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Abstract

This work aims at investigating the topic of shareholders' agreements in the context of the U.S. close corporation. Attention is given to the peculiar setting behind the entity at issue, as it certainly represents the very first characterization of this form of legal enterprise, especially when compared to others under U.S. law. It is then from this very own pattern that the relationships (and fiduciary duties) among the shareholders of the close corporation unfold, as well as those between the latter and the corporation's stakeholders. Here comes what gives way to the need for shareholders' agreements, by then redefining the corporate structure as a whole. Also the internal functioning of the corporate bodies results in being profoundly affected, as a direct consequence of the many ways in which the full range of arrangements at shareholders' disposal interacts with such functioning—particularly. Along the same line, the development of the reasoning behind courts' scrutiny dealing with validity and effects of shareholders' agreements and their effective use and application to date is taken into pivotal consideration.

I. INTRODUCTION

The term *close corporation*[1] usually connotes an incorporated business in which: there are only a few shareholders (distinguished from a publicly held corporation);[2] the owners consider themselves to have formed a partnership and act as partners—accordingly;[3] the principal shareholders are generally active in management as if they were directors of the company.[4] Virtually all of the legal characteristics of the corporate form, including limited liability, may fail to capture significant features of the *bargain* among the small number of equity participants in closely held corporations. The overall objective of electing close corporation status is more than likely to invoke the statutory imprimatur for the close corporation participants to organize the governance of their business and their own participation in a manner different from what customarily follows from being a corporation.[5] The foremost consideration in this regard is the so-called shareholders' agreement that is authorized by most close corporation statutes.[6] While

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[1] "Close corporation," "closed corporation" and "closely held corporation" are often considered to be synonymous and are used interchangeably. "Closed" sometimes emphasizes a determination on the part of the participants in the enterprise to keep outsiders from acquiring any interest in the business and may indicate that they have taken steps to accomplish that objective by shareholders' agreement or provision in the articles of incorporation or bylaws. "Closely held" seems to focus more on the number of shareholders in the corporation at that particular time, indicating that they are few in number. The term "statutory close corporation" is sometimes used to describe those corporations which are covered by a statutory close corporation supplement or other special statute, particularly legislation that requires the corporation to elect to come under the special statute (O'Neal & Thompson, O'Neal and Thompson's Close Corporations and LLCs: Law and Practice, §1:4 (rev. 3rd ed. 2009, database updated July 2013).

[2] Allen, Kraakman & Subramanian, Commentaries and Cases on the Law of Business Organization, 80 (4th ed. 2012).

[3] Ripin v. Atlantic Mercantile Co., 98 N.E. 855, 856 (N.Y. 1912) ("chartered partnerships").

[4] While dealing with an action to rescind a corporate purchase of shares and recover the purchase price, a Massachusetts court commented that a close corporation is characterized by: (1) a small number of stockholders; (2) no ready market for the corporate stock; and (3) substantial majority stockholder participation in the management, direction and operation of the company (Donahue v. Rodd Electrotype Co., 328 N.E.2d 505, 511 (Mass. 1975)).

[5] On a brief comparative note, the same broad leeway has been made available to those forming a *società a responsabilità limitata* (limited liability company) as opposed to a *società per azioni* (joint-stock company) under Italian law (d'Alessandro, *«La provincia del diritto societario (ri)determinata». Ovvero: esiste ancora il diritto societario?*, in *Riv. soc.*, 2003, 1, 40). With particular respect to shareholders' agreements and their standing in the corporate structure as a whole, see Angelici, *Le società per azioni, I. Principi e problemi*, Milano, Giuffrè, 2012, 240 et seq.

[6] Of those states that authorize shareholders' agreements, most follow the style first enacted in North Carolina by setting forth various bases on which the agreement cannot be attacked. For example, the Delaware statute provides:

seeking statutory authority for a shareholders' agreement is the primary reason for electing close corporation status, most state statutes contain several other significant provisions that are available only to close corporations. What is noteworthy with regard to these special provisions is the lack of uniformity across the nation. That is, with the exception of varying forms of authorization for shareholders' agreements provided in their close corporation statutes, the states lack any consensus in what other areas special concessions are appropriate or necessary.[7]

In the United States, explicit statutory and judicial recognition of the unique features of the private corporation did not emerge until the late 1960s.[8] Today, however, American corporate statutes allow legal planners enormous latitude in customizing the form of the close corporation. Most often, this new flexibility is characterized by a *unified* corporations statute, which explicitly permits planners to contract around statutory provisions through either general opt-out clauses[9] or opt-out provisions restricted to close corporations.[10] Other states, by contrast, provide specialized close corporations statutes, which companies meeting the statutory criteria of a close corporation can elect to be governed by, in lieu of general corporation law.

"No written agreement among the stockholders of a close corporation … shall be invalid on the ground that it is an attempt by the parties to the agreement or by the stockholders of the corporation to treat the corporation as if it were a partnership or to arrange relations among the stockholders or between the stockholders and the corporation in a manner that would be appropriate only among partners" (Del. Code Ann., tit. 8, §354 (2001). See also Cal. Corp. Code §300(b) (West 1990); N.Y. Business Corporation Law §620(b) (McKinney 2003).
On reflection, authorization that takes the form, as does the above Delaware provision, of negating the types of arguments that can be raised against the agreement is a very curious form of legislative authorization. Viewed historically, the statute can be seen as a strong legislative statement rejecting an early line of cases that more often than not invalidated shareholders' agreements on the grounds captured today in the statute. In contrast, the recently enacted Texas close corporation provisions provide a nonexclusive list of many broad topics that may validly be included in a shareholders' agreement (Tex. Bus. Corp. Act Ann. art. 12.32 to 12.35 (2003). See also Md. Code Ann., Corps. & Ass'n §4-401(a); Model Statutory Close Corp. Supp. §20).

[7] Thus, for example, Maryland has the unique provision that no annual meetings need be held for a close corporation unless requested by a stockholder and accords close corporation shareholders more liberal inspection rights than shareholders customarily enjoy. A few states permit any shareholder of a close corporation to petition for dissolution (whereas in other corporations the petitioning stockholder must own a certain percentage of the company's shares), but other states do not relax the standing requirement for close corporations. Express provision for provisional directors appears in some close corporation statutes, as well as authorization to include in the articles a provision that any stockholder may request that the company be dissolved at any time.

[8] Conversely, European jurisdictions have long recognized the close or private corporation as a distinct form.

[9] Such as, "unless otherwise provided in the articles of incorporation."

[10] See, e.g., Revised Model Business Corporation Act §8.01(b).

Notwithstanding the great freedom that business planners now have to customize the form of a close corporation, problems arise, as every contingency cannot be dealt with upfront.[11] The importance of the close corporation as a corporate form is nowadays firmly connected to the rise of hedge funds and private equity firms in the financial and legal landscape of corporate America. Indeed, their influence on U.S. corporate governance extends to larger public held companies as well as to smaller closely held companies: On one hand, small closely held companies need the management capabilities and the capital that hedge funds and private equity firms can supply; on the other, large publicly held companies may not need either the management expertise or the capital that a hedge fund or a private equity investor can provide.[12]

Close corporations provide shareholders with a unique organizational structure of the company itself and of its business, much different from what customarily follows from being a publicly held corporation. In this respect, participation in management—and certainly the receipt of a salary that comes along with it—is the reward shareholders customarily seek when investing in a close corporation. While seeking statutory authority for a shareholders' agreement is the primary reason for electing close corporation status, most states statuses contain several other significant provisions that are available only to close corporations. These special provisions, in many respects, all lack of uniformity when compared to each other across the states legislation.
In most states the general business corporation act now contains a number of provisions designed primarily to deal with close corporation problems. Among the provisions found in the general corporation law of a number of states are the following: specific authorization to restrict

[11] As in the case of dissolving partnership, shareholders' disputes in close corporations often raise questions about the proper role of courts in superintending ongoing businesses. The difference, of course, is that equity participants in close corporations have selected the corporate form—with its associated characteristics of permanence, centralized management, etc.—to frame their long-term deal.

[12] Macey, Corporate Governance: Promises Kept, Promises Broken, 249 (2008). For hypothesis and suggestions for further research on the reasons why shareholders' agreements are not much used in listed corporations, see Ventoruzzo, Why Shareholders' Agreements Are Not Used in U.S. Listed Corporations: A Conundrum in Search of an Explanation, Bocconi Legal Studies Research Paper and Penn State Law Research Paper No. 42 (2013).

the transferability of shares;[13] specific authorization for shareholders' agreements or special clauses in the articles or bylaws that depart from the corporate norm of management by the directors;[14] a grant of power to courts to dissolve the corporation, impose a buyout of a shareholder by another shareholder or by the corporation, or provide other appropriate remedy on a deadlock among the directors and shareholders, fraud or gross mismanagement by those in control of a corporation, oppression of some of the shareholders or management misconduct prejudicial to shareholders.[15] Less commonly a statute will empower a court to appoint a provisional director for the corporation.[16]

A number of states have enacted special legislation to define and govern the close corporation. In Delaware and several other states, for example, this special statutory regulation states that a close corporation's article of incorporation must provide that its stock shall not be: (1) held by more than a specified number of stockholders; (2) subject to transfer restrictions; and (3) subject to public offerings.[17] A substantial number of states have enacted special close corporation statuses or have added to their general corporation statute separate supplements or divisions that apply only to close corporations. In most states with special close corporation legislation, a corporation must meet stated requirement to qualify as a close corporation and must elect close corporation status for the special rules to apply. Ordinarily, special close corporation statuses should be viewed as supplementing rather than displacing the special treatment accorded

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[13] See, e.g., Cal. Corp. Code §418 (West 1990); Del. Code Ann. tit. 8, §202 (2001).

[14] See Model Business Corporation Act Ann. §7.32 (3rd ed. Supp. 1997). Cf. Foote & Davies, Inc. v. Arnold Craven, Inc., 596, 324 S.E.2d 889, 893 (N.C. Ct. App. 1985) ("The courts have rather consistently held officers in a close corporation to possess powers to bind the corporation under circumstances which would make a similar holding questionable in a publicly held corporation."), quoting Zimmerman v. Hogg & Allen, 209 S.E.2d 795, 801 (N.C. App. 1974).

[15] See, e.g., Cal. Corp. Code §1800 (West 1990); Ill. Ann. Stat. ch. 805, §5/12.50 (Smith-Hurd 2004); New York Business Corporation Law §1104 (McKinney 2003); S.C. Code §33-14-300 (West 2006).

[16] See, e.g., Cal. Corp. Code §§308 (West Supp. 2009), 1802 (West 1990).

[17] Del. Code Ann. tit. 8, §342(a)(1) to (3) (2001) (30 nominal shareholders). In a few states, the special close corporation statute defines "close corporation" simply as any corporation that elects close corporation status for purposes of the statute (Md. Code Ann., Corps. & Ass'n §4-101).

by courts to closely held corporations. However, the rule is otherwise in Delaware: The Delaware Supreme Court refused to grant protection to minority shareholders that were not granted by the close corporation statute.[18] In broad overview, the legislative pattern is two-fold: many states have integrated close corporation provisions with a separate chapter devoted to close corporations, where those close corporations' provisions are an integral part of the state overall statute; conversely, a few states sprinkle throughout their code exceptions applicable only to close corporations.[19]

Corporations electing to be close corporations under the typical close corporation statute must include in their articles of incorporation a statement that the corporation is a close one.[20] If the election is made after shares have been issued, an amendment to the articles of incorporation adding or deleting the provision must obtain the approval of a supermajority of the stockholders.[21] As far as the number of stockholders is concerned, states sometimes require the articles of incorporation to provide that the shares of the electing close corporation will be held by no greater number than the one stated in the articles, which cannot exceed that specified in the statute.[22] A transfer of shares that causes the corporation to exceed the limit stated in its articles of incorporation terminates the entity's status as a close corporation.[23] In some states, the corporation is granted a short statutory period of grace in which to take corrective actions, such as amending the articles to increase within the statutory limits the number of shareholders specified or reducing the number of shareholders by purchase.[24] Several states also condition

[18] Nixon v. Blackwell, 626 A.2d 1366, 1379 (Del. 1993).

[19] The integrated approach is by far the more frequent and cohesive of the two.

[20] Del. Code Ann. tit. 8, §343 (2001).

[21] Del. Code Ann. tit. 8, §§344 & 346 (2001) (two-thirds vote to elect or terminate election).

[22] See, e.g., Cal. Corp. Code §158(a) (West Supp. 2009) (35 holders); Del. Code Ann. tit. 8, §342 (2001) (30 persons).

[23] California has a unique provision deeming any *inter vivos* transfer void if it causes the number of shareholders to exceed the specified limit, provided the share certificate contains the statutorily prescribed notice (See Cal. Corp. Code §§158(e) (West Supp. 2009), 418(c), (d) (West 1990)).

[24] See, e.g., Del. Code Ann. tit. 8, §348 (2001) (30 days).

close corporation status on all shares being subject to a restriction on transfer. [25]

Close corporation statuses vary widely not simply in the approach each takes toward meeting the unique needs of close corporations, but also in the legislature's perception of what areas of the close corporation merit special treatment. This scenario carries some implications when it comes to courts decision on content and implementation of shareholders' agreements in the close corporation. Furthermore, as in the case of dissolving partnerships, disputes among shareholders in close corporations often raise questions about the proper role of courts in superintending ongoing businesses. The difference, of course, is that equity participants in close corporations have selected the corporate form to carry out and implement their long-term deal—effectively.[26] Further, on this note, the absence of a ready market for close corporation shares may also affect how courts and legislatures treat close corporations when it comes to corporate players' liability: As there is no market to monitor management decisions in close corporations, as there is in publicly held corporations,[27] courts may be more cautious in invoking the business judgment rule, by which they have traditionally curbed their own monitoring of corporate decision-making and deferred to the decisions of the directors;[28] in other words, courts may not be as quick to apply the business judgment rule in closely held corporations as they are in publicly held corporations.[29]

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[25] In any case, there commonly is a requirement that share certificates give notice that the company has elected to be a close corporation (Model Statutory Close Corp. Supp. §10(a)). Delaware adds the additional requirement that the shares have not been offered through a public offering (Del. Code Ann., tit. 8, §342(a)(3) (2001)).

[26] Allen, Kraakman & Subramanian, Commentaries and Cases on the Law of Business Organization, 317 (4th ed. 2012).

[27] For a discussion of this market check on corporate decisions, see Manne, Mergers and the Market for Corporate Control, 73 J. Pol. Econ. 110 (1965).

[28] For a general discussion of the business judgment rule, see O'Neal and Thompson's Oppression of Minority Shareholders and LLC Members §§3:3, 10:4 (Rev. 2nd ed).

[29] See Manne, Our Two Corporation Systems: Law and Economics, 53 Va. L. Rev. 259 (1967). But see Comments of Daniel Fischel in Edited Transcript of Proceedings of the Business Roundtable, Emory University Law and Economics Center Conference on Remedies Under the ALI Proposals: Law and Economics, 71 Cornell L. Rev. 301, 371 (1986) (cannot say a priori that liability rules are more or less important in close corporations).

II. REASONS AND CONTENT OF SHAREHOLDERS' AGREEMENTS

Participants in close corporations often want to depart from the traditional corporate management framework, which contemplates a centralized management and gives control of the corporation to holders of a majority of the corporation's voting shares. If the parties simply form a corporation and do nothing to change the default governance rules specified in the statute, the result will be to put all corporate power in the hand of the board of directors and to permit the majority to elect the entire board. Instead, the parties may think of themselves as partners and want to retain the freedom that partners have to determine among themselves who is to control the enterprise and how that control is to be exercised. The close corporation bears striking resemblance to a partnership, in fact: The relationship among stockholders must be one of trust, confidence, and absolute loyalty if the enterprise is to succeed.

The possibility to enter into agreements among shareholders (and the company, too)[30] represents a specific and important tool for shareholders of close corporations to effectively address their expectations with regard to the investment in the enterprise. Such agreements enable them to tailor the firm with respect to the latter's key corporate functions—particularly. Indeed, participants in close corporation often enter into these agreements in order to better address their specific position and interest within the enterprise.[31] Needless to say, such position and interest vary according to the role shareholders aim to play within the corporate entity, and also taking into account the latter's peculiar ownership structure. Thus, not uncommonly the participants' range of interests extends to substantially all corporate acts.[32]

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[30] Cox & Halen, Treatise on the Law of Corporations, §14:3 (3rd ed. 2009, database updated November 2013).

[31] O'Neal & Thompson, O'Neal and Thompson's Close Corporations and LLCs: Law and Practice, §4:2 (rev. 3rd ed. 2009, database updated July 2013). See also Hochstetler & Svejda, Statutory Needs of Close Corporations—An Empirical Study: Special Close Corporation Legislation or Flexible General Corporation Law?, 10 J. CORP. L. 849, 904 (1985).

[32] See Zion v. Kurtz, 50 N.Y.2d 92, 428 N.Y.S.2d 199, 405 N.E.2d 681, 15 A.L.R.4th 1061 (1980), noted 33 Syracuse L. Rev. 15–17 (1982), for a case in which a shareholders' agreement provided that no business or activities of a closely held corporation could be conducted without the consent of the minority shareholder.

The difficulty of disposing of holdings in a close corporation augments the desire of minority shareholders to share control over corporate decisions. Since these shareholders lack the easier exit available to investors in publicly held companies, they have a greater incentive to bargain for a voice in the making of corporate decisions. At the same time the participants value the limitation on personal liability and the other benefits of the corporate form. As has often been said, shareholders in a close corporation not uncommonly desire to be shareholders to the outside world but partners among themselves[33] and the control arrangements at issue arise from disparate business relationships. Shareholders' agreements are one of the most flexible tools available to the close corporation:[34] they are intended to perform the same role in a close corporation that a partnership agreement would have played had the parties formed a partnership instead. They also secure the small business shareholders' unique expectations, to wit: employment, salary, returns on investment, and choice of business associates—primarily.[35] As far as agreements amongst majority shareholders are concerned, the latter often times relate to vastly various objectives; the intent behind them is usually, though, the one for shareholders to secure their influence in acting jointly in the making of corporate decisions and in affecting business and operation of the company—effectively.

Where there are multiple shareholders, but no current majority holder, the parties may desire to enter into an agreement that assures any one shareholder of a continued financial return or corporate office even if a majority later forms, either by change in the ownership of shares or

[33] See Bradley, Toward a More Perfect Close Corporation—The Need for More and Improved Legislation, 54 Georgia Law Journal 1145, 1148 (1966). See also Stewart v. Schwag, [1956] 4 S. Afr. L. Rev. 971 (Transvaal Prov. Div.) (upholding shareholders' agreement that their relationship inter se would be that of partners). See generally Validity of Stockholders' Agreement Allegedly Infringing on Directors' Management Powers—Modern Cases, 15 ALR4th 1078.

[34] Ghinger, Shareholders' Agreements for Closely Held Corporations: Special Tools for Special Circumstances, 4 U. Balt. L. Rev. 211, 212 (1975).

