as to whether the restriction on transfer and cross-option agreement should still be included in a shareholders' agreement, rather than in the certificate of incorporation, would seem to be that of its duration. If it is desired that it endure for longer than the ten-year period it must still be embodied in a shareholders' agreement, because a provision forbidding amendment of the certificate of incorporation except upon unanimous or qualified majority consent of shareholders included in the certificate of incorporation under the new statute would not be effective beyond ten years unless renewed.

⁵²*Ibid.*

⁵³However, by-law number 4 requiring unanimity for amendment of the by-laws of Kenton Hotel, Inc., was sustained.

III. To create veto powers of the various types discussed above.

It is in this aspect that the greatest change in practise resulting from the new statute will probably occur. Looking back at our discussion of the various types of veto powers sought and the devices used for obtaining them, practically all such devices may depend or can be made to depend for their effectiveness in particular situations on provisions requiring unanimity or qualified majority for shareholders' or directors' action or both, either generally or as to specified matters.

The statute contains a saving clause, preserving the validity (if under the decided cases they were valid) of existing certificate provisions, by-laws or agreements, and condemns only such veto powers as depend on Section 9 itself for their validity if it be attempted to impose them without compliance with the statute. Theoretically, therefore, there remains an area in which counsel, in reliance on *Clark v. Dodge*, might prefer a shareholder's agreement requiring the employment of *X* at a stated salary for life and during good behavior to a requirement for unanimous directors' action to remove any officer, or specifically the president, for a ten-year period. Since neither the *Benintendi* nor the *Long Park* case specifically overruled *Clark v. Dodge*, reliance on it may still be justified. Other cases, however, will not be half so clear, and in the writer's view the courts will probably tend toward strict construction of agreements entered into after September 1, 1948; and thus toward a holding that even the agreement to employ *X* for life and during good behavior depends on the new statute for its validity and thus should be struck down unless arrived at by indirection under the new statute.

An agreement that the participants will vote for each other as directors is still unobjectionable, though possibly a weak reed, as indicated above. More important is the power to remove a director, or to change the number of the board. Provisions of shareholders' agreements forbidding removal or change by statutory majority are probably invalid under the new statute because they appear elsewhere than in the certificate of incorporation.

Employment contracts, properly drawn, remain effective to protect the employee-shareholder against termination of his employment or diminution of his salary during the contract period, but not against removal from elective office. Clearly a provision in a shareholders' agreement which attempts to give added protection by requiring unanimity or qualified majority of the board to remove an officer would be invalid under the new statute. On the other hand, once the original election to office and employment at an agreed

salary are accomplished, reliance can be placed on a provision of the certificate of incorporation, adopted in accordance with the new statute, requiring unanimity or qualified majority for removal from office or for any change of an executive salary. Even though the officers are elected to serve "at the pleasure of the board"⁵⁴ and not for any fixed term, the protection would seem to be complete for the permitted statutory period.

As to extraordinary shareholders' action, the new statute, where it can be complied with, would seem to dispense with the necessity for the relatively complicated classification of shares or voting trust, and removes any vestige of doubt as to the validity of requiring more than a statutory majority of a single class of shares to vote or consent on a particular matter. Here again, inclusion of such requirements in a shareholders' agreement may henceforth be ineffective.

The dissolution cases cited above serve to emphasize one basic point: No scheme, however well conceived and skillfully executed, will suffice to protect any individual who commits a fraud or acts in bad faith toward his co-participants. The factual burden of proof that the removal of an officer was for good cause, or that the nonfeasance of a shareholder-executive is actually injuring the business, may be difficult to meet, but once it is met the broad powers of equity can work out a fair result.

To sum up, whether the new statute will dispense with the necessity for a shareholders' agreement must be decided on the facts of the particular situation. Clearly it does not dispense with the necessity of thinking the problem through in the light of the various capacities—shareholders, directors, officers, employees—in which the participants will be acting. Respect for the statutory hierarchy remains essential to the skilled and effective counseling of the participants in a close corporation. The new statute does provide a method, exclusive in the area of directors' action, of setting up the veto powers which the participants in close corporations usually desire to accomplish their objective of equation to the partnership set-up. It seeks to safeguard the potential innocent purchaser of shares by providing that notice of the existence of a certificate provision inserted under the new statute shall appear "plainly on the face or back of all stock certificates." This statutory notice cannot be buried in a small type text of "designations, preferences, privileges and voting powers." Probably it requires as large a type as the main body of the certificate and perhaps also separation from it. The writer would suggest that a legend typed or stamped across the face or in an other-

⁵⁴As they should be under New York Stock Corporation Law § 60.

wise blank space, combining this notice with the restriction on transfer, would probably be effective. The following is a suggested form:

"Transfer of these shares is restricted pursuant to agreement dated, 19..; and pursuant to Section 9 of the Stock Corporation Law, the certificate of incorporation contains provisions requiring a majority (or plurality) greater than that prescribed by law for a (quorum) (vote) (or consent) of (directors) (or shareholders). A copy of said agreement and of the certificate of incorporation are on file at the office of the corporation."

If it is desired to make assurance doubly sure, either of the following texts could be inserted before the last sentence:

- A. "to which the rights and interests of the holders of this certificate are subject, and to which such holder, by his acceptance hereof, specifically consents"; or
- B. "which by this reference are made a part hereof with the same force and effect as if herein set forth at length."

Unquestionably the new statute has narrowed the gap in the equation between the close corporation and the partnership. It is still not possible to reach the desired result in all instances by the direct route—an affirmative agreement between the participants binding upon them in all of their various capacities. It has become possible to reach it in almost every instance by careful analysis of the factual situation, based upon which requirements for unanimity or qualified majority may be imposed either generally or as to specific matters. Our statutes still fail specifically to recognize the close corporation as a separate concept. Yet there can be no doubt that the new statute would be of little practical use to a public issue corporation. Indeed a public issue corporation which attempted to use the statute would probably have difficulty in finding an underwriter for its securities. Practically, therefore, the new statute has made available to the genuine close corporation a clear, if technical, path toward equation with the fixed term partnership, and thus has lessened the likelihood that changed circumstances, unforeseen and perhaps unforeseeable at organization, will cripple the smooth functioning of a profitable business.