[35] Hancock, Minority Interests in Small Business Entities, 17 Clev.-Marshall. L. Rev. 130, 137 (1968).

agreement among existing shareholders.[36] Thus, an agreement may provide who are to be the corporate officers or assure participation or employment for all shareholders. In other instances a shareholders' agreement brings together two or more minority shareholders who together constitute a majority and who seek to assure that the contracting parties will continue to act together in making corporate decisions.[37] Such alliances often seek to prevent a party from being able to influence corporate decisions, and in these circumstances it often becomes important to specify dispute resolution agreements if the majority is unable to agree.

Matters most often covered by shareholders' agreements in close corporations in the various contexts just described are the following: how the shares of the parties to the agreement are to be voted in the election of directors; who are to be the officers of the corporation; salaries to be paid in favor of shareholder-employees; long-term employment arrangements for some or all of the participants; amount of time each participant is to devote to the business and whether

[36] See, e.g., Wasserman v. Rosengarden, 84 Ill. App. 3d 713, 40 Ill. Dec. 430, 406 N.E.2d 131 (1st Dist. 1980) (court upheld the validity of an oral agreement among all the shareholders in a close corporation providing for the election of the parties thereto as directors and officers and for an equal distribution of salaries and profits as long as the parties remained shareholders or the corporation remained in existence).

[37] See, e.g., Ramos v. Estrada, 8 Cal. App. 4th 1070, 10 Cal. Rptr. 2d 833 (2d Dist. 1992), reh'g denied and opinion modified, (Sept. 11, 1992) (shareholders' agreement was used to preserve group voting and control for one group after a merger); Ringling Bros.-Barnum & Bailey Combined Shows v. Ringling, 29 Del. Ch. 610, 53 A.2d 441 (1947) (agreement between two of three family groups seeking to exclude the third family group from control of the corporation). In Stenehjem v. Sette, 240 N.W.2d 596, 598 (N.D. 1976) two of the three major factions of shareholders, in a small bank, the Stenehjems and the Wildfangs, without the knowledge of the third, the Settes, entered into an agreement to vote their shares as a block to support the elevation of Mr. Stenehjem, to chief executive officer of the bank "by whatever means he deems necessary"; they agreed they would "vote as a block against any purchase by the said bank of any new building or additions to the present building if doing so would require the issuance of additional capital stock [or] any additional contributions by the present stockholders to pay for the same, or the issuance of additional stock or any kind of assessment against the present stockholders to increase the capital stock of said bank"; the Stenehjems promised that if they purchased the stock owned by the Settes, they would also buy all the stock owned by the Wildfangs at the same price per share; and the Stenehjems further promised that they would not sell their shares in the bank without also including in the sale all of the shares of the Wildfangs. The court did not pass on the validity of this agreement, as its validity was not at issue in the case. Another common undertaking among shareholders is to refrain from engaging in a competing business. See, e.g., Simons v. Fried, 302 N.Y. 323, 98 N.E.2d 456 (1951) (specific performance granted of undertaking by shareholder not to engage in any business similar to that of the corporation as long as he remained a shareholder). Compare Morgan v. Jacobs, 200 So. 2d 443 (Miss. 1967) and Hansen v. Edwards, 83 Nev. 189, 426 P.2d 792 (1967) (covenants not to compete on termination of employment enforced) with Silverberg v. Photo-Marker Corp., 233 Ga 383, 155 SE2d 385 (1967) (similar covenant held unenforceable).

the participant will be able to engage part-time in other activities;[38] power of one or more of the participants to veto corporate decisions; circumstances in which dividends are to be declared; and method of resolving corporate disputes (e.g., arbitration or some procedure for dissolving the corporation in the event of dissension or deadlock among the shareholders or directors).[39]

Although the corporate form provides advantages (i.e., limited liability, perpetuity, and so forth), it also supplies an opportunity for majority stockholders to oppress or disadvantage minority ones. In this respect, a person taking a minority position in a close corporation may desire and therefore bargain for protection against the power of those holding a majority of a corporation's voting stock to make decisions that will prejudice minority interests.[40] Indeed, many shareholders' agreements stem from the objective to protect the minority shareholder against the power vested in the majority by the principles of centralized control and majority rule and to permit the minority shareholder to obtain membership on the board of directors or some other

[38] For an illustration of how failure to include an item of this kind can lead to dissension and litigation, see Sternheimer v. Sternheimer, 208 Va. 89, 155 S.E.2d 41 (1967). For an interesting and highly unusual shareholders' agreement among three brothers, who were the principal shareholders in various family corporations, see Glazer v. Glazer, 374 F.2d 390 (5th Cir. 1967). The agreement provided, among other things, that nothing in it was to restrict any party from engaging in outside ventures nor from using the corporation's facilities upon payment of reasonable compensation; the parties were to discharge all claims whatsoever they had against one another; and they agreed "to make every effort to create a good, healthy, and harmonious relationship; to refrain from causing dissension and arguments and from unnecessarily interfering with the welfare or duties of each other and from doing or causing anything to be done that is contrary to the purposes and intent of this agreement." The agreement was poorly drafted in a number of respects, and the appellate court concluded that the trial court could properly leave its interpretation to the jury.

[39] Shareholders' agreements also sometimes contain a provision spelling out the rights of the participants to inspect corporate books and records. See Rosenberg v. Steinberg-Kass, Inc., 18 Misc. 2d 880, 190 N.Y.S.2d 135 (Sup. 1959) (court refused to enforce contractual provision allowing inspection of the corporate records by a former employee because such an inspection was unnecessary to determine the percentage of profits due him); Nash v. Gay Apparel Corp., 16 Misc. 2d 176, 187 N.Y.S.2d 32 (Sup. 1959), judgment rev'd, 9 A.D.2d 345, 193 N.Y.S.2d 246 (1st Dep't 1959), judgment aff'd, 8 N.Y.2d 978, 204 N.Y.S.2d 545, 169 N.E.2d 126 (1960) (in a contract by which one shareholder in a two-person company sold all of his shares to the other shareholder, a nonspecific provision giving the seller a right to inspect corporate books conferred a right to inspect books of about 60 subsidiaries as well as the books of the parent corporation). Shareholders' agreements often contain provisions on non-management matters. Perhaps the most important items of the non- management kind typically included in shareholders' agreements are restrictions on the transfer of shares and buyout arrangements.

[40] Besides shareholders' agreements, participants may use some kind of contractual arrangement to set up a control pattern for the corporation that differs from the traditional corporation control structure: The arrangement may take the form of a pre-incorporation agreement among the participants, a voting trust, special articles and bylaws provisions, irrevocable proxies, or employment contracts between the corporation and the shareholder-employees of the corporation.

voice in the management of the corporation.[41] Holders of the controlling interests in a corporation may be willing to share their control in order to bring into the enterprise persons who otherwise would not buy a minority interest. In some situations the majority shareholder may agree to a unanimity provision for all or important corporate actions or other terms that would permit the minority an equal say when it comes to corporate decisions. Alternatively, the agreement may be less comprehensive and focus on assuring the minority continued participation or employment.

Minority shareholders in close corporations are often subject to oppressive conduct by the majority shareholders. In fact, the latter frequently will attempt to squeeze out some or all of the former. A *squeeze-out* occurs when majority shareholders holding strategic positions in a corporation use inside information or other devices to eliminate minority shareholders from the corporation;[42] further, it usually involves the payment of less than fair value for the rights and powers taken from minority shareholders. Partial squeeze-outs reduce the participation or powers of a group of shareholders, diminish their claims on earnings or assets, or deprive them of business income or advantages to which they are entitled in the first place.[43] Such squeeze-out techniques create severe problems for the minority shareholders in a close corporation: These shareholders may be deprived of effective participation in the management of the corporation, and of information on the affairs of the business. A squeezed-out shareholder may eventually

[41] See, e.g., Ringuet v. Bergeron, [1960] Can. Sup. Ct. 672, noted in 80 S.A.L.J. 281 (1963), 37 Can. Bar Rev. 490 (1959) (court upheld a shareholders' agreement among three persons whereby they were to join together and acquire control of a company; elect themselves to the board of directors; elect one of their number president, one vice-president and general manager, and one secretary-treasurer; and vote their shares as a unit at all meetings of the company).

[42] O'Neal, Squeeze-Outs of Minority Shareholders: Expulsion or Oppression of Business Associates, §1.01 (1975 & Supp. 1983). The term 'freeze- out' is often used as a synonym for 'squeeze-out.'

[43] See Painter, Corporate and Tax Aspects of Closely Held Corporations, §§4.1-4.4 (2d ed. 1981 & Supp. 1984); Kutcher, Freeze-outs of Minority Shareholders in Closely-Held Corporations, 25 LA. B.J. 123 (1977); Moore, Going Private: Techniques and Problems of Eliminating the Public Shareholder, 1 J. CORP. L. 32 (1976); O'Neal, Minority Owners Can Avoid Squeeze-outs, 41 Harvard Business Review 150 (1963); O'Neal, Arrangements Which Protect Minority Shareholders Against 'Squeeze-outs,' 45 Minn. L. Rev. 537 (1961).

even lose his employment with the corporation.[44] Although the exact frequency of squeeze-outs is not known, litigation on squeeze-outs and comments of scholars and practitioners indicate that the number of squeeze-outs is large and might even be increasing.[45] Given the problems that squeeze-outs can create for minority shareholders, the latter's investment and position in the close corporation needs adequate protection.[46]

Minority shareholders often seek agreements that will provide them with representation on the board of directors or will otherwise give them some saying in the management of the corporation.[47] This of course unfolds on the assumption that membership alone provides the minority with arguably little protection against the power vested in the majority by the principle of majority rule. As a result, the minority may bargain for veto powers with respect to some or all of corporate decisions or for some other effective participation in corporate affairs.[48] Other matters that may be covered are the circumstances in which dividends will be declared, and alternative methods for resolving disputes that are likely to arise among the participants.[49]

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[44] A dissatisfied minority shareholder in a close corporation may not be able to withdraw his investment because of the lack of a ready market for close corporation shares. This difficulty may be further increased by share transfer restrictions. Seldom can anyone be found who is willing to buy a minority interest in a close corporation, particularly if the company is divided by bitter disputes. A minority shareholder may have all or a substantial part of his capital invested in the company, and at the same time be denied the opportunity to withdraw his interest without the consent of the very shareholders with whom he is in disagreement. Also, a minority shareholder may be concerned about a loss of prestige, which may result from a squeeze-out (Hochstetler & Svejda, Statutory Needs of Close Corporations—An Empirical Study: Special Close Corporation Legislation or Flexible General Corporation Law?, 10 J. CORP. L. 849 (1985)).

[45] O'Neal, Squeeze-Outs of Minority Shareholders: Expulsion or Oppression of Business Associates, §7 (1975 & Supp. 1983).

[46] By way of, say: (1) imposing a fiduciary duty upon all shareholders in the close corporation; (2) allowing the minority shareholders direct participation in the management through voting arrangements and employment contracts; (3) protecting the minority shareholders' investment through preemptive rights and inspection of corporate records; and (4) restricting the transfer of shares (Hochstetler & Svejda, Statutory Needs of Close Corporations—An Empirical Study: Special Close Corporation Legislation or Flexible General Corporation Law?, 10 J. Corp. L. 849 (1985)).

[47] See Anchel v. Shea, 762 A.2d 346, 359–60 (Pa. Super. 2000) (shareholders' agreement calling for each employee to be a director prevented voting trust trustee from removing an employee as a director).

[48] See Painter, Corporate and Tax Aspects of Closely Held Corporations, ch. 3 (2d ed. 1981 & Supp. 1985); Gelb, Close Corporation Control and the Voting Agreement, 16 Land & Water L. Rev. 225 (1981).

[49] Possible means of resolving disputes are provision for arbitration, agreement to dissolve the corporation on the occurrence of stated events, or an arrangement for a buy-out of some shareholders by others or by the corporation

Furthermore, these agreements typically cover selection of the members of the board of directors, the naming of corporate officers, employment of shareholders and their salaries, and the amount of time each participant is to devote to the business.[50] The majority may agree to share its power with the minority for different sets of purposes as to the actual business needs.[51]

in the event of deadlock or dissention (Cox & Halen, Treatise on the Law of Corporations, §14:3 (3rd ed. 2009, database updated November 2013)).

[50] See Sternheimer v. Sternheimer, 155 S.E.2d 41 (Va. 1967) (failure to include provision dealing with amount of time participants are to work for corporation and extent to which outside part-time activities are allowed can lead to dissension and litigation).

[51] Among such purposes, bringing valuable patents into the enterprise or providing needed executives or scientifically skilled employees as key members of the company.

III. TYPES OF SHAREHOLDERS' AGREEMENTS

Shareholders' agreements may take a number of different forms in reflecting the various intents contracting parties carry along while entering into them.[52] The main objective is generally to restrict shareholders' freedom or to arrange the latter' economic rights in a manner different than would follow from their proportionate share ownership. What might be called affirmative agreements include matters usually thought to be within the directors' control of the corporation, such as employment, compensation and the like; these are sometimes referred to as "shareholders' control agreements" to indicate agreements that depart from the usual corporate norms that directors manage the business and affairs of the corporation. These were long the most questionable of shareholders' agreements because legislatures and courts adhered to the view that such interference was not permissible in the corporate form. This broadened recognition of the governance permissible in a corporate venture has been one of the most dramatic developments of the last few decades in the law of close corporations and has greatly broadened the role for shareholders. There also are agreements speaking only to shareholders' functions, a much smaller area of action in the corporate form with election of directors being the most important act. Included in this category are pooling agreements, irrevocable proxy agreements, and voting trusts. A "pooling" agreement is a simple contract providing that the shareholders will vote their shares as a unit in the election of directors and perhaps on other matters; under such an arrangement, each shareholder retains title to the shares and the right to vote them as he merely binds himself contractually to vote in accordance with a prearranged plan.[53]

A shareholders' agreement, however, may do more than merely cover how the

[52] See Henn & Alexander, Laws of Corporations, §267 (3rd ed. 1983); O'Neal & Thompson, O'Neal and Thompson's Close Corporations and LLCs: Law and Practice §4.3 (rev. 3rd ed. 2009, database updated July 2013); Painter, Corporate and Tax Aspects of Closely Held Corporations, §1.7 (2nd ed. 1981 & Supp. 1985).

[53] On this type of voting agreement, see Validity and effect of agreement controlling the vote of corporate stock, 45 ALR2d 799.

shareholders will vote their shares. It may create irrevocable proxies, which take away the shareholders' power to vote their shares and vest that power in one or more of the shareholders or in other persons.[54] Further, an agreement may establish a trust or voting trust pursuant to which the shareholders transfer legal title to their shares to trustees, who vote the shares in accordance with the terms of the trust instrument. In other words, agreements creating voting trusts transfer the legal title of shareholders' stock to trustees, who become the owners of the stock and are thus entitled to cast the vote in accordance with the terms of the trust instrument itself.[55] Pooling agreements, irrevocable proxies and voting trusts are actually rather clumsy ways of establishing the kind of control of a corporation that the participants usually desire. Each of those devices focuses on action at the shareholder level. However, under traditional statutory norms, the shareholders' functions are limited; most important corporate decisions, such as selection of officers, salary determination, and authorization of corporate distributions, are within the province of the directors. Thus, while these arrangements provide ways of determining who will be directors, they do not directly control what those directors will do.

In earlier times shareholders used these shareholder-focused arrangements to actually control what the corporation and its directors did. Such indirect methods to control were sometimes the only available alternative because courts were likely to declare invalid shareholders' agreements directly controlling directors' decisions. In recent times, because of a heightened awareness of the needs of close corporations, both statutes and judicial decisions

[54] This is not the case under Italian law where proxies are always revocable notwithstanding any agreement to the contrary. For compelling arguments pointing out the limits of the application to shareholders' agreements, see Libonati, *Il problema della validità dei sindacati di voto: situazione attuale e prospettive*, in *Sindacati di voto e sindacati di blocco*, Bonelli e Jaeger (a cura di), Milano, Giuffrè, 1993, 13 et seq.; Libertini, *Limiti di validità dei patti parasociali*, Università Bocconi, Research Unit Law and Economics Studies (RULES), 2013, 27; Costi, *I patti parasociali*, in *La riforma delle società quotate*, Milano, Giuffrè, 1998, 132); Oppo, *Commento all'art. 123*, in *Commentario al testo unico delle disposizioni in materia di intermediazione finanziaria*, Alpa e Capriglione (a cura di), Padova, Cedam, 1998, 1137.

[55] In Italy such devices are not allowed and are therefore held void as a result of the application of the principle that the shareholder must always be free to cast his vote contrary to the content of the agreement. In other words, the possibility to be in breach of the agreement must never be taken away from the shareholder's disposal. Scholars have criticized such an outcome of the scrutiny as being quite "crazy" (Lener, *Appunti sui patti parasociali nella riforma del diritto societario*, in *Riv. dir. priv.*, 2004, 1, 51; see also Cottino, *Ancora dei sindacati di voto: con qualche variazione sul tema*, in *Giur. it.*, 1998, 12, 2337).

provide greater leeway for shareholders' agreements that directly control decisions traditionally left to directors. Yet, even in this more permissive legal environment, participants in a close corporation may still prefer the more limited pooling agreement. They may have complete confidence in each other, and each may be willing to assume that his or her associates will not act dishonestly or unfairly. Each shareholder may be satisfied with a right to participate as a director, and thereby have a voice in corporate decision-making. Each shareholder may be willing to rely on the high fiduciary duties the law imposes on shareholders in a close corporation for protection against blatantly unfair treatment. Put another way, shareholders may sometimes prefer (or be willing to accept) assured participation as directors in an ongoing, ever-changing, business relationship, instead of the relative inflexibility of a detailed and highly structured arrangement that specifies how particular business decisions must be made. For such shareholders, assurance of director status may be psychologically preferable to an arrangement which sterilizes the board of directors and, implicitly at least, suggests that one's associates are not to be trusted. Also, such complex control arrangements could increase the possibility of deadlock or corporate paralysis and leave the parties subject to default governance rules that do not fit with their expectations for the enterprise.

Some settings fall between specifying the precise contours of control and the mere provision of participation: This is the case with arrangements focused on giving one or more parties a veto. A participant may be willing to invest in a particular kind of business and in nothing else, and thus may want to be able to veto an amendment of the articles authorizing the corporation to engage in other activities. More frequently, a participant seeks a veto over key policy decisions. An investor who provides most of the cash for an enterprise often seeks a veto over such corporate acts as incurring additional debt, issuing additional stock, or making major

changes in corporate management.[56]

[56] Among the corporate acts over which a shareholder in a close corporation or an outsider thinking of investing in a close corporation might want to have a veto are the following: (1) engaging in any business except that which the corporation is specifically formed to conduct; (2) committing more than a specified percentage of its assets to any particular activity; (3) liquidating, dissolving, merging, consolidating, selling substantially all its property, or acquiring any other business entity; (4) making loans or advances to officers, directors or employees; (5) issuing additional shares of stock, perhaps including the issuance of shares pursuant to an employee compensation plan; and (6) borrowing money. An inactive investor, otherwise content with being a preferred shareholder with a priority right to dividends, may want a veto over major corporate transactions, such as an increase in the corporation's debt, its issuance of additional preferred shares, and merger or consolidation. See Special Comment—Close Corporations, Model Business Corporation Act Ann. §35 par 2 at 759 (2nd ed.).

IV. VALIDITY OF SHAREHOLDERS' AGREEMENTS

The validity and enforceability of control arrangements have been subjects of litigation for more than a century. The early decisions almost invariably held a challenged shareholders' agreement to be invalid. Modern statutes and case law, reflecting the realities of relationships in closely held enterprises, have overturned many of these earlier decisions and given participants in a close corporation substantial room to plan for the rules that best fit their needs. Following is a brief introduction to the major challenges that have been raised, which is aimed at providing a clear understanding of this development and a context for the reader to position a particular decision or statute in the chronology of this area of the law.

Infringing on directors' authority to manage the corporation

Of the traditional reasons given to challenge control arrangements in shareholders' agreements, the one most likely to seem relevant to modern corporate law readers are the argument that these agreements are inconsistent with the statutory norm that the board of directors shall manage the business of a corporation.[57] A considerable number of cases have invalidated shareholders' agreements on the basis of its inconsistency with such statutory provision conferring management powers over the directors.[58] Thus, the New York Court of

[57] See, e.g., Model Business Corporation Act §8.01; Del. Code Ann. tit. 8 §141. Most states now qualify this language by requiring management "by or under the direction of the board of directors." See, e.g., Cal. Corp. Code §300; Del. Code Ann. tit. 8, §141; New York Business Corporation Law §701; Ohio Rev. Code Ann. §1701.59. For most of the 20th century, state statutes were not so flexible. See Model Business Corporation Act Ann. 759 to 761 (2nd ed.) (over 40 states required management "by" a board of directors). See generally Comment, "Shareholders' Agreements" and the Statutory Norm, 43 Cornell L.Q. 68 (1957).

[58] Abercrombie v. Davies, 35 Del. Ch. 599, 123 A.2d 893 (1956); Jackson v. Hooper, 76 N.J. Eq. 592, 75 A. 568 (Ct. Err. & App. 1910); Long Park v. Trenton-New Brunswick Theatres Co., 297 N.Y. 174, 77 N.E.2d 633 (1948); McQuade v. Stoneham, 263 N.Y. 323, 189 N.E. 234 (1934); Fells v. Katz, 256 N.Y. 67, 175 N.E. 516 (1931). See also Kaplan v. Block, 183 Va. 327, 31 S.E.2d 893 (1944) (agreement requiring shareholder approval of directors' actions held invalid); Shaw v. Bankers' Nat. Life Ins. Co., 61 Ind. App 346, 357 to 359, 112 NE 16, 20 (1916) ("the act under which appellee is organized requires that its affairs be managed by a board of directors [...]. The contract under consideration not only delegates to the board of managers a very considerable important part of such powers, including those so specifically designated, but also so delegates them for a period of 30 years [...]. Assuming, without deciding, that a board of directors may for the term of its own existence delegate powers as comprehensive as in the contract here, we know of no decision or authority that it may be done beyond recall to be effective for such an extended period"). See generally Validity of Stockholders' Agreement Allegedly Infringing on Directors' Management Powers—Modern Cases, 15 ALR4th 1078.

Appeals struck down an agreement (among all the shareholders), which gave broad management powers to specified shareholders, on the ground that the agreement sterilized the board of directors and therefore violated the statute.[59] The same court refused to give effect to an agreement among all the shareholders which provided that a designated person would serve as president of the corporation for a period of ten years and that during that term he would not be subject to discharge by the board.[60]

Other statutes on which attacks on shareholders' agreements may be grounded include those with provisions generally to the following effect: directors shall be elected by a plurality of votes cast by the shareholders;[61] specified kinds of shareholders' action (e.g., that required for articles amendment or dissolution) shall be passed by stated percentages of the stock vote;[62] the shareholders shall be entitled to one vote for each share of stock held, except to the extent otherwise provided in the corporation's articles;[63] the shareholders shall meet annually at a time and place fixed in the bylaws; the election of directors shall be by ballot at a shareholders' meeting; directors shall be elected by cumulative voting;[64] a director shall be deemed qualified after he has filed a written acceptance and not before; a director shall hold office until his or her

[59] Long Park v. Trenton-New Brunswick Theatres Co., 297 N.Y. 174, 77 N.E.2d 633 (1948).

[60] Fells v. Katz, 256 N.Y. 67, 175 N.E. 516 (1931). Since the decisions discussed in this paragraph, the enactment of the New York Business Corporation Act has considerably broadened the power of participants in a close corporation to depart from traditional director control; that statute authorizes the use in the articles of provisions to restrict the discretion or powers of the board (New York Business Corporation Law §620(b)).

[61] Benintendi v. Kenton Hotel, 294 N.Y. 112, 60 N.E.2d 829, 159 A.L.R. 280 (1945).

[62] Benintendi v. Kenton Hotel, 294 N.Y. 112, 60 N.E.2d 829, 159 A.L.R. 280 (1945).

[63] See Groub v. Blish, 88 Ind. App. 309, 152 N.E. 609 (1926) (sustaining agreement); Nickolopoulos v. Sarantis, 102 N.J. Eq. 585, 141 A. 792 (Ct. Err. & App. 1928) (invalidating agreement because of conflict with statute). See, generally, Validity of Variations From One Share-One Vote Rule Under Modern Corporate Law, 3 A.L.R.4th 1204.

[64] See E.K. Buck Retail Stores v. Harkert, 157 Neb. 867, 62 N.W.2d 288, 45 A.L.R.2d 774 (1954) (constitutional provision requiring cumulative voting held not to invalidate an agreement between the two principal shareholders of a corporation which provided that each of the contracting parties would designate two members of the four-person board of directors, even though the effect of this was to enable a holder of only 40 percent of the corporation's stock to select half the corporation's board). But see People ex rel. Arkansas Valley Sugar Beet & Irrigated Land Co. v. Burke, 72 Colo. 486, 212 P. 837, 30 A.L.R. 1085 (1923).

successor is elected and qualified;[65] and the officers shall be elected by the directors.

An insistence on rigid compliance with the norms and strict adherence to the traditional scheme of corporation management may be proper in publicly held corporations, but this rigidity is not justified in close corporations.[66] After all, the norms in the corporation statutes reflect those to protect shareholders and investors in publicly held corporations, where there is a separation of management from ownership and a very real danger to the investing public at large. In all probability, the legislatures in enacting these norms did not think of close corporations at all. It then seems fair to argue that had the purpose of the statutory sections, rather than their literal language, be allowed to control their application, they would not be applied to invalidate shareholders' agreements in close corporations, at least where all the shareholders are parties to them.

A shareholders' agreement in a close corporation is usually entered into by the parties only after careful deliberation and sometimes only after prolonged bargaining. Unlike investors in a publicly held corporation – who play no part in preparing the articles of incorporation or bylaws which set up the organization or structure of the corporation and who, therefore, may need the protection afforded by statutory norms – participants in a close corporation (owners and prospective managers of their own business) are in a position to take an active and informed part in setting up the structure of their enterprise. The effect of applying the statutory norms to shareholders' agreements in close corporations is to give the shareholders a protection that they do not need or want, and hinder them in the operation of their business by making it impossible for them to mold the corporate form of enterprise to the needs of their business situation.

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[65] See Peck v. Horst, 175 Kan. 479, 264 P.2d 888 (1953), opinion adhered to on reh'g, 176 Kan. 581, 272 P.2d 1061 (1954), (sustaining a management agreement against attacks based on a number of the statutory Sections mentioned in the text).

[66] Delaney, The Corporate Director: Can His Hands Be Tied in Advance?, 50 Colum. L. Rev. 52, 61 to 62 (1950), points out that it would be unrealistic to adhere strictly to a norm giving directors complete freedom of action, because all contracts relating to corporate management and the employment of key personnel and most loan agreements restrict the discretion of corporate directors in the management of the enterprise.

Hence, corporate norms, including the section providing that the board of directors shall manage the business of a corporation, should be interpreted and applied against the background of well-known facts of corporate life. The conception of the board of a close corporation as a body separate and apart from the shareholders, with unfettered independence and discretion in the conduct of corporate affairs, is a fiction that should not be permitted to becloud the real issue when a party to a business agreement tries to "welch" on his bargain.[67]

Since at least 1960 courts and legislators have shown an increased sensitivity to the need of close corporations to depart from the traditional statutory norms.[68] Court decisions reflect a definite trend toward greater judicial readiness to uphold shareholders' control agreements in close corporation settings.[69] Statutes in almost all the states now expressly authorize inclusion of provisions in a corporation's articles to limit the board's management of the corporation,[70] and most statutes expressly authorize shareholders' agreements to control actions normally handled by directors.[71] Together, there is now substantial support for arrangements permitting deviation

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[67] O'Neal & Thompson, O'Neal and Thompson's Close Corporations and LLCs: Law and Practice, §4:4 (rev. 3rd ed. 2009, database updated July 2013).

[68] "[T]here has been a definite, albeit inarticulate, trend toward eventual judicial treatment of the close corporation as *sui generis*. Several shareholder-director agreements that have technically 'violated' the letter of the Business Corporation Act have nevertheless been upheld in the light of existing practical circumstances, i.e., no apparent public injury, the absence of a complaining minority interest, and no apparent prejudice to creditors [...]. [C]ourts have long ago, quite realistically, we feel, relaxed their attitudes concerning statutory compliance when dealing with close corporation behavior, permitting 'slight deviations' from corporate 'norms' in order to give legal efficacy to common business practice." Galler v. Galler, 32 Ill. 2d 16, 28, 203 N.E.2d 577, 584 (1964).

[69] See Adler v. Svingos, 80 A.D.2d 764, 436 N.Y.S.2d 719 (1st Dep't 1981), noted 35 Syracuse L. Rev. 40 to 43 (1984) (court held that a provision in a shareholders' agreement executed by all three shareholders in a closely held corporation specifying that all corporate operations, including changes in corporate structure, would require the unanimous consent of the shareholders was valid.) See also Wasserman v. Rosengarden, 84 Ill. App. 3d 713, 40 Ill. Dec. 430, 406 N.E.2d 131 (1st Dist. 1980) (court upheld the validity of an oral agreement among all the shareholders in a close corporation providing for the election of the parties thereto as directors and officers and for an equal distribution of salaries and profits as long as the parties remained shareholders or the corporation remained in existence); Kantzler v. Benzinger, 214 Ill. 589, 73 N.E. 874 (1905); De Felice v. Garon, 395 So. 2d 658 (La. 1980) (court held that an agreement by which two of five respondents had secured a right to control the management of a corporation did not contain an invalidating condition); Hughes v. Sego Intern. Ltd., 192 N.J. Super. 60, 469 A.2d 74 (App. Div. 1983) (court stated that shareholder agreements are normally enforceable); Clark v. Dodge, 269 N.Y. 410, 199 N.E. 641 (1936). See, generally, Validity of Stockholders' Agreement Allegedly Infringing on Directors' Management Powers—Modern Cases, 15 ALR4th 1078; Elson, Shareholders' Agreements, A Shield for Minority Shareholders of Close Corporations, 22 Bus. Law 449 (1967).

[70] See, e.g., Cal. Corp. Code §300(a); Del. Code Ann. tit. 8, §141(a); MCLA §§450.1463, 450.1501.

[71] See, e.g., Ga. Code Ann. §14-2-920(4); Me. Rev. Stat. Ann. tit. 13-C, §743.

from the traditional pattern of corporation management. Even in the 1930's, at a time when many courts were invalidating shareholders' agreements, the New York Court of Appeals upheld an agreement of all of a corporation's shareholders that "impinged" only slightly on the statutory norm of management by the directors.[72] Other courts have sustained agreements by refusing to find a conflict between the agreements and the statutes.[73] Similarly, a shareholders' agreement giving one of the shareholders power to veto changes in corporate officers (or their salaries) and to veto proposals to incur expenses or pay dividends was sustained against the claim that it violated a statute fixing a quorum for the transaction of business by the directors.[74] Still other courts have sustained shareholders' agreements by ruling that conflicting statutes were merely directory.[75]

A number of courts have taken what appears to be a very sensible approach to the problem and have held that shareholders may in some instances waive rights under statutory norms by contracting away protections and privileges afforded by those norms. According to this

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[72] Clark v. Dodge, 269 N.Y. 410, 199 N.E. 641 (1936). See also Drucklieb v. Sam H. Harris, 209 N.Y. 211, 102 N.E. 599 (1913); Ripin v. Atlantic Mercantile Co., 205 N.Y. 442, 448, 98 N.E. 855, 857 (1912). "So, where the public was not affected, 'the parties in interest, might, by their original agreement of incorporation, limit their respective rights and powers,' even where there was a conflicting statutory standard." Clark v. Dodge, 269 N.Y. 410, 416, 199 N.E. 641, 643 (1936). But see Long Park v. Trenton-New Brunswick Theatres Co., 297 N.Y. 174, 77 N.E.2d 633 (1948) (unanimous shareholders' agreement held invalid because it 'sterilized' the board of directors).

[73] See, e.g., In re American Fibre Chair Seat Corp., 241 A.D. 532, 272 N.Y.S. 206 (2d Dep't 1934), aff'd, 265 N.Y. 416, 193 N.E. 253 (1934) (statute providing that each shareholder shall have one vote for every share standing in his name does not prevent shareholders from making an agreement among themselves to set up a system of cumulative voting); K. Buck Retail Stores v. Harkert, 157 Neb. 867, 62 N.W.2d 288, 45 A.L.R.2d 774 (1954) (shareholders' control agreements have been held not to violate constitutional and statutory requirements of cumulative voting in elections of directors.). Cf. In Sensabaugh v. Polson Plywood Co., 135 Mont. 562, 342 P.2d 1064 (1959), the Montana Supreme Court stated that shareholders may validly contract not to vote cumulatively in spite of a constitutional guarantee of such right, but held that agreements of that kind cannot be implemented through the medium of the bylaws or the articles of incorporation because then the provisions would bind all shareholders, including those who had not consented to forego their right to vote cumulatively. See also Galler v. Galler, 32 Ill. 2d 16, 203 N.E.2d 577 (1964) (10-year statutory limitation on voting trusts held not applicable to a control agreement executed by the two principal shareholders and their wives which was to remain in effect until the death of the last of the contracting parties).

[74] Fitzgerald v. Christy, 242 Ill. App. 343, 1926 WL 3943 (1st Dist. 1926).

[75] E.g., Clark v. Foster, 98 Wash. 241, 167 P. 908, 911 (1917) (in passing on a statute's effect on the validity of a voting trust, court indicated that only a "positive prohibitory statute" would invalidate the trust, commenting that it "is the settled policy of the law [...] to recognize and sustain the right of the parties to deal freely, and unless a statute, which provides in general terms that a thing may be done in a certain manner, is clearly prohibitory in its terms, or carries some penalty for its violation, to hold it to be directory.").

view, the validity of an agreement which waives a statutory right or deviates from a statutory rule depends on the purpose for which the statute was enacted and the effect (if any) the agreement has on the achievement of that purpose; ordinarily, an agreement is not held invalid unless it is injurious in some ways to the interests of society and thus frustrates the purpose of the statute.[76] Thus, a voting trust and management agreement (executed by holders of all of a corporation's stock) which gave three trustees control of the corporation for a period of ten years was sustained against the contention that it violated a number of sections of the Kansas Corporation Code, including the provision that a corporation shall be managed by its board of directors.[77] Similarly, an agreement by a corporation's two shareholders which prohibited either one from causing the dissolution of the corporation except in ways specified in the agreement was given effect by a Massachusetts court, even though a statute provided that a corporation or its members might file for dissolution under circumstances different from those set forth in the agreement.[78] The court concluded that through the contract the parties had waived their statutory right to file a petition for dissolution.[79]

This reasoning finds itself to be unnecessary if the corporation statute clearly permits deviation from the traditional statutory norms as is now common. A state's enactment of section 7.32 of the Model Business Corporation Act, now found (or language like it) in the majority of

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[76] Peck v. Horst, 175 Kan. 479, 264 P.2d 888 (1953), opinion adhered to on reh'g, 176 Kan. 581, 272 P.2d 1061 (1954). "Generally speaking public policy requires compliance with statutes regulating the management of corporations. But whether the effect of any specific statute can be avoided by contract depends upon the purpose for which the statute was enacted." Continental Corp. v. Gowdy, 283 Mass. 204, 217, 186 N.E. 244, 249, 87 A.L.R. 1039 (1933).

[77] Peck v. Horst, 175 Kan. 479, 264 P.2d 888 (1953), opinion adhered to on reh'g, 176 Kan. 581, 272 P.2d 1061 (1954). See also Logan, Methods To Control the Closely Held Kansas Corporation, 7 U. Kan L. Rev. 405, 431 (1959), where the author concludes that Peck v. Horst "would seem to establish that in Kansas the owners can do as they wish on any or all management questions."

[78] Leventhal v. Atlantic Finance Corp., 316 Mass. 194, 55 N.E.2d 20, 154 A.L.R. 260 (1944).

[79] "Leventhal and Epstein owned all the beneficial interest in the corporation by virtue of their ownership of the stock, and there is nothing in the nature of the remedy afforded a stockholder by Section 50 that he cannot waive or contract away. It comes within the general rule that one may waive the benefits of a statutory remedy provided he does not thereby contravene the public policy of the Commonwealth." Leventhal v. Atlantic Finance Corp., 316 Mass. 194, 206, 55 N.E.2d 20, 26, 154 A.L.R. 260 (1944).

states, removes many challenges to the validity of shareholders' agreements.[80] The Official

[80] Section 7.32 Shareholder Agreements of the Model Business Corporation Act reads as follows:
"(a) An agreement among the shareholders of a corporation that complies with this Section is effective among the shareholders and the corporation even though it is inconsistent with one or more other provisions of this Act in that it:
(1) eliminates the board of directors or restricts the discretion or powers of the board of directors;
(2) governs the authorization or making of distributions whether or not in proportion to ownership of shares, subject the limitations in Section 6.40;
(3) establishes who shall be directors or officers of the corporation, or their terms of office or manner of selection or removal;
(4) governs, in general or in regard to specific matters, the exercise or division of voting power by or between the shareholders and directors or by or among any of them, including use of weighted voting rights or director proxies;
(5) establishes the terms and conditions of any agreement for the transfer or use of property or the provision of services between the corporation and any shareholder, director, officer or employee of the corporation or among any of them;
(6) transfers to one or more shareholders or other persons all or part of the authority to exercise the corporate powers or to manage the business and affairs of the corporation, including the resolution of any issue about which there exists a deadlock among directors or shareholders;
(7) requires dissolution of the corporation at the request of one or more of the shareholders or upon the occurrence of a specified event or contingency; or
(8) otherwise governs the exercise of the corporate powers or the management of the business and affairs of the corporation or the relationship among the shareholders, the directors and the corporation, or among any of them, and is not contrary to public policy.
(b) An agreement authorized by this Section shall be:
(1) set forth (A) in the articles of incorporation or bylaws and approved by all persons who are shareholders at the time of the agreement or (B) in a written agreement that is signed by all persons who are shareholders at the time of the agreement and is made known to the corporation;
(2) subject to amendment only by all persons who are shareholders at the time of the amendment, unless the agreement provides otherwise; and
(3) valid for 10 years, unless the agreement provides otherwise.
(c) The existence of an agreement authorized by this Section shall be noted conspicuously on the front or back of each certificate for outstanding shares or on the information statement required by Section 6.26(b). If at the time of the agreement the corporation has shares outstanding represented by certificates, the corporation shall recall the outstanding certificates and issue substitute certificates that comply with this subSection. The failure to note the existence of the agreement on the certificate or information statement shall not affect the validity of the agreement or any action taken pursuant to it. Any purchaser of shares who, at the time of purchase, did not have knowledge of the existence of the agreement shall be entitled to rescission of the purchase. A purchaser shall be deemed to have knowledge of the existence of the agreement if its existence is noted on the certificate or information statement for the shares in compliance with this subSection and, if the shares are not represented by a certificate, the information statement is delivered to the purchaser at or prior to the time of purchase of the shares. An action to enforce the right of rescission authorized by this subSection must be commenced within the earlier of 90 days after discovery of the existence of the agreement or two years after the time of purchase of the shares.
(d) An agreement authorized by this Section shall cease to be effective when shares of the corporation are listed on a national securities exchange or regularly traded in a market maintained by one or more members of a national or affiliated securities association. If the agreement ceases to be effective for any reason, the board of directors may, if the agreement is contained or referred to in the corporation's articles of incorporation or bylaws, adopt an amendment to the articles of incorporation or bylaws, without shareholder action, to delete the agreement and any references to it.
(e) An agreement authorized by this Section that limits the discretion or powers of the board of directors shall relieve the directors of, and impose upon the person or persons in whom such discretion or powers are vested, liability for acts or omissions imposed by law on directors to the extent that the discretion or powers of the directors are limited by the agreement.
(f) The existence or performance of an agreement authorized by this Section shall not be a ground for imposing personal liability on any shareholder for the acts or debts of the corporation even if the agreement or its performance treats the corporation as if it were a partnership or results in failure to observe the corporate formalities otherwise applicable to the matters governed by the agreement.

Comment to that section states: "Heretofore, however, the Model Act has never expressly validated shareholders' agreements. Rather than relying on further uncertain and sporadic development of the law in the courts Section 7.32 rejects the older line of cases. It adds an important element of predictability currently absent from the Model Act and affords participants in closely held corporations greater contractual freedom to tailor the rules of their enterprise."[81] Since the advent of statutes authorizing articles' provisions limiting the powers of directors, some courts have taken the approach that since the statute now expressly permits departure from the traditional norms by charter provision, there is really no strong state policy against departing from the norms. Consequently, when a corporation's shareholders by agreement assent to depriving directors of traditional powers, a court can appropriately find that the parties have contracted, if only by implication, to amend the articles to satisfy the statutory requirement and thus achieve the objective of their agreement.[82]

In the minority of states where the express language only validates deviations that appear in the corporation's articles, this reasoning from the prior cases may continue to be helpful.[83] For a variety of reasons, participants in close corporations sometimes do not put their control arrangements into the articles; so that even under some modern statutes, the traditional statutory

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(g) Incorporators or subscribers for shares may act as shareholders with respect to an agreement authorized by this Section if no shares have been issued when the agreement is made."

[81] See Changes in the Revised Model Business Corporation Act—Amendments Pertaining to Closely Held Corporations, 46 Bus. Law 297, 302 (1990).

[82] See, e.g., Adler v. Svingos, 80 A.D.2d 764, 436 N.Y.S.2d 719 (1st Dep't 1981), noted 35 Syracuse L. Rev. 40 to 43 (1984) (court held that a provision in a shareholders' agreement executed by all three shareholders in a closely held corporation specifying that all corporate operations, including changes in corporate structure, would require the unanimous consent of the shareholders was valid, and did not violate the provisions of Section 620(b) of the New York Business Corporation Law, which states the circumstances in which such a veto provision may be included in a corporation's certificate of incorporation, even though the shareholders had not amended their corporation's certificate of incorporation to include the unanimous consent agreement); Zion v. Kurtz, 50 N.Y.2d 92, 428 N.Y.S.2d 199, 405 N.E.2d 681, 15 A.L.R.4th 1061 (1980), noted 33 Syracuse L. Rev. 15 to 17 (1982) (court held that a shareholders' agreement prohibiting the conduct of corporate business without the consent of the minority shareholder was not against the public policy of Delaware, and was enforceable even though it was not incorporated in the corporation's articles as specified by Section 351 of the Delaware Corporation Code).

[83] See, e.g., Del. Code Ann. tit. 8, §141; N.J. Rev. Stat. §14A:6-1.

norms may still provide grounds for attacking shareholders' agreements.[84]

Limiting shareholders' ability to use the corporate form and be partners inter se

Courts have sometimes indicated that, even aside from the violation of specific statutory norms, shareholders' agreements will be held void if they establish a pattern of corporation management and operation different from that contemplated by the corporation statute.[85] In some sense, the idea reflects the concession theory of corporate existence developed in earlier times that incorporation and limited liability are special privileges granted by the state and that the enjoyment of those privileges is conditioned on strict conformity to the traditional pattern of corporation management and operation. A related notion is that directors derive their powers from the state and not from the shareholders, and therefore the shareholders cannot by contract among themselves deprive the directors of their powers.

More generally, shareholders' agreements frequently run counter to the idea, expressed from time to time in judicial opinions, that business participants who incorporate must consistently conduct their enterprise as a corporation; i.e., they must operate the business in the traditional corporate manner and cannot revert, whenever they so desire, to partnership practices in the management of the business or in relations among themselves. Thus, a number of

[84] See, e.g., Somers v. AAA Temporary Services, Inc., 5 Ill. App. 3d 931, 284 N.E.2d 462 (1st Dist. 1972) (shareholders cannot by agreement amend the bylaws to reduce the number of directors if the power to amend the bylaws has not been reserved to the shareholders by the articles of incorporation); Gazda v. Kolinski, 91 A.D.2d 860, 458 N.Y.S.2d 387 (4th Dep't 1982), aff'd in part, appeal dismissed in part, 64 N.Y.2d 1100, 489 N.Y.S.2d 907, 479 N.E.2d 252 (1985) (court held that insofar as a shareholders' agreement provided that there could be no increase in salaries without unanimous shareholder approval, it was void and unenforceable where the certificate of incorporation did not provide for such a limitation).

[85] See Jackson v. Hooper, 76 N.J. Eq. 592, 75 A. 568 (Ct. Err. & App. 1910). "Where it is not otherwise provided, the implication in a grant of corporate power and life is that the corporation shall exercise its powers and carry on its business through its own officers and employees [...]." Anglo-American Land, Mortgage & Agency Co. v. Lombard, 132 F. 721, 736 (C.C.A. 8th Cir. 1904). In Frieda Popkov Corp. v. Stack, 198 Misc. 826, 103 N.Y.S.2d 507, 509 (Sup. 1950), the court, in holding invalid an agreement by a corporation to enter into a partnership, stated: "It is a fundamental principle of the laws of this State governing corporations that the management and affairs of each corporation are to be guided by the officers provided for or authorized in its charter. This management must be separate and exclusive, and any arrangement by which control of the affairs of a corporation may be taken from its stockholders and authorized officers and agents would be hostile and in opposition to the established policy of our general corporation statutes [...]."

jurisdictions refused to recognize that a corporation could serve as the mere instrumentality of a partnership or joint adventure on the conceptual ground that a corporation is a distinct type of business organization and that its characteristics cannot be mingled with those of a partnership or joint adventure.[86] This idea was perhaps most forcefully expressed in a New Jersey opinion,[87] in which the court stated: "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 co-partnership or a corporation, as the exigencies or purposes of their joint enterprise may from time to time require [...]. 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 rights, duties, and obligations of stockholders. They cannot be partners inter se and a corporation as to the rest of the world."[88]

Some courts never accepted this idea that shareholders cannot conduct the corporation and regulate their relations among themselves as though they were partners,[89] and its influence in

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[86] See Manacher v. Central Coal Co., 284 A.D. 380, 131 N.Y.S.2d 671 (1st Dep't 1954), judgment aff'd, 308 N.Y. 784, 125 N.E.2d 431 (1955); Note, 69 Harv. L. Rev. 565 (1956), citing Jackson v. Hooper, 76 N.J. Eq. 592, 75 A. 568 (Ct. Err. & App. 1910). See also Seitz v. Michel, 148 Minn. 80, 181 N.W. 102, 12 A.L.R. 1060 (1921); Sun River Stock & Land Co. v. Montana Trust & Savings Bank, 81 Mont. 222, 262 P. 1039 (1928); Leviton v. North Jersey Holding Co., 106 N.J. Eq. 517, 151 A. 389 (Ch. 1930). In 1960 a New York court stated: "In any event, it is well-settled law in New York that a joint venture may not be carried on by individuals through a corporate form. The two methods of conducting a business, namely, a joint venture and a corporate entity are mutually exclusive and each is governed by a separate body of law." Loverdos v. Vomvouras, 23 Misc. 2d 464, 466, 200 N.Y.S.2d 921, 923 (Sup 1960). See also Tow v. Moore, 24 A.D.2d 648, 262 N.Y.S.2d 134 (2d Dep't 1965) (memorandum) (partners who utilize corporate entity relegate themselves to whatever rights they have as shareholders, directors, or officers). But see Arditi v. Dubitzky, 354 F.2d 483, 485 (2d Cir. 1965); Kruger v. Gerth, 16 N.Y.2d 802, 806, 263 N.Y.S.2d 1, 4, 210 N.E.2d 355 (1965) (Fuld, J., dissenting). See generally Powers, Cross Fire on the Close Corporation: Norms Versus Needs, 11 U. Fla. L. Rev. 433, 470 (1958): "Forcing partners who wish to incorporate to submit to majority rule and the formal mechanics of publicly held corporations will not contribute an iota to the protection of creditors or to the progress and stability of the world of business and should not be regarded as the quid pro quo for limited liability."

[87] Jackson v. Hooper, 76 N.J. Eq. 592, 75 A. 568, 571 (Ct. Err. & App. 1910).

[88] Similar language is contained in In re Klaus, 67 Wis. 401, 406, 29 N.W. 582, 584 (1886): The incorporators have secured the advantages of a corporation, and they should be governed by all the other incidents of a corporation. Why not? They cannot be a corporation, and still remain, in respect to the same business a co-partnership. The one must completely displace the other [...]. The stockholders, directors, and officers cannot act as partners, or be personally bound as partners. The incorporators, if formerly partners in the same business, and the partnership, are merged in the corporation—not partially, but fully and completely.

[89] See, e.g., Beardsley v. Beardsley, 138 U.S. 262, 11 S. Ct. 318, 34 L. Ed. 928 (1891); Wabash Ry. Co. v. American Refrigerator Transit Co., 7 F.2d 335 (C.C.A. 8th Cir. 1925); Elsbach v. Mulligan, 58 Cal. App. 2d 354, 136 P.2d 651

decisions passing on the validity of shareholders' agreements has steadily decreased.[90] The many statutes and decisions permitting shareholders' agreements which modify the traditional pattern of corporate control[91] and the abundant statutory and case authorities supporting veto provisions in the articles and bylaws show without question that in most jurisdictions participants in a closely held enterprise can in practical effect be partners among themselves, or nearly so, but a corporation to the rest of the world. As the United States Court of Appeals for the Second Circuit stated: "There is little logical reason why individuals cannot be 'partners inter se and a corporation as to the rest of the world,' so long as the rights of third parties such as creditors are not involved."[92]

Separating voting power from the ownership of stock

A third argument, which had its greatest use in the early era of the development of American corporate law, focused on the shareholder's role.[93] Some of the decisions – mostly decided before 1910 – indicated that there could be no agreement, or any device whatsoever, by which the voting power of stock was irrevocably separated from the ownership of the stock,[94] at

(1st Dist. 1943); Hladovec v. Paul, 222 Ill. 254, 78 N.E. 619 (1906); Fitzgerald v. Christy, 242 Ill. App. 343, 1926 WL 3943 (1st Dist. 1926); Mendelsohn v. Leather Mfg. Corp., 326 Mass. 226, 93 N.E.2d 537 (1950); Hathaway v. Porter Royalty Pool, 296 Mich. 90, 295 N.W. 571, 138 A.L.R. 955 (1941), opinion amended, 296 Mich. 733, 299 N.W. 451, 138 A.L.R. 955 (1941).

90 See, e.g., Arditi v. Dubitzky, 354 F.2d 483 (2d Cir. 1965) (court held that a complaint for breach of a joint venture agreement stated a cause of action under New York and New Jersey law despite subsequent incorporation of the venture, if the parties intended the corporation to be merely an instrumentality of the joint venture). See also Hornstein, Judicial Tolerance of the Incorporated Partnership, 18 Law & Contemp. Prob. 435, 443 (1953) (criticizing the notion that persons cannot be partners among themselves and a corporation as to the rest of the world).

91 See particularly the decisions cited in §§4:6 to 4:8. See, generally, Validity of Stockholders' Agreement Allegedly Infringing on Directors' Management Powers—Modern Cases, 15 ALR4th 1078.

92 Arditi v. Dubitzky, 354 F.2d 483, 486 (2d Cir. 1965).

93 See Lilienthal, Corporate Voting and Public Policy, 10 Harvard Law Review 428 (1897).

94 Perry v. Missouri-Kansas Pipe Line Co., 22 Del. Ch. 33, 191 A. 823 (1937) (voting trust in excess of statutory term held wholly invalid); In re Chilson, 19 Del. Ch. 398, 168 A. 82 (1933) (proxy not coupled with an interest, though stated to be irrevocable, held revocable at any time); Morel v. Hoge, 130 Ga. 625, 61 S.E. 487 (1908) (voting agreement held against public policy, although the court acknowledged that the motives of the contracting parties might have been to promote the prosperity of the corporation); Luthy v. Ream, 270 Ill. 170, 110 N.E. 373 (1915) (agreement to vote shares as a unit for ten years held invalid); Lothrop v. Goudeau, 142 La. 342, 76 So. 794 (1917); Warren v. Pim, 66 N.J. Eq. 353, 59 A. 773 (Ct. Err. & App. 1904) (voting trust not in compliance with statute held invalid); White v. Thomas Inflatable Tire Co., 52 N.J. Eq. 178, 28 A. 75 (Ch. 1893) (voting trust held void); Bridgers

least as long as the power to vote was not coupled with some interest in the stock.[95] The power to vote was treated as inherently annexed to, and inseparable from, the ownership of the shares.[96] Further, the shareholders were considered to have contracted for each other's independent advice and judgment to be exercised at shareholders' meetings—primarily.[97] Thus, each shareholder owed to fellow shareholders a duty to vote shares in what the shareholder conceived to be the best interest of the corporation,[98] and the other shareholders were thought to have a right to insist that they exercise independent judgment in casting this vote. As was said in an early

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v. Staton, 150 N.C. 216, 63 S.E. 892 (1909) (10-year pooling agreement held against public policy); Roberts v. Whitson, 188 S.W.2d 875 (Tex. Civ. App. Dallas 1945), writ refused w.o.m., (Oct. 3, 1945) (agreement by majority shareholders to vote as a unit, decision to be made by arbitrator in event of disagreement, held void). In Harvey v. Linville Imp. Co., 118 N.C. 693, 24 S.E. 489, 490 (1896), the court declared that "any combination or device by which a number of stockholders shall combine to place the voting of their shares in the irrevocable power of another is held contrary to public policy." See also Nickolopoulos v. Sarantis, 102 N.J. Eq. 585, 587, 141 A. 792, 793 (Ct. Err. & App. 1928) ("The stockholders are powerless, except by the method provided [by law], to alter the voting power of any share of stock"). It has been suggested that the hostility to voting agreements might have arisen in the 1890's when stock pooling agreements were among the devices used to evade the antitrust laws. Note, 52 Mich. L. Rev. 1243 (1954).

[95] "It is true that in a number of cases voting agreements and irrevocable proxies have been sustained, but this does not seem ever to have been done except where the person to whom the voting power is delegated by agreement or by proxy has some recognizable property or financial interest in the stock in respect of which the voting power is to be exercised by him, as distinguished from an interest in the corporation generally, on the one hand, and an interest in the bare voting power or the results to be accomplished by the use of it, on the other hand." In re Chilson, 19 Del. Ch. 398, 409, 168 A. 82, 85 (1933). Judge Pitney made the following pithy comments in Warren v. Pim, 66 N.J. Eq. 353, 384, 59 A. 773, 784 (Ct. Err. & App. 1904): "[T]here is in my mind no doubt that the right to vote cannot be annexed to a trust which holds only the power of voting. An appurtenant right cannot be appurtenant to itself alone. An incidental power cannot be incidental to itself alone. Such a status is to me so unthinkable as a human voice without a human being; as a lever without a fulcrum."

[96] Luthy v. Ream, 270 Ill. 170, 181, 110 N.E. 373, 376 (1915); Harvey v. Linville Imp. Co., 118 N.C. 693, 24 S.E. 489 (1896).

[97] Notes, 3 Chi. L. Rev. 640, 642 (1936); 98 Pa L. Rev. 401 (1950); Comment, 47 Mich. L. Rev. 547, 549 (1949). In Haldeman v. Haldeman, 176 Ky. 635, 649, 197 S.W. 376, 382 (1917), the court commented "Although a stockholder may vote as he pleases, public policy forbids the enforcement of a contract by which a stockholder undertakes to bargain away his right to vote for directors according to his best judgment, and in the interest of the corporation. He has no right to disable himself by contract from performing this duty." See also Ham, The Close Corporation Under Kentucky Law, 50 Ky. L.J. 125, 144 to 156 (1961); Smith, Limitations on the Validity of Voting Trusts, 22 Colum. L. Rev. 627, 630 (1922).

[98] Morel v. Hoge, 130 Ga. 625, 61 S.E. 487 (1908); Guernsey v. Cook, 120 Mass. 501, 1876 WL 14262 (1876); Gage v. Fisher, 5 N.D. 297, 65 N.W. 809 (1895). "Stockholders have a duty to perform, that is, to use their voting power for the best interests of the corporation, and cannot agree or combine in such a way as to place their voting power in others, thereby disqualifying themselves to perform this duty; but at all times must be free to cast their vote for what they deem the best interests of the corporation." Roberts v. Whitson, 188 S.W.2d 875, 878 (Tex. Civ. App. Dallas 1945), writ refused w.o.m., (Oct. 3, 1945).

Connecticut decision,[99] a shareholder may shirk his duty by failing to attend meetings, but "the law will not allow him to strip himself of the power to perform his duty." Perhaps many of the early cases were properly decided on their facts, because some of the agreements declared invalid had objectives which were clearly fraudulent;[100] but the broad sweeping statements unequivocally condemning all voting agreements were most unfortunate in that they deprived business participants and their lawyers of very useful devices for molding the corporate form to the needs of particular business enterprises.[101]

About 1910, and in some jurisdictions even before 1910, there was a sharp reversal of judicial thinking concerning voting arrangements;[102] and by the mid-twentieth century, most courts declined to hold a shareholders' voting agreement void per se solely because it separates voting power from the ownership of the shares.[103] In many jurisdictions, early judicial

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[99] Bostwick v. Chapman, 60 Conn. 553, 579, 24 A. 32, 41 (Super. Ct. 1890). See also Haldeman v. Haldeman, 176 Ky. 635, 197 S.W. 376 (1917). "His associates had a right to believe, that in all his acts as such stockholder [...] he had a common, and in proportion to his shares, an equal interest, and they had a right to rely on his judgment, his recommendations of directors and other acts, with all the confidence inspired by such a belief." Fuller v. Dame, 35 Mass (18 Pick) 472, 484 (1836).

[100] "We have examined case after case, and find generally that the agreements declared void by the courts, where the power to vote was separated from the stockholder, and vested in third persons, were under circumstances which showed that the purpose to be accomplished was unlawful [...]." Mobile & O.R. Co. v. Nicholas, 98 Ala. 92, 118, 12 So. 723, 731 (1893). The language used in practically all of the above decisions was much broader than was called for by the facts involved in them. See Lilienthal, Corporate Voting and Public Policy, 10 Harv. L. Rev. 428, 430 (1897).

[101] Delaney, The Corporate Director: Can His Hands Be Tied in Advance?, 50 Colum. L. Rev. 52, 65 (1950).

[102] For an analysis of the authorities as of 1910, see Tuller, The Rules Which Determine the Validity or Invalidity of Voting Agreements of Corporate Stock, 44 Am. L. Rev. 663 (1910). In 1910, the Virginia Supreme Court of Appeals stated that: it is impossible not to be impressed with the change of opinion which has taken place with respect to the true nature of such contracts. In the early stages of the development of this idea, there was a strong sentiment against them which found expression in the opinions of judges and in the not always temperate language of distinguished commentators upon the law; but experience has demonstrated their usefulness, and the hostility evinced toward them has by degrees diminished. Carnegie Trust Co. v. Security Life Ins. Co. of America, 111 Va. 1, 20, 68 S.E. 412, 418 (1910). For developments between 1910 and 1918, see Wormser, The Legality of Corporate Voting Trusts and Pooling Agreements, 18 Colum. L. Rev. 123 (1918).

[103] Many of the decisions are collected in Validity and effect of agreement controlling the vote of corporate stock, 45 ALR2d 799, superseding 71 A.L.R. 1289. See also Hall v. Merrill Trust Co., 106 Me. 465, 76 A. 926 (1910). In Mackin v. Nicollet Hotel, 25 F.2d 783, 786 (C.C.A. 8th Cir. 1928), the court said that "the old theory which seemed to dominate the earlier writers, to the effect that every stockholder in a corporation is entitled to have the benefit of the judgment of every other stockholder in the selection of a board of directors, has necessarily been rendered obsolete because of our modern business being conducted by large corporations with thousands of stockholders located in all parts of the country." Query whether the court gave the real reason for the abandonment of the old theory. Voting arrangements appear to be as justified in close corporations as in publicly held corporations, and in fact are at least as widely used in close corporations as in publicly held corporations. But see Odman v. Oleson, 319

declarations broadly condemning all voting agreements (largely dicta in the first place) were softened[104] or ignored[105] in later opinions; and when other jurisdictions ruled on voting agreements for the first time, they sustained those in which there was "a property interest to conserve, some definite policy in the interest of the corporation to be carried out, some beneficial interest of the stockholders to be served, or some purpose not unlawful of an advantageous character to the stockholders to be effectuated."[106] As was said in a Nebraska decision,[107] hostility toward voting "agreements and combinations seems to be lessening, or perhaps is becoming more discriminating between good and bad ends."

The trend toward sustaining voting agreements gained added momentum with the widespread adoption of statutes authorizing agreements.[108] An important Delaware decision on corporate vote buying rejected efforts to define impermissible vote buying by reference to this earlier public policy, that the agreement frustrated the shareholder's exercise of personal judgment.[109] In the context of a public corporation, the court refused to apply the traditional per se rule for vote buying to an agreement that it found "was entered into primarily to further the

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Mass. 24, 26, 64 N.E.2d 439, 440 (1946), (the court, citing some of the early cases, reaffirmed the view that "although a stockholder is not in general a fiduciary in his relations to the corporation [...] a contract is void as against public policy which takes away even from stockholders freedom to use their judgment as to the best interests of the corporation."); Smith v. Biggs Boiler Works Co., 32 Del. Ch. 147, 82 A.2d 372 (1951), (finding agreement of two shareholders whose shares were being held by a bank under an escrow agreement, did not satisfy requirements of voting trust, pooling or irrevocable proxy statutes) See also Cummins v. McCoy, 22 Tenn. App. 681, 125 S.W.2d 509 (1938); Roberts v. Whitson, 188 S.W.2d 875 (Tex. Civ. App. Dallas 1945), writ refused w.o.m., (Oct. 3, 1945).

[104] Comment, 47 Mich. L. Rev. 547, 550 (1949).

[105] Compare Katcher v. Ohsman, 26 N.J. Super. 28, 97 A.2d 180 (Ch. Div. 1953), with Jackson v. Hooper, 76 N.J. Eq. 592, 75 A. 568 (Ct. Err. & App. 1910), and Warren v. Pim, 66 N.J. Eq. 353, 59 A. 773 (Ct. Err. & App. 1904).

[106] Boyer v. Nesbitt, 227 Pa. 398, 76, 76 A. 103 (1910).

[107] E.K. Buck Retail Stores v. Harkert, 157 Neb. 867, 62 N.W.2d 288, 297, 45 A.L.R.2d 774 (1954).

[108] See e.g., Weil v. Beresth, 154 Conn. 12, 220 A.2d 456 (1966); Galler v. Galler, 32 Ill. 2d 16, 203 N.E.2d 577 (1964); Peck v. Horst, 175 Kan. 479, 264 P.2d 888 (1953), opinion adhered to on reh'g, 176 Kan. 581, 272 P.2d 1061 (1954); De Boy v. Harris, 207 Md. 212, 113 A.2d 903 (1955); E.K. Buck Retail Stores v. Harkert, 157 Neb. 867, 62 N.W.2d 288, 45 A.L.R.2d 774 (1954); Katcher v. Ohsman, 26 N.J. Super. 28, 97 A.2d 180 (Ch. Div. 1953).

[109] Schreiber v. Carney, 447 A.2d 17, 25 (Del Ch. 1982) (the potential injury that might flow to other stockholders as a result of the agreement forms the heart of the rationale underlying the breach of public policy doctrine).

interests of [the corporation's] other shareholders."[110] Yet, the Court held that vote buying, even for some laudable purpose, still is "so easily susceptible of abuse" that it must be viewed as a voidable transaction subject to a test for intrinsic fairness.[111]

[110] Schreiber v. Carney, 447 A.2d 17, 25 (Del Ch. 1982).

[111] Schreiber v. Carney, 447 A.2d 17, 26 (Del Ch. 1982). That setting raises important questions about the alignment required between individual voters and the collective interest if voting is to play a consistent role in corporate governance, particularly in light of activities of hedge funds and other activist investors. See, e.g., Hu and Black, Equity and Debt Decoupling and Empty Voting II: Importance and Extensions, 156 U. Pa. L. Rev. 625 (2008). But in any event, the application of such policy in a public setting will differ from a close corporation, see Thompson & Edelman, Corporate Voting, 62 Vand. L. Rev. (2009).

V. STATUTORY APPROACHES TO SHAREHOLDERS' AGREEMENTS

Most states have statutes on the four principal types of shareholders' agreements we briefly introduced above, to wit: shareholders' control agreements, voting trusts, pooling agreements, and irrevocable proxies: Following is an overview of the various statutory approaches, whereas subsequent sections discuss in more detail the legislation applicable to each of these types of agreements.

Shareholders' control agreements

The statutory development with the greatest potential impact on planning the allocation of corporate control is the enactment by most states of statutes which authorize shareholders' agreements transferring to all or some shareholders decisions normally reserved to the directors under traditional corporate norms.[112] Section 7.32 of the Model Business Corporation Act, added in 1991, seeks to remove many challenges to the validity of such shareholders' agreements and answers many of the statutory authority questions raised in the previous section. A majority of the states have such a statute patterned on section 7.32 or language with similar effects.[113] Conversely, almost all of the states without an express statute authorizing shareholders' control agreements have amended their statute placing corporate powers with the board so that variations from this norm are permitted if they are set forth in a corporation's articles.[114] Even in these states, a unanimous shareholders' agreement has sometimes been held to effectively allocate power.[115]

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[112] See, e.g., MCLA §450.1488; Minn. Stat. §302A.457 (permits shareholders to agree unanimously to bind each other and the corporation on any matter, even those matters traditionally reserved to the board of directors).

[113] See Changes in the Revised Model Business Corporation Act—Amendments Pertaining to Closely Held Corporations, 46 Bus. Law 297, 302 (1990).

[114] See, e.g., Del. Code Ann. tit. 8, §141(a); N.M. Stat. Ann. §53-11-35; Cf. La. Rev. Stat. Ann. §12:81 (variation by provision in the articles or bylaws).

[115] Zion v. Kurtz, 50 N.Y.2d 92, 428 N.Y.S.2d 199, 405 N.E.2d 681, 15 A.L.R.4th 1061 (1980), noted 33 Syracuse L. Rev. 15 to 17 (1982) (court enforced a shareholders' agreement providing that no business or activities of a closely held corporation could be conducted without the consent of the minority shareholder, deeming the requirements for the articles of incorporation to provide for shareholders' management of the corporation to be met, since all of the

Some states permit so called statutory close corporations additional flexibility in the reach of shareholders' control agreements, usually by including a provision in the corporation's articles claiming this status.[116] These states, in most cases, also have the general provision just discussed permitting any corporation to include a provision in the articles changing the governance. Using the special close corporation status may enable the group to avoid drafting an elaborate agreement in favor of rules for shareholders' control provided in the statute or to avoid publicity of the control agreement in the articles. California's authorization of shareholders' voting agreements, for example, applies specifically to statutory close corporations requiring provisions in the articles limiting shareholders to 35 and specifically identifying the corporation as a close corporation.[117] A California court upheld the validity of a shareholder's agreement among an enterprise that was a close corporation, but had not taken steps to become a statutory close corporation.[118] The court relied on a section of the statute specifying that the approval of

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corporation's shareholders had approved the shareholders' agreement and authorized all action to be taken that might be necessary to give it effect) and Adler v. Svingos, 80 A.D.2d 764, 436 N.Y.S.2d 719 (1st Dep't 1981), noted 35 Syracuse Law Review 40 to 43 (1984) (court held that a provision in a shareholders' agreement executed by all three shareholders in a closely held corporation specifying that all corporate operations, including changes in corporate structure, would require the unanimous consent of the shareholders was valid, even though the shareholders had not amended their corporation's certificate of incorporation to include the unanimous consent agreement).

116 See, e.g., Cal. Corp. Code §300(b); Del. Code Ann. tit. 8, §§350, 354; Ohio Rev. Code Ann. §1701.591(B). See also Folk, The Delaware Corporate Law 526 (1972) (Section 354 of the Delaware Code "should be liberally construed to authorize all sorts of internal agreements and arrangements which are not affirmatively improper or more particularly, injurious to third parties"). In states following the Model Business Corporation Act in its form between 1984 and 1991, any corporation with 50 or fewer shareholders may dispense with or limit the authority of the board by describing in its articles who will perform some or all the duties of the board. See the pre-1991 Model Business Corporation Act §8.01(c). This subSection was deleted from the Model Business Corporation Act in 1991 in light of the broad language of Section 7.32, but continues in force in some states that based their statute on the 1984 version of the Model Business Corporation Act. See, e.g., Tenn. Code Ann. §48-18-101(c). These provisions are only available to corporations with 50 or fewer shareholders, but no election or qualification is required other than the articles provisions. The statutes typically provide that the persons named to perform the duties of the board shall be subject to the same standards of conduct imposed on directors. N.J. Rev. Stat. §14A:5-21(2) (authorizes abolition of the board of directors if the articles provide for the transfer to others of all management functions the board would otherwise possess).

117 Cal. Corp. Code §§706, 158 (defining statutory close corporations). For an analysis of the provisions of the California close corporation statute expressly validating pooling agreements among shareholders of close corporations, see Wang, The California Statutory Close Corporation: Gateway to Flexibility or Trap for the Unwary, 15 S.D. L. Rev. 687 (1978).

118 Ramos v. Estrada, 8 Cal. App. 4th 1070, 10 Cal. Rptr. 2d 833 (2nd Dist. 1992), reh'g denied and opinion modified, (Sept. 11, 1992).

specified agreements "shall not invalidate any voting or other agreement among shareholders [...] which agreement [...] is not otherwise illegal."[119] Such statutes now cover a variety of arrangements as reflected in the express language of the section 7.32 that is the template for the broadest statutes.[120]

Voting trust agreements

Statutes governing the voting trust present the most uniform pattern of regulation. All states have legislation authorizing and regulating the voting trust.[121] In most jurisdictions, a voting trust agreement is valid for no more than 10 years, although most states permit extensions for a period equal to the original maximum term.[122] Statutes commonly require that a copy of the trust agreement be filed or deposited at the corporation's principal office or otherwise provide for disclosing the agreement.[123]

Pooling agreements

The regulation of pooling agreements has taken a somewhat different course. More than two-thirds of the states have statutes that authorize two or more shareholders to agree on how they will vote their shares.[124] All but a handful of the remaining states recognize vote-pooling

[119] Ramos v. Estrada, 8 Cal. App. 4th 1070, 10 Cal. Rptr. 2d 833, 836 (2nd Dist. 1992), reh'g denied and opinion modified, (Sept. 11, 1992), quoting Cal. Corp. Code §706(d).

[120] See, generally, Model Business Corporation Act §7.32.

[121] See, e.g., Cal Corp Code §706(b); Del. Code Ann. tit. 8, §218; New York Business Corporation Law §621; Ohio Rev. Code Ann. §1701.49; See also Model Business Corporation Act Ann. 7-235 (4th ed.).

[122] See, e.g., Cal. Corp. Code §706(b); Tenn. Code Ann. § 48-17-302. Compare Ohio Rev. Code Ann. §1701.49(B) (limited to 10 years unless coupled with an interest); La Rev Stat. Ann. §12:78 and Nev. Rev. Stat. §78.365 (limited to 15 years); Me. Rev. Stat. Ann. tit. 13-C, §741 and N.J. Rev. Stat. §14A:5-20 (limited to 21 years); Mo. Rev. Stat. §351.246 (no limit expressed). Most of the states that limit the term of a voting trust allow the trust to be renewed, usually for a period equal to that originally allowed. See, e.g., Cal. Corp. Code §706(b); Del. Code Ann. tit. 8, §218(b); NJ Rev. Stat. §14A:5-20(4); N.Y. Business Corporation Law §621(d); Ohio Rev. Code Ann. §1701.49(B).

[123] See, e.g., Cal. Corp. Code §706(b); Del. Code Ann. tit. 8, §218(a); Me. Rev. Stat. Ann. tit. 13-C, §741; New York Business Corporation Law §621(c).

[124] See, e.g., Del. Code Ann. tit. 8, §218(c); New York Business Corporation Law §620(a); Va. Code Ann. §13.1-671. Cf. Cal. Corp. Code §706(a) (applicable to close corporations only). For a decision interpreting Section 620(a) of the New York Business Corporation Law, see Neuman v. Pike, 591 F.2d 191, 194 (2d Cir. 1979) ("[t]wo or more shareholders may agree in writing that, in exercising any voting rights, the shares held by them shall be voted as provided in the agreement.") See also Stein v. Capital Outdoor Advertising, Inc., 273 N.C. 77, 159 S.E.2d 351 (1968)

agreements by expressly exempting voting agreements from the restrictions applicable to voting trusts.[125] Most states, for example, do not impose a limit on the duration of the agreement or require that a copy of the agreement be deposited at the corporation's principal office or otherwise require publicity of its terms.[126] As an enforceable pooling agreement can achieve the same control as a voting trust, no reason is apparent for a different regulation.[127] The restrictions in the voting trust statutes may be due to the development of those statutes at an earlier time when the separation of voting power from the other attributes of share ownership was viewed unfavorably, or perhaps to a legislative perception of the greater likelihood that voting trusts would be used principally in publicly held corporations, where increased safeguards might be needed to protect passive shareholders.[128]

(strictly construing North Carolina statute validating contracts between two or more shareholders to vote their shares as a unit for the election of directors; held inapplicable to an agreement between two of the three shareholders under which one of the contracting parties transferred the right to vote his shares to the other party; the agreement was not limited to the election of directors and it did not provide that the shares were to be voted as a unit); R. H. Sanders Corp. v. Haves, 541 S.W.2d 262 (Tex. Civ. App. Dallas 1976).

[125] See, e.g., Del. Code Ann. tit. 8, §218(e); Kan. Stat. Ann. §17-6508(C); Minn. Stat. §302A.455. See also Model Business Corporation Act Ann. §7.31 (4th Ed) (shareholders' agreements are not subject to the provisions on voting trusts).

[126] For examples of statutes that require publication or filing of shareholder pooling agreements, see Del. Code Ann. tit. 8, §218; Tex. Bus. Org. Code art. 6.252 (agreement to be deposited with the corporation and subject to examination). For a federal decision interpreting the requirements of the predecessor Texas provision, see Sanders v. McMullen, 868 F.2d 1465 (5th Cir. 1989) (court held that the failure to comply with the Texas corporation law requirements that voting agreements be in writing, that the counterpart of the agreement be deposited in the corporation's main office, and that reference to the agreement be on certificates representing the corporate shares precluded the minority shareholder from enforcing an oral agreement pursuant to which the majority shareholder allegedly agreed to vote his shares to keep a minority shareholder on the board of directors; some shareholders were totally unaware of the agreement).One court looked beyond the language of the Texas statute to its underlying purpose to uphold a pooling agreement.). But see R. H. Sanders Corp. v. Haves, 541 S.W.2d 262, 265 (Tex. Civ. App. Dallas 1976) (voting agreement held valid although all statutory requirements had not been met; the court indicated that the purpose of the statutory provision requiring a copy of a voting agreement to be filed with the corporation and a legend to be placed on share certificates stating that the shares are subject to the agreement is to give notice to shareholders or share purchasers who are not parties to the agreement; thus as the parties to the litigation were all the corporation's shareholders and had knowledge of the agreement and no outside buyers were involved, technical compliance with those notice provisions was not necessary).

[127] See Clark, Corporate Law §18.3.3. See also Oceanic Exploration Co. v. Grynberg, 428 A.2d 1, 7 (Del. 1981) (describing the change in judicial attitudes toward voting trusts and other agreements).

[128] For examples on how voting trusts have been used in publicly held corporations, see Brown v. McLanahan, 148 F.2d 703, 159 A.L.R. 1058 (C.C.A. 4th Cir. 1945).

Irrevocable proxies

Proxy agreements are regulated by statute in all American jurisdictions.[129] The most common statute is one that limits the duration of proxies to 11 months unless a longer period is expressly provided.[130] Pursuant to the law of agency, proxies of any duration are revocable at any time, unless "coupled with an interest." Revocability is an obvious drawback to the use of proxies in planning a corporate control pattern. To deal with this problem, almost all states have a statute permitting a proxy to be made irrevocable in certain circumstances.[131]

[129] See, e.g., Cal. Corp. Code §705; Del. Code Ann. tit. 8, §212; New York Business Corporation Law §609; Ohio Rev. Code Ann. §1701.48.

[130] See, e.g., Cal. Corp. Code §705(b); New York Business Corporation Law §609(b); Tenn. Code Ann. §48-17-203; Wis. Stat. §180.0722. Compare Del. Code Ann. tit. 8, §212(b) (proxy limited to three years); Okla. Stat. tit. 18, §1057 (proxy limited to three years).

[131] See, e.g., Cal. Corp. Code §705(e); Del. Code Ann. tit. 8, §212(c); Mo. Rev. Stat. §351.245(4); New York Business Corporation Law §609(f).

VI. RESPECTIVE ADVANTAGES AND DISADVANTAGES OF SHAREHOLDERS' ARRANGEMENTS

There are different devices for allocating control over shareholders' action, to wit: shareholders' control agreements, voting trusts, shareholders' pooling agreements, irrevocable proxies, and special provisions in the articles and bylaws. The choice among the devices to set up a desired control arrangement to use in a given situation is not always an easy task, and it may be dictated by the existence or absence in the particular jurisdiction of statutory or judicial authority affecting the validity or efficacy of the respective devices. Thus, a voting trust may be chosen because a statute expressly recognizes the legality of voting trusts — while satisfactory statutory or judicial support for a control agreement, a pooling agreement or an irrevocable proxy cannot be found in that jurisdiction — or it imposes conditions that do not fit with the needs of a particular enterprise. Further, a voting trust may be selected because it is self-executing, while specific performance of a shareholders' agreement might not be certain in a particular jurisdiction, and in any event would involve risks and delays. A key element is the degree of control the parties desire to specify in the agreement. A shareholders' control agreement typically addresses management questions that are more specific and detailed. Pooling agreements or voting trusts are effective to insure participants a seat at the table, without necessarily specifying what the result will be of discussion among the parties. Supermajority and similar provisions in the corporation's articles provide a negative control, giving one or more parties a veto over corporate action without necessarily specifying what the affirmative actions should be.

In most jurisdictions, a shareholders' control agreement (perhaps including provision for irrevocable proxies) is usually preferable to a voting trust device for allocating control in a close corporation. Especially in a jurisdiction with a statute validating shareholders' agreements and not limiting them to a specified maximum term, a shareholders' agreement is likely to be more desirable than a voting trust. As has been pointed out elsewhere, most voting trust statutes set a

maximum limit on the duration of a voting trust that is usually of ten years. The business situation may well require a control arrangement of much longer duration. Further, some states have a statute that empowers the beneficial owners of a majority of the shares in a voting trust to terminate it.[132] Such a statute greatly decreases the usefulness of the voting trust as a device for consolidating voting power.[133]

Other limitations or conditions set up by some of the voting trust statutes may prove to be undesirable (from the point of view of the persons establishing the trust): e.g., the requirement that a copy of the trust agreement be deposited with the corporation, thus making the terms of the agreement available to all shareholders, or, the privilege sometimes granted to any shareholder to come into the trust, a privilege which precludes the establishment of a trust limited to shareholders with the same interests and goals.[134] Besides, setting up a control arrangement by a voting trust is somewhat more complicated than establishing one by a shareholders' agreement. The establishment of a voting trust involves the selection of voting trustees, the transfer of title in the shares to the trustees and the issuance of voting trust certificates. A consideration of some importance is the fact that the transfer of title to the trustees is subject to transfer taxes in some states.[135] Practitioners should be alert to tax laws that

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[132] See, e.g., Minn. Stat. §302A.453(1) (unless otherwise specified in the agreement).

[133] California formerly had such a statute. See Cal. Corp. Code §2231(1955), discussed in Goss v. Edwards, 68 Cal. App. 3d 264, 137 Cal. Rptr. 252 (2d Dist. 1977) (notwithstanding §2231, the court held a voting trust agreement that was part of a divorce settlement to be irrevocable, since both parties to the divorce settlement had entered into the settlement on the basis of the voting trust agreement, the wife had accepted substantial benefits under the divorce settlement, and revocation of the voting trust would be seriously detrimental to the husband). See also Note, The Voting Trust: California Erects a Barrier to a Rational Law of Corporate Control, 18 Stan. L. Rev. 1210, 1219 to 1220 (1966).

[134] See La Rev. Stat. Ann. §12:78(B) (but the trust agreement may provide otherwise).

[135] See, e.g., N.Y. Tax Law §270. Until January 1, 1966, transfers of stock were subject to a federal tax. This tax was repealed by the Excise Tax Reduction Act of 1965, §401, 79 Stats 148. For a discussion of transactions incident to voting trusts which now are or formerly were subject to taxes imposed on the issuance or transfer of stock, see Iron Fireman Mfg. Co. v. U.S., 106 F.2d 831 (C.C.A. 9th Cir. 1939). See In re Chilson, 19 Del. Ch. 398, 168 A. 82, 84 (1933), for an instance in which the expenses of transferring the shares to the trustees and particularly the cost of transfer stamps was found to be prohibitive.

could impact voting trusts.[136] In addition, voting trust certificates are subject to federal or state securities laws.[137] The issuance of voting trust certificates in a close corporation will probably come within an exemption to the registration requirements of the securities laws,[138] but the transaction could be subject to the anti-fraud provisions of those laws.[139]

A possible disadvantage of the voting trust would follow if the transfer of title means the shareholders become legal strangers to the corporation and lose some of the rights and remedies they had as shareholders.[140] The Model Business Corporation Act and the laws of many states provide that holders of voting trust certificates have the inspection rights of shareholders.[141] Although veto provisions are exceedingly useful tools in fashioning management patterns for closely held corporations, the limitations and disadvantages of veto provisions must not be overlooked.[142] In the first place, they give a veto and no more; they do not enable minority shareholders to affirmatively determine corporate policy and go forward with the execution of

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136 Until the Tax Reform Act of 1976, a corporation was more likely to be disqualified for Subchapter S tax status by some of the participants placing their shares in a voting trust than by their executing a voting agreement. But that Act allowed a trust "created primarily to exercise the voting power of stock to it" to qualify as a Subchapter S shareholder. See 26 U.S.C.A. §1371(f)(2).

137 Voting trust certificates are expressly included in the definition of a security under §2(1) of the Securities Act of 1933 (15 U.S.C.A. §77b(1)) and §3(10) of the Securities Exchange Act of 1934 (15 U.S.C.A. §78c(a)(10)). See also Disher v. Fulgoni, 161 Ill. App. 3d 1, 112 Ill. Dec. 949, 514 N.E.2d 767 (1st Dist. 1987) (voting trust certificates sold to an employee are subject to the registration requirements of the Illinois Securities Act); Goldblum v. Boyd, 341 So. 2d 436 (La. Ct. App. 2d Cir. 1976) (court held a voting trust to be invalid because of failure to comply with the Louisiana blue sky law in exchanging shares for voting trust certificates).

138 See Buono Sales, Inc. v. Chrysler Motors Corp., 449 F.2d 715 (3d Cir. 1971) (registration of voting trust certificates was required under securities laws; absent such registration the solicitation of consent to extend the trust agreement violated proxy regulations, because such extension amounted to a continuation of the initial security); Greater Iowa Corp. v. McLendon, 378 F.2d 783 (8th Cir. 1967) (though not all voting trusts come under the securities laws, an organized, widespread solicitation of voting rights in an effort to influence or control a corporation should be governed by SEC rules under the securities laws); Dunning v. Rafton, CCH Fed Sec L. Rep 1964-1966 Transfer Binder 91,660 (ND Cal 1965) (solicitation of trust certificate votes to terminate a voting trust comes under securities regulation governing solicitation of consents).

139 See, e.g., Rule 10b-5, 17 C.F.R. §240.10b-5.

140 See Ballantine, Voting Trusts, Their Abuses and Regulation, 21 Tex. L. Rev. 139, 160 to 161 (1942).

141 These rights are specifically protected in some states by statute. See, e.g., Cal. Corp. Code §706(b); D.C. Code Ann. §29-101-345(c); 805 ILCS 5/7.75; 7.80; N.J. Rev. Stat. §14A:5-28(5); New York Business Corporation Law §624(b), 626(a).

142 See Levinson, Conflicts that Plague Family Businesses, Harvard Business Review 90 (1971), in which the author asserts that when drafters of a close corporation's documents insert provisions preventing non-unanimous action, the stage is institutionally set forth for intense conflict.

that policy. Secondly, they deprive the corporation of the flexibility it may need in order to adjust to unexpected business situations. At the time an enterprise is being incorporated, the drafters cannot foresee changes in policy and methods of operation that may in the future become advantageous. Thirdly, and perhaps most importantly, even if all the shareholders in a particular corporation can be expected to act in good faith, the presence of veto arrangements increases the chance that a deadlock will occur in the corporation's management which will paralyze the corporation and render it unable to conduct its affairs.[143] A deadlock may result in a corporation's dissolution under a statute giving courts power to dissolve a deadlocked corporation. Several decisions in which courts have refused to uphold veto provisions have arisen in situations where a minority shareholder sought to invoke the veto in order to establish a deadlock to provide a ground for the shareholder to petition for dissolution.[144] Judicial reluctance to grant dissolution may have led the courts to void the supermajority provision and thus breaking the deadlocks. Finally, veto provisions may place an unscrupulous shareholder in a position to extort (as a condition of approval of beneficial corporate action) unfair concessions from the other shareholders. However, arbitrary and unreasonable refusal by a minority shareholder who holds a veto power to approve desirable corporate action is not without risk to the shareholder. In a

[143] A minority shareholder's power to veto corporate decisions could create tax problems for the corporation. See Atlantic Properties, Inc. v. C. I. R., 519 F.2d 1233 (1st Cir. 1975). In that decision the court upheld the imposition of an accumulated earnings tax, even though the corporation explained that it had accumulated excessive earnings because an 80 percent shareholder vote was necessary to approve corporate action, and the shareholders had deadlocked on whether to distribute accumulated funds. See also Smith v. Atlantic Properties, Inc., 12 Mass. App. Ct. 201, 422 N.E.2d 798 (1981) (the court held that the vetoing shareholder could be charged with expenditures incurred by the corporation for penalty taxes and related counsel fees because he had unreasonably withheld his consent to a declaration of dividends, with the result that the corporation was subjected to tax liability). Cf. Westland Capital Corp. v. Lucht Engineering Inc., 308 N.W.2d 709 (Minn. 1981) (minority shareholders withheld consent to the acquisition of fixed assets with cost exceeding $25,000; their action was held not to be unreasonable because it did not work a fraud on the other shareholders or result in private benefits to the minority shareholders). It has been asserted that the dangers of deadlock are overemphasized. See, e.g., Dykstra, Molding the Utah Corporation: Survey and Commentary, Utah Law Review 1, 9 (1960).

[144] See, e.g., Roach v. Bynum, 403 So. 2d 187 (Ala. 1981), noted 71 Ky L.J. 282 (1982) (court refused to order dissolution of a corporation on the grounds that its shareholders were deadlocked in conducting corporate business, because the bylaw which required a high vote for shareholder action and thus created the deadlock could be amended, altered or repealed by a majority vote of the shareholders). Cf. Jacobson v. Moskowitz, 27 N.Y.2d 67, 313 N.Y.S.2d 684, 261 N.E.2d 613 (1970) (court refused to enforce supermajority vote requirement for board action, placed in both the articles and bylaws; dissenting opinion recognized the possibility of deadlock and involuntary dissolution as risks the parties knowingly accepted when adopting the supermajority provisions).

Massachusetts case, the court held a minority shareholder responsible for losses the corporation suffered when the minority's veto of a dividend led to additional tax liability for the corporation under the accumulated earnings provisions of the Internal Revenue Code.[145] A decision on whether to use veto provisions or other control arrangements involves weighing the safeguards necessary to protect the interests of minority shareholders against the freedom of corporate action that may be beneficial to the corporation and the shareholders as a group.

[145] Smith v. Atlantic Properties, Inc., 12 Mass. App. Ct. 201, 422 N.E.2d 798 (1981).

VII. SHAREHOLDERS' AGREEMENTS ON MATTERS WITHIN DIRECTORS' DISCRETION OR AUTHORITY

Most modern statutes provide that shareholders' agreements may stipulate the manner in which the parties will vote their shares,[146] but this does not preclude attacks based on violation of other statutory norms. A common basis for attacking shareholders' control agreements is that they are incompatible with the statutory scheme of corporate management and operation.[147] Shareholders in a close corporation often enter into agreements among themselves that not only designate who will be directors or how directors are to be selected (i.e., management agreements), but also determine in advance particular corporation policies. The issue may arise as these policies normally fall within the scope of the board of directors' action altogether.

In light of this possible conflict, many states legislation nowadays gives wide latitude to shareholders in allocating control in a close corporation. It is then quite plausible to argue that, in the absence of such permissive legislation, shareholders' agreements would have to deal with some sort of additional scrutiny by traditional statutory norm of corporate management.[148] In the past courts looked with much distrust on shareholders' agreements and often condemned not only dishonest schemes but also agreements that might conceivably have been injurious to non-

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[146] See Model Business Corporation Act §§7.30, 7.31 (2008); Former Model Business Corporation Act §34 (1969); O'Neal & Thompson, O'Neal and Thompson's Close Corporations and LLCs: Law and Practice §4.5 (rev. 3rd ed. 2009, database updated July 2013). See also, e.g., Ronnen v. Ajax Electric Motor Corp., 671 N.E.2d 534 (N.Y. 1996) (shareholders' agreement giving a shareholder the right to vote co-shareholder's shares regarding the corporation's "day to day management and operations" included the right to elect directors).

[147] See Benintendi v. Kenton Hotel, Inc., 60 N.E.2d 829 (N.Y. 1945) (invalidating bylaws).

[148] According to Section 33 of the 1950 and 1960 versions of the Model Business Corporation Act "the business and affairs of a corporation shall be managed by a board of directors." This statutory affirmation of the traditional corporate management pattern presents "an invitation to litigate borderline situations" that departs from the traditional pattern. The following provision was added to the management Section of the Model Business Corporation Act in 1969: "except as may be otherwise provided in the articles of incorporation." The 1984 version of the Model Business Corporation Act contains the following even more modern statement of the powers of the board of directors: "All corporate powers shall be exercised by or under the authority of, and the business and affairs of the corporation managed under the direction of, its board of directors, subject to any limitation set forth in the articles of incorporation." The 1984 Model Business Corporation Act clearly gives great flexibility in defining the board's powers in close corporations by providing: "A corporation having 50 or fewer shareholders may dispense with or limit the authority of a board of directors by describing in its articles of incorporation who will perform some or all of the duties of a board of directors."

contracting shareholders or corporate creditors. In fact, in some instances, courts were overly strict and rejected shareholders' agreements that served a useful purpose—ultimately. The reasoning behind these decisions was particularly frustrating: It was driven by the fact that courts applied their concepts of public policy unrealistically, insofar as they did tend not to consider that a party to a shareholders' agreement who alleges the illegality of the agreement itself as a defense, often does so simply to escape an honest bargain that has become burdensome to her.[149]

The statutory section providing that the board of directors of a corporation shall manage its business was frequently used to rebut the validity of a shareholders' agreement if the agreement purports to control matters within the traditional powers of directors.[150] Such claims towards shareholders' agreements (even agreements that are simply pooling agreements and do not purport to control directors' action) have been based on statutes according to which:[151] except as otherwise provided in the articles, shareholders are entitled to one vote for each share of stock held; directors shall be elected by a plurality vote of the shareholders; directors shall be elected by cumulative voting; certain shareholders' actions require a specified percentage of the stock vote for adoption; the time and place of the annual shareholders' meeting shall be set forth in the bylaws; election of directors shall be by ballot at a shareholders' meeting; directors shall hold office until a qualified successor is elected.

The courts reasoned that since the statute provided that the business of a company shall be managed by or under the supervision of its board,[152] the directors' power of control existed

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[149] Cox & Halen, Treatise on the Law of Corporations, §14:5 (3rd ed. 2009, database updated November 2013).

[150] See, e.g., Conn. Gen. Stat. Ann. §33-735(b) (2005); Pa. Stat. Ann. tit. 15, §1721 (Supp. 2009). But cf. Del. Code Ann. tit. 8, §141(a) (2001); Ill. Ann. Stat. Ch. 805, §5/8.05 (Smith-Hurd 2004); Md. Code Ann., Corps. & Ass'n §§4-301 & 302; N.J. Stat. Ann. §14A:6-1 (West 2007); New York Business Corporation Law §701 (McKinney 2003); N.C. Gen. Stat., §55-8-01 (2001); Wis. Stat. Ann. § 180.0801 (West 2002). For a successful attack on this basis, see Gazda v. Kolinski, 458 N.Y.S.2d 387 (App. Div. 1982); contra Adler v. Svingos, 436 N.Y.S.2d 719 (App. Div. 1981).

[151] Cox & Halen, Treatise on the Law of Corporations, §14:5 (3rd ed. 2009, database updated November 2013).

[152] See Model Business Corporation Act §8.01(b) (1984); Former Model Business Corp. Act §35 (1969) ("all corporate powers shall be exercised under the authority of, and the business and affairs of a corporation shall be managed under the direction of, a board of directors except as may be otherwise provided in this Act or the articles of incorporation.").

for the benefit of all of the shareholders, and thus the latter could not bargain away the free exercise of management's discretion upfront. Shareholders' agreements involving directors' actions have often been held invalid even though the agreements were made in good faith, and turned out to benefit the company and its shareholders.[153] Especially agreements signed by less than all of a corporation's shareholders that purported to restrict directors' discretion and leeway were held invalid as contrary to public policy.[154] Given this, shareholders' agreements calling for the election of "sterilized" or "dummy" directors who would place or maintain designated persons in the corporation's employment were generally held void.[155] The New York Court of Appeals invalidated a unanimous shareholders' agreement giving broad management powers to designated shareholders inasmuch as it would have sterilized the board.[156]

Yet, the latest trend has been toward an increasing statutory and judicial acceptance of shareholders' management agreements.[157] Some courts have upheld shareholders' agreements depriving directors of certain managerial powers provided they concluded that the agreements involved only relatively unimportant powers and, thus, it was only slightly at odds with the

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153 See Kennerson v. Burbank Amusement Co., 260 P.2d 823 (Cal. Ct. App. 1953); Jackson v. Hooper, 75 A. 568 (N.J. 1909); Long Park, Inc. v. Trenton-New Brunswick Theatres Co., 77 N.E.2d 633 (N.Y. 1948); McQuade v. Stoneham, 189 N.E. 234 (N.Y. 1934), *reh'g denied,* 191 N.E. 514 (N.Y. 1934). *But see* Zion v. Kurtz, 405 N.E.2d 681, 686 (N.Y. 1980) (stating that Long Park and McQuade had been statutorily overruled).

154 West v. Camden, 135 U.S. 507 (1890); Haldeman v. Haldeman, 197 S.W. 376 (Ky. 1917); Lothrop v. Goudeau, 76 So. 794 (La. 1917); Seitz v. Michel, 181 N.W. 102 (Minn. 1921); Cone's Exrs. v. Russell, 21 A. 847 (N.J. Ch. 1891); Manson v. Curtis, 119 N.E. 559 (N.Y. 1918); Withers v. Edwards, 62 S.W. 795 (Tex. Civ. App. 1901); Williston, Treatise on the Law of Contracts, §§1736, 1737 (Walter H. E. Jaeger ed., 3rd ed. 1972).

155 See Meck, Employment of Corporate Executives by Majority Stockholders, 47 YALE L.J. 1079 (1938); Note, The Validity of Stockholders' Voting Agreements in Illinois, U. CHI. L. Rev. 640, 648 (1936); Note, Validity of Contract Among Stockholders to Control a Corporation, 44 YALE L.J. 873 (1935). Cf. Marvin v. Solventol Chem. Prods., Inc., 298 N.W. 782 (Mich. 1941) (contract with lender for appointment of specified corporate comptroller held invalid).

156 Long Park, Inc. v. Trenton-New Brunswick Theatres Co., 77 N.E.2d 633 (N.Y. 1948). The same court refused to enforce a unanimous shareholders' agreement providing that a designated person would serve as president of the company for ten years and not be subject to discharge by the board. The current New York statute is more liberal in sanctioning arrangements that deprive directors of traditional powers, provided those arrangements are placed in the corporation's certificate of incorporation.

157 See, e.g., Galler v. Galler, 203 N.E.2d 577, 585 (Ill. 1964); Wasserman v. Rosengarden, 406 N.E.2d 131 (Ill. App. Ct. 1980); Westland Capitol Corp. v. Lucht Engg., Inc., 308 N.W.2d 709 (Minn. 1981); Hughes v. Sego Int'l, 469 A.2d 74 (N.J. Super. Ct. 1983); Adler v. Svingos, 436 N.Y.S.2d 719 (App. Div. 1981). See also O'Neal & Thompson, O'Neal and Thompson's Close Corporations and LLCs: Law and Practice §§4.5 to 4.18 (rev. 3rd ed. 2009, database updated July 2013); Davidian, Business Associations, 35 Syracuse Law Review 13, 40–43 (1984); Valenti, Business Associations, 33 Syracuse Law Review 11, 15–17 (1982); 15 A.L.R.4th 1078.

statutory norm of directors' management. The typical shareholders' management agreement in a close corporation gives minority holders a voice in control and management of the corporation and assures them of employment by the corporation. Such an agreement is now usually held valid, at least if all of the shareholders are parties to it, and the agreement is not detrimental to prospective shareholders.[158] To this end, courts appear not to emphasize the quantum of discretion removed from the directors by the agreement, but instead emphasize the shareholders' freedom in defining the relationship they prefer through private contractual arrangements in close corporations.[159] As a result, it appears that now courts tend to perform an invariably contractual approach to the issue.[160] In conclusion, it is fair to argue that there are two main rules to abide by when dealing with the scope or validity of shareholders' agreements affecting directors' discretion or authority; that is, no agreement should conflict with the governing corporate statute[161], and no fraud should occur in its execution or operation by the relevant parties.[162]

Limiting or influencing directors' decisions

Shareholders of close corporations often enter into agreements that not only designate who will be directors or how directors are to be selected but also determine in advance particular corporation policies normally left to the board of directors (e.g., designation of company's

[158] See Glazer v. Glazer, 374 F.2d 390 (5th Cir.), cert. denied, 389 U.S. 831 (1967), motion denied, 274 F.Supp. 471 (E.D. La.), on remand, 278 F.Supp. 476 (E.D. La. 1968) (agreement held valid under laws of Tennessee, Ohio, and Florida but invalid under West Virginia law); Hayden v. Beane, 199 N.E. 755 (Mass. 1936); O'Neal & Thompson, O'Neal and Thompson's Close Corporations and LLCs: Law and Practice §§4:6 to 4:9 (rev. 3rd ed. 2009, database updated July 2013).

[159] See, e.g., Wasserman v. Rosengarden, 406 N.E.2d 131 (Ill. App. Ct. 1980); Westland Capitol Corp. v. Lucht Engg., Inc., 308 N.W.2d 709 (Minn. 1981); Roos v. Aloi, 487 N.Y.S.2d 637 (Sup. Ct. 1985); Adler v. Svingos, 436 N.Y.S.2d 719 (App. Div. 1981); R. H. Sanders Corp. v. Haves, 541 S.W.2d 262 (Tex. Ct. App. 1976).

[160] The strong contractual undercurrent to the courts' approach has caused some commentators to question the desirability of close corporation statutes that may only introduce unneeded technical requirements in the parties' path toward resolving their own relationship through private agreements. See Karjala, A Second Look at Special Close Corporation Legislation, 58 Tex. L. Rev. 1207 (1980).

[161] See, e.g., Gazda v. Kolinski, 458 N.Y.S.2d 387 (App. Div. 1982).

[162] See Miller v. Miller, 700 S.W.2d 941 (Tex. Ct. App. 1985).

officers, employees, fixation of salaries to be paid, circumstances in which dividends are to be declared). Statutes in most states have now supplanted the prior judicial insistence that directors' discretion to manage a corporation be unfettered by shareholders' interference. Section 7.32 of the Model Business Corporation Act, added in 1991, reflects the modern statutory support for shareholders' control agreements. The Official Comment states clearly the broad reach of the statute, "Section 7.32(a) validates virtually all types of shareholder agreements that in practice, normally concern shareholders and their advisors."[163]. The specific language of the statute itself verifies such a broad sweep with a list of seven topics authorized for shareholders' agreements, namely: (i) eliminating the board or restricting its power; (ii) making distributions; (iii) naming directors or officers or providing rules relating to their status; (iv) dividing voting power among directors and shareholders or among either group; (v) governing conflict transactions; (vi) permitting transfer of corporate power to a person to resolve deadlock or in a broader context; and (vii) requiring dissolution of the corporation.

In addition to the above, a catchall category permits other provisions "not contrary to public policy." The Official Comment notes even such an expansive authorization is not unlimited, giving examples of agreements that provide directors with no duties of care or exculpated directors beyond the express provisions of the Model Act as provisions that would go beyond its limits. Section 7.32 does contain several requirements. In this respect, most importantly, the agreement must be unanimous, so that if it does not involve all shareholders – such as agreements designed to keep control within a block – it must look elsewhere for being upheld. The agreement must be in writing, so that oral agreements, which have sometimes been approved by courts, must also look elsewhere for approval.[164] However, unlike some earlier

[163] Model Business Corporation Act Ann. at 7-268 (4th Ed).

[164] Wasserman v. Rosengarden, 84 Ill. App. 3d 713, 40 Ill. Dec. 430, 406 N.E.2d 131 (1st Dist. 1980) (court upheld the validity of an oral agreement among all the shareholders in a close corporation providing for the election of the parties thereto as directors and officers and for an equal distribution of salaries and profits as long as the parties remained shareholders or the corporation remained in existence); Weber v. Sidney, 19 A.D.2d 494, 244 N.Y.S.2d 228

statutes, the written agreement does not have to be in the articles or bylaws; separate written agreements are specifically permitted. The section specifies a 10-year limit duration, a similar period to voting trusts, but unlike voting trusts, this period is just a default rule, so that if the parties specify a longer period it is permitted.[165] Finally, the Model Act language requires that a legend appear on the stock certificates flagging the agreement for purchasers who buy shares covered by such an agreement. The Model Act provision provides a self-executing termination of these agreements when a corporation's shares become publicly traded.[166]

The provision in section 7.32 providing for an agreement not being a ground for imposing personal liability on a shareholder for the debts of the corporation does not apply to shareholders' personal liability for breach of a shareholders' agreement.[167] As previously stated, about half the states have statutes based on section 7.32 and others have alternative language to provide authorization for alternative governance through agreements. Minnesota and North Dakota, for instance, explicitly authorize shareholders' control agreements. Pennsylvania permits the other arrangement to be in shareholders approved bylaws, and Ohio requires the agreement to meet certain notice requirements. North Carolina and Tennessee use somewhat different language insulating the arrangements from traditional arguments that it would be treating the corporation as a partnership. Alaska and Rhode Island have expanded their pooling agreement statutes to include voting or other agreements without adding any more specificity.

The Official Comment to 7.32 explicitly recognizes that many of the corporate norms

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(1st Dep't 1963), order aff'd, 14 N.Y.2d 929, 252 N.Y.S.2d 327, 200 N.E.2d 867 (1964) (oral agreement between two shareholders for an equal division of the corporation's earnings "whether in the form of salary, expense accounts, salaries to relatives or otherwise" was held binding on the contracting shareholders, although perhaps not on the corporation, which was not a party to the agreement).

165 Three states in enacting a 7.32 type statute eliminate the 10-year limit entirely and Georgia put its period at 20 years. Model Business Corporation Act Ann. at 7-276 (4th Ed). See, Ansley v. Ansley, 307 Ga. App. 388, 705 S.E.2d 289 (2010) (declining to apply Georgia's version of Section 7.32 with its 20-year limit on shareholders' agreements to agreement imposing restrictions on transfers governed by separate statute that contained no time restriction).

166 Model Business Corporation Act Ann. at 7-268 (4th Ed).

167 Lindon v. Dalton Hotel Corp., 49 So. 3d 299, 305 (Fla. Dist. Ct. App. 5th Dist. 2010).

contained in the Model Act and in the statutes of most states "were designed with an eye towards public corporations, where management and share ownership are quite distinct." Section 7.32 recognizes these functions are conjoined in the close corporation and validates for these corporations various agreements inconsistent with the statutory norms. Almost all states without such a statute have authorized flexibility in shareholders' control agreements by amendments to the statute comparable to section 141 in Delaware or section 8.01 under the Model Act, which provide all corporate power is to be authorized by or under the direction of the board, subject to any limitations set forth in the articles.[168] In some states, the section specifically authorizes corporations with less than 50 shareholders to use this flexibility to dispense with the board, reflecting the language of the Model Act prior to the enactment of section 7.32.[169] Only Missouri and the District of Columbia have not updated their statute to provide explicit flexibility for departures from the traditional rule of director control of corporate affairs.[170] The Official Comment to section 7.32 recognizes the greater willingness of modern decisions to uphold shareholders' agreements as well as the statutes previously enacted and seeks to add "an important element of predictability" to afford "participants in closely held corporations greater contractual freedom to tailor the rules of their enterprise."[171]

Courts in several large commercial states whose statutes have not been based on the Model Act, have interpreted their statutes, permitting the articles to contain limiting provisions on the board's power, to allow shareholders' control agreements even if the precise procedural requirements have not been met. In this respect, New York upheld an agreement even though

[168] See, e.g., Del. Code Ann. tit. 8 §141(a); N.M. Stat. Ann. §53-11-35. Cf. La. Rev. Stat. Ann. §12:81 (variation by provision in the articles or bylaws).

[169] See, e.g., Ark. Code Ann. §4-27-801; Ind. Code Ann.§32-1-33-1 and Ky. Rev. Stat. Ann. §271B.8-010.

[170] Missouri and the District of Columbia do have a statutory close corporation provisions permitting governance alternatives in those corporations. See Mo. Stat Ann. §351.805; D.C. Code Ann. §29-101.164.

[171] See Official Comment to §7.32.

not specifically included in the articles.[172] Illinois produced one of the earlier decisions to this effect, its court holding that where "no complaining minority interest appears, no fraud or apparent injury to the public or creditors is present, and no clearly prohibitory statutory language is violated, we can see no valid reason for precluding the parties [to a shareholders' agreement] from reaching any arrangements concerning the management of the corporation which are agreeable to all."[173] That decision sustained an agreement of the two principal shareholders and their wives, which provided among other things that the corporation would declare dividends annually if it had accumulated earned surplus in excess of a specified amount, that it would make "salary continuation" payments to the widow of a principal shareholder, and that it would purchase sufficient shares of its stock from the estate of a deceased shareholder to pay estate and inheritance taxes and the estate's administrative expenses. Other states have similar holdings.[174] California's authorization of shareholders' voting agreements applies specifically to statutory close corporations, requiring provisions in the articles limiting shareholders to 35 and specifically identifying the corporation as a close one.[175] A California court upheld the validity of a shareholder's agreement among an enterprise that was a close corporation, but had not taken

[172] See, e.g., Zion v. Kurtz, 50 N.Y.2d 92, 428 N.Y.S.2d 199, 405 N.E.2d 681, 15 A.L.R.4th 1061 (1980), noted 33 Syracuse L. Rev. 15 to 17 (1982) (court enforced a shareholders' agreement, approved by all of the shareholders, providing that no business or activities of a closely held corporation could be conducted without the consent of the minority shareholders); Adler v. Svingos, 80 A.D.2d 764, 436 N.Y.S.2d 719 (1st Dep't 1981), noted 35 Syracuse L. Rev. 40 to 43 (1984) (court held that a provision in an agreement executed by all three shareholders of a corporation specifying that all corporate operations, including changes in corporate structure, would require the unanimous consent of the shareholders was valid, and did not violate the provisions of Section 620(b) of the New York Business Corporation Law, which specifies the circumstances in which a veto provision may be included in a corporation's certificate of incorporation, even though the shareholders had not amended their corporation's certificate of incorporation to include the unanimous consent agreement).

[173] Galler v. Galler, 32 Ill. 2d 16, 30, 203 N.E.2d 577, 585 (1964). Galler v. Galler is quoted and followed in Pohn v. Diversified Industries, Inc., 403 F. Supp. 413 (N.D. Ill. 1975) (holding that a management agreement which vested in the manager full responsibility to hire, supervise, and discharge corporate personnel and fix their compensation was valid and enforceable and required the board to approve the manager's proposed employees' profit-sharing plan).

[174] See also Bunnett v. Smallwood, 768 P.2d 736 (Colo. Ct. App. 1988), judgment rev'd in part, 793 P.2d 157, 9 A.L.R.5th 1191 (Colo. 1990) (court held that the shareholders who own substantially all of the stock of a corporation may lawfully contract with one another concerning the management of corporate affairs; such an agreement is binding upon both the contracting parties and the corporation, provided that the agreement does not involve rights of creditors, violate statutes, or contravene public policy).

[175] Cal. Corp. Code §§706, 158 (defining statutory close corporations).

steps to become a statutory close corporation.[176] The court relied on a section of the statute specifying that the approval of specified agreements "shall not invalidate any voting or other agreement among shareholders [...] which agreement [...] is not otherwise illegal."[177]

Corporate officers' designation, compensation, and tenure

Many agreements among shareholders in close corporations contain provisions naming the persons who are to occupy some or all corporate offices or granting one or more of the contracting parties the privilege of naming corporate officers. Section 7.32 of the Model Business Corporation Act permits shareholders' agreements designating officers and establishing the terms and conditions for the provision of services between the corporation and any director, officer, or employee.[178] A majority of states now have such statutes, which erase traditional challenges to those agreements based on director's authority to manage the corporation, or more specific provisions according to which directors shall select corporate officers.[179]

As previously discussed, almost all states that do not have a statute authorizing a shareholders' control agreement do have statutory provisions allowing articles to depart from directors' control of a corporation, by authorizing shareholders to provide for election of officers pursuant to an agreement; in addition, special close corporation statutes in many states permit shareholders in statutory close corporations to designate officers.[180] In those states where shareholders seek to designate officers by agreement when the only statutorily sanctioned

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176 Ramos v. Estrada, 8 Cal. App. 4th 1070, 10 Cal. Rptr. 2d 833 (2d Dist. 1992), reh'g denied and opinion modified, (Sept. 11, 1992).

177 Ramos v. Estrada, 8 Cal. App. 4th 1070, 10 Cal. Rptr. 2d 833, 836 (2d Dist. 1992), reh'g denied and opinion modified, (Sept. 11, 1992), quoting Cal. Corp. Code §706(d).

178 See Changes in the Revised Model Business Corporation Act—Amendments Pertaining to Closely Held Corporations, 46 Bus. Law 297 (1990).

179 See, e.g., Mo. Rev. Stat. §351.360; Ohio Rev. Code Ann. §1701.64. Some statutes provide for greater flexibility in the selection of corporate officers. See, e.g., Del. Code Ann. tit. 8, §142(b) ("officers shall be chosen in such manner [...] [as] prescribed by the bylaws or determined by the board of directors"); New York Business Corporation Law §715(b) ("[t]he certificate of incorporation may provide that all officers or that specified officers shall be elected by the shareholders instead of by the board [of directors]").

180 See also Ohio Rev. Code Ann. §1701.591(B)(4); Wis. Stat. §180.821(12).

method for interfering with directors' discretion is by articles amendment, courts must decide if a shareholders' agreement impermissibly deprives the directors of their usual powers.[181]

Decisions in several large commercial states have upheld shareholders' agreements even if they did not satisfy statutes requiring inclusion in the articles.[182] Other decisions have upheld[183] or have dictum[184] indicating that shareholders' agreements designating corporate officers will be

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[181] Early case law invalidating such agreements include West v. Camden, 135 U.S. 507, 10 S. Ct. 838, 34 L. Ed. 254 (1890) (agreement bound a director to keep a person permanently in the position of vice-president); Teich v. Kaufman, 174 Ill. App. 306, 1912 WL 2785 (1st Dist. 1912) (five-year agreement among majority shareholders that they would elect themselves directors and as directors would elect some of their number to corporate offices at designated salaries); Odman v. Oleson, 319 Mass. 24, 64 N.E.2d 439 (1946) (agreement between all shareholders except one which among other things named an officer for indefinite period and fixed his salary held void as against public policy); Cone v. Russell, 48 N.J. Eq. 208, 21 A. 847 (Ch. 1891) (agreement by a shareholder to give the other shareholder his proxy irrevocable for five years to vote his shares at all shareholders' meetings so as to secure continuous employment as manager of the company at a salary of $2,500 a year held against public policy); Abbott v. Harbeson Textile Co., 162 A.D. 405, 147 N.Y.S. 1031 (1st Dep't 1914) (agreement among sole shareholders, who were also officers, which provided among other things that each officer should have a salary for a term of years held void as against public policy).

[182] Galler v. Galler, 32 Ill. 2d 16, 203 N.E.2d 577 (1964); Zion v. Kurtz, 50 N.Y.2d 92, 428 N.Y.S.2d 199, 405 N.E.2d 681, 15 A.L.R.4th 1061 (1980).

[183] Glazer v. Glazer, 374 F.2d 390 (5th Cir. 1967); Thompson v. J.D. Thompson Carnation Co., 279 Ill. 54, 116 N.E. 648 (1917) (contract named the president, vice-president, secretary-general manager, and treasurer); Compton v. Paul K. Harding Realty Co., 6 Ill. App. 3d 488, 285 N.E.2d 574 (5th Dist. 1972); In the Matter of Evening Journal Association, 5 N.J. 142, 74 A.2d 303 (1950) (buyer of shares promised seller that he would vote his shares to have the seller retained as treasurer of the corporation); Weber v. Sidney, 19 A.D.2d 494, 244 N.Y.S.2d 228 (1st Dep't 1963), order aff'd, 14 N.Y.2d 929, 252 N.Y.S.2d 327, 200 N.E.2d 867 (1964); Clark v. Dodge, 269 N.Y. 410, 199 N.E. 641 (1936); Samuelson v. Starr, 28 Misc. 2d 479, 481, 213 N.Y.S.2d 889, 892 (Sup 1961) (an agreement "by all of the shareholders of a corporation to vote for certain persons as directors and to continue a director as manager is not unlawful on its face and may be specifically enforced if there is no interference with rights of creditors or minority shareholders"); Schmith v. Fornander, 26 Misc. 2d 339, 200 N.Y.S.2d 505 (Sup 1960), judgment aff'd, 13 A.D.2d 478, 215 N.Y.S.2d 462 (1st Dep't 1961) (the court not only upheld a shareholders' agreement which designated corporate officers but refused to set the agreement aside on the ground of "frustration" even though the person who had been designated treasurer was mentally incapable of performing the duties of the office).

But see Gazda v. Kolinski, 91 A.D.2d 860, 458 N.Y.S.2d 387 (4th Dep't 1982), aff'd in part, appeal dismissed in part, 64 N.Y.2d 1100, 489 N.Y.S.2d 907, 479 N.E.2d 252 (1985) (court held that insofar as a shareholders' agreement provided that there could be no increase in salaries without unanimous shareholder approval, it was void and unenforceable where the certificate of incorporation did not provide for such a restriction on salary increases), noted 35 Syracuse L. Rev. 41 to 42 (1984).

The court, in Ringuet v. Bergeron, [1960] Can Sup Ct 672, 684, noted in 80 S.A.L.J. 281 (1963), 37 Can. B. Rev. 490 (1959), stated: "It is no more than an agreement among shareholders owning or proposing to own the majority of the issued shares of a company to unite upon a course of policy or action and upon the officers whom they will elect. There is nothing illegal or contrary to public order in an agreement for achieving these purposes. Shareholders have the right to combine their interests and voting powers to secure such control of a company and to ensure that the company will be managed by certain persons in a certain manner. This is a well-known, normal and legal contract and one which is frequently encountered in current practice and it makes no difference whether the objects sought are to be achieved by means of an agreement such as this or a voting trust. Such an arrangement is not prohibited either by law, by good morals or public order."

[184] See, e.g., Smith v. San Francisco & N.P. Ry. Co., 115 Cal. 584, 47 P. 582, 588 (1897); Luthy v. Ream, 270 Ill. 170, 110 N.E. 373 (1915). "It is not illegal or against public policy for two or more stockholders owning the majority of

sustained if they do not work a fraud on the corporation or its minority shareholders. In some of these decisions,[185] but not in others,[186] all of the shareholders were parties to the agreement. As was said by one court in sustaining an agreement among all the shareholders which gave one of the parties power to veto any change in corporate officers or their salaries: "[T]he mere fact that the property, which all the parties owned, came to be represented by the corporate stock could 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 or the public good."[187]

In New York, an agreement among all the shareholders to keep specified persons in corporate offices apparently will be sustained,[188] but only if it can be construed so as not to

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the shares of stock to unite upon a course of corporate policy or action, or upon the officers whom they will elect." Manson v. Curtis, 223 N.Y. 313, 319, 119 N.E. 559, 561 (1918). See also Bator v. United Sausage Co., 138 Conn. 18, 81 A.2d 442 (1951) (court refused to enforce the agreement against the corporation but indicated that plaintiff might have an action against the other contracting shareholders). Courts show a preference for a construction of a shareholders' agreement which will permit the agreement to be upheld. See, e.g., In re Farm Industries, Inc., 41 Del. Ch. 379, 196 A.2d 582 (1963) (court upheld a shareholders' agreement by refusing to construe it as precluding the board of directors from replacing corporate officers named in the agreement); Ireland v. Charlesworth, 98 N.W.2d 224 (N.D. 1959), noted in 46 Iowa L. Rev. 146 (1960) (court upheld an agreement giving an employee an option to purchase stock "so long as he shall continue in said employment" by refusing to construe the agreement as providing for permanent employment of the employee as a corporate officer, but rather as preventing the promisor from arbitrarily terminating the employment).

185 Merlino v. West Coast Macaroni Mfg. Co., 90 Cal. App. 2d 106, 202 P.2d 748 (1st Dist. 1949); Clark v. Dodge, 269 N.Y. 410, 199 N.E. 641 (1936).

186 Glazer v. Glazer, 374 F.2d 390 (5th Cir. 1967); Galler v. Galler, 32 Ill. 2d 16, 203 N.E.2d 577 (1964) (agreement was among the two principal shareholders and their wives; an employee who was not a party owned a few shares); Thompson v. J.D. Thompson Carnation Co., 279 Ill. 54, 116 N.E. 648 (1917) (voting agreement among three persons owning a few shares less than a majority); In the Matter of Evening Journal Association, 5 N.J. 142, 74 A.2d 303 (1950) (court treated as valid an agreement by buyer of 50 percent of corporation's stock to vote his shares to retain seller as treasurer for two years, but also said agreement had been ratified by later agreement among all shareholders). "Such an agreement is valid notwithstanding all of the stockholders are not parties thereto." Storer v. Ripley, 1 Misc. 2d 235, 242, 125 N.Y.S.2d 831, 837 (Sup 1953), judgment aff'd, 282 A.D. 950, 125 N.Y.S.2d 339 (2d Dep't 1953). See also Lockley v. Robie, 301 N.Y. 371, 93 N.E.2d 895 (1950) (impliedly sustained agreement between the two principal shareholders although a few shares were held by other persons; agreement provided that ownership of a specified number of shares carried a right to hold one of three corporate offices).

187 Fitzgerald v. Christy, 242 Ill. App. 343, 353, 1926 WL 3943 (1st Dist. 1926).

188 Clark v. Dodge, 269 N.Y. 410, 199 N.E. 641, 642 (1936); Martocci v. Martocci, 2 Misc. 2d 330, 42 N.Y.S.2d 222 (Sup 1943), order aff'd, 266 A.D. 840, 43 N.Y.S.2d 516 (1st Dep't 1943); Harris v. Magrill, 131 Misc. 380, 226 N.Y.S. 621 (Sup 1928) ("Where the directors are the sole stockholders), there seems to be no objection to enforcing an agreement among them to vote for certain people as officers.").

See also Samuelson v. Starr, 28 Misc. 2d 479, 481, 213 N.Y.S.2d 889, 892 (Sup 1961) (an agreement "by all of the stockholders of a corporation to vote for certain persons as directors and to continue a director as manager is not

require the retention of persons who have violated their duties to the corporation or acted in a manner injurious to the best interests of the corporation.[189] "An agreement among stockholders," stated the Court of Appeals in a leading case, "whereby the directors are deprived of their power to discharge an unfaithful employee of the corporation is illegal as against public policy."[190]

Under the broad statutes that now authorize shareholders' agreements or by judicial construction of other statutes, shareholders' agreements of various kinds that designate officers have been upheld. These include the following: all shareholders agreeing to vote for each other as officers;[191] agreements between corporations in a joint venture;[192] majority shareholder promising that a purchaser who will acquire a minority interest will be an officer; majority shareholder

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unlawful on its face and may be specifically enforced if there is no interference with the rights of creditors or minority stockholders").

189 "Stockholders in a closed corporation may agree to the election of officers. Clark v. Dodge, 269 N.Y. 410, 199 N.E. 641, 643 (1936) But in the Clark case, the agreement was to vote for Clark 'so long as he proved faithful, efficient, and competent.' However, it is questionable whether an agreement could be upheld which attempted to divest a board of directors of their power to discharge an unfaithful officer." Blum v. Oxman, 190 Misc. 647, 648, 75 N.Y.S.2d 177, 179 (Sup 1947). A shareholders' agreement to elect a designated person as president and a director was held to incorporate "the requirement of the law that he perform the duties of these offices faithfully, which requirement was to be treated as an implied term of the agreement." Schaffer v. Below, 174 F. Supp. 505, 518 (D.V.I. 1959), judgment aff'd, 278 F.2d 619 (3d Cir. 1960). Even though an agreement does not expressly condition retention in office on the continuing competence and loyalty of the officer, that condition will be implied. Fells v. Katz, 256 N.Y. 67, 175 N.E. 516 (1931). In accord: Lubliner v. Sylu Knitting Mills, Inc., 213 N.Y.S.2d 726 (Sup 1961). Removal for even dishonesty and gross breach of trust could not be affected in the face of this provision [an arbitration clause]; and the duty of the board of directors to manage the affairs of the corporation in accordance with their best judgment would be wholly abrogated in all cases. Directors may not be bound by any such agreement in the exercise of their duties, nor may their authority in any way be delegated to others. In re Allied Fruit & Extract Co., 243 A.D. 52, 56, 276 N.Y.S. 153, 157 (1st Dep't 1934). See also Puro v. Puro, 89 Misc. 2d 856, 393 N.Y.S.2d 633 (Sup 1976) (court refused to enforce a shareholders' agreement providing that a designated person be elected to a directorship and corporate office; the person had been guilty of conduct potentially disruptive or otherwise against the best interests of the corporation); Redmond v. Redmond, 42 A.D.2d 542, 345 N.Y.S.2d 12 (1st Dep't 1973) (court refused to enforce a shareholders' agreement provision providing for the employment of a shareholder by the corporation; corporation sought to remove the shareholder-employee for disloyalty).

190 Fells v. Katz, 256 N.Y. 67, 175 N.E. 516, 517 (1931).

191 Wasserman v. Rosengarden, 84 Ill. App. 3d 713, 40 Ill. Dec. 430, 406 N.E.2d 131 (1st Dist. 1980) (court upheld the validity of an oral agreement among all the shareholders in a close corporation which, among other things, provided for the election of the parties thereto as directors and officers of the corporation). See also Kronenberg v. Sullivan County Steam Laundry Co., 91 N.Y.S.2d 144, 155 (Sup 1949), order aff'd, 277 A.D. 916, 98 N.Y.S.2d 658 (3d Dep't 1950), in which the court said: The parties to the agreement comprised all the stockholders and directors. They not only constituted the three persons who contributed the entire capital of the corporation but they owned its shares in equal amount. The rights of neither creditors nor other persons are involved. Under such circumstances, it has been held that the stockholders may do as they please with their corporate concerns and may agree to perpetuate themselves as directors, officers and employees.

192 See also Jacksonville Terminal Co. v. Florida East Coast Ry. Co., 363 F.2d 216 (5th Cir. 1966) (court upheld an agreement requiring the unanimous approval of shareholders to elect officers and entitling any shareholder to demand the dismissal of an officer).

agreeing that compensation of both majority and minority shareholders will be equal[193] or that officers' compensation to majority shareholders will not exceed an amount specified in an agreement;[194] and an agreement not to designate certain persons as officers.[195]

Policy as to dividends and disposal of corporate assets or profit

Participants in a close corporation occasionally attempt to control its dividend policy by entering into agreements to this end. Here again the question is raised as to whether an encroachment by the shareholders on an area of management normally within the province of the directors invalidates the agreement at issue.[196] Section 7.32 of the Model Business Corporation Act and statutes in a majority of the states explicitly authorize agreements governing the authorization of dividends.[197] In states without such a statute, the general corporation act usually authorizes clauses in the articles (and/or sometimes in the bylaws) that transfer management powers from the directors to the shareholders, thereby sanctioning, at least where such a provision in the articles or bylaws has been utilized, an arrangement among the shareholders which regulates dividend payments and other corporate distributions. A number of states also have statutes that expressly validate shareholders' agreements in statutory close corporations that regulate the declaration and payment of dividends or the division of corporate

[193] See also Davis v. Rondina, 741 F. Supp. 1115 (S.D. N.Y. 1990) (where shareholder's agreement provided that compensation of the two shareholders "shall be equal and shall continue at the same rate unless changed by mutual agreements," minority shareholder was likely to succeed, for purposes of preliminary injunction, on claim that majority shareholder breached shareholder's agreement by unilaterally lowering the salaries of the two shareholders, even though he lowered them equally).

[194] Bordelon v. Cochrane, 533 So. 2d 82 (La. Ct. App. 3d Cir. 1988), writ denied, 536 So. 2d 1255 (La. 1989) (court held that the minority shareholder's allegations that the corporation, as well as its officers and directors, by ratification of shareholders' agreements entered into prior to his becoming a shareholder breached the agreements by paying sums to a director and his family in excess of the amount provided for by the agreements, stated a cause of action for breach of the shareholders' agreements).

[195] See Klausman v. Rosenberg, 221 Ga. 59, 143 S.E.2d 164 (1965) (employment of relative of a shareholder who was objectionable to the other shareholder was held to violate an agreement between them not to hire any employee objectionable to a shareholder).

[196] See generally Validity of Stockholders' Agreement Allegedly Infringing on Directors' Management Powers—Modern Cases, 15 ALR4th 1078.

[197] See Changes in the Revised Model Business Corporation Act—Amendments Pertaining to Closely Held Corporations, 46 Bus. Law 297 (1990).

profits.[198]

Even in those states where the statute does not unequivocally sanction shareholders' agreements relating to dividends and the agreement has failed to satisfy the placement in the articles or other requirements, an agreement which places reasonable restrictions on the powers of the directors by prohibiting the declaration of dividends for a limited period of time or under specified circumstances has been sustained.[199] The Illinois Supreme Court, for example, upheld an agreement among the two principal shareholders of a corporation and their wives which provided, among other things, for the mandatory payment of dividends by the corporation.[200] An agreement among all the shareholders of a corporation giving one of the parties to the agreement power to veto any proposal to declare dividends or incur expenses was upheld.[201]

As already seen, case law on distributions has evolved from a starting point where such agreements were held invalid on the grounds that they unlawfully deprive directors of their powers.[202] Some later courts interpreted the contract provisions as to avoid conflict with the

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198 See, e.g., Cal. Corp. Code §300(b); M.d. Corps. & Ass'ns Code Ann. §4-401(a)(7); Ohio Rev. Code Ann. §1701.591(B)(7); Tex. Bus. Corp. Act Ann. §12.32(A)(3). See also Norton, Adjustment and Protection of Shareholder Interests in the Closely-Held Corporation in Texas, 39 S.W. L.J. 781 (1985).

199 See Hornstein, Stockholders' Agreements in the Closely Held Corporation, 59 Yale Law Journal 1040, 1045 (1950).

200 Galler v. Galler, 32 Ill. 2d 16, 203 N.E.2d 577 (1964), noted 60 N.W. U. L. Rev. 386 (1965). The clause in the agreement in Galler providing for mandatory dividends reads as follows: [The] directors of said corporation shall, out of the accumulated earned surplus in excess of $500,000 declare and pay a minimum annual dividend of $50,000 payable quarterly. However, if fifty percent of the annual net profits after taxes shall exceed such minimum of $50,000 then the directors in their discretion may declare a dividend up to fifty percent of such annual profits. If the net earnings after taxes in any one year shall not be sufficient for the declaration of such minimum dividend of $50,000, nevertheless the said minimum dividend of $50,000 shall be declared and paid providing the surplus of $500,000 shall be maintained.

201 Fitzgerald v. Christy, 242 Ill. App. 343, 1926 WL 3943 (1st Dist. 1926).

202 Abbott v. Harbeson Textile Co., 162 A.D. 405, 410, 147 N.Y.S. 1031, 1035 (1st Dep't 1914). (agreement which provided that each of the contracting parties "shall have a salary for a term of years, and that the profits shall be distributed in a certain way, irrespective of stock held" was struck down as against public policy. "The statute commits to the directors the management of the business and affairs of a corporation and their acts cannot be hampered and controlled by an agreement of the character of the one here alleged."). See also Broyles v. Johnson, 99 Ga. App. 69, 107 S.E.2d 851 (1959) (agreement between two shareholders, each of whom owned 50 percent of a corporation's stock, that all corporate profits were to be divided equally was not sufficient to state a cause of action against the corporation to require dividends to be paid, because the contract did not bind the corporation); Flanagan v. Flanagan, 273 A.D. 918, 77 N.Y.S.2d 682 (2d Dep't 1948), judgment aff'd, 298 N.Y. 787, 83 N.E.2d 473 (1948) (agreement between two brothers, each of whom held 29 of corporation's 60 shares of outstanding stock (their wives held the other two shares), declared contrary to public policy in that it provided that designated corporate

norm of director control. Thus, where an agreement provided that no dividends shall be declared or paid by the corporation until loans to the corporation from one of the contracting shareholders and a company in which that shareholder held a large interest had been repaid, the court avoided conflict with the directors power by construing[203] the dividend provision "as merely a declaration of desirable corporate policy." [204] Most courts upheld agreements affirmatively providing how corporate income is to be distributed.[205] A federal court sustained an agreement where several railroads organized a refrigerator company and agreed that the surplus revenues of the refrigerator company would be distributed among them in proportion to their contributions to the gross income of the refrigerator company (i.e., in proportion to the payments they had made to it for services).[206] Likewise, the New York Court of Appeals sustained an agreement entered into by the two shareholders of a corporation containing a provision guaranteeing one of the contracting parties permanent employment and one-fourth of

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property should upon specified contingencies be distributed to one or the other of the contracting parties); Cuppy v. Ward, 187 A.D. 625, 176 N.Y.S. 233 (1st Dep't 1919), aff'd, 227 N.Y. 603, 125 N.E. 915 (1919) (two purchasers of all corporation's stock agreed between themselves that 20 percent of the corporation's net income would be paid to the shareholders and the other 80 percent should be allocated first to one of the parties until advances made by him had been paid in full and then to the other party until advances made by him had been paid).

[203] Lending institutions often require a borrowing corporation to agree to restrict dividends. Standard forms for bank loans typically contain a provision reading somewhat as follows: "If borrower is a corporation, it will not, without the consent of the bank, pay any dividends on any of its outstanding shares, or alter or amend its capital structure." An agreement between a lender and a corporate borrower restricting the payment of dividends is valid. See, e.g., Bell Bakeries, Inc. v. Jefferson Standard Life Ins. Co., 245 N.C. 408, 96 S.E.2d 408 (1957) (undertaking by corporation not to pay dividends or retire any of its stock unless its financial condition met certain minimum requirements).

[204] Hart v. Bell, 222 Minn 69, 23 NW2d 375, 379 (1946). As one writer pointed out, the court, instead of indulging in the fiction that the clause was merely exhortatory, might better have predicated its decision solely on the fact that the agreement did not evidence any intention to defraud other shareholders or damage minority interests; the dividend provision was simply a reasonable device to safeguard advances which were beneficial to the corporation; Delaney, The Corporate Director: Can His Hands Be Tied in Advance?, 50 Columbia Law Review 52, 60–61 (1950).

[205] See, e.g., Arizona Western Ins. Co. v. L. L. Constantin & Co., 247 F.2d 388 (3d Cir. 1957); New England Trust Co. v. Penobscot Chemical Fibre Co., 142 Me. 286, 50 A.2d 188 (1946); Crocker v. Waltham Watch Co., 315 Mass. 397, 53 N.E.2d 230 (1944); Allied Supermarkets, Inc. v. Grocers' Dairy Co., 391 Mich. 729, 219 N.W.2d 55 (1974) (agreement that patronage refunds be made in lieu of dividends). See also Philco Finance Corp. v. Pearson, 335 F. Supp. 33 (N.D. Miss. 1971); Wasserman v. Rosengarden, 84 Ill. App. 3d 713, 40 Ill. Dec. 430, 406 N.E.2d 131 (1st Dist. 1980) (court upheld the validity of an oral agreement among all the shareholders in a close corporation which, among other things, provided for the equal distribution of salaries and profits as long as the parties thereto remained shareholders or the corporation remained in existence). Cf. Petruzzi v. Peduka Const., Inc., 362 Mass. 190, 285 N.E.2d 101, 102 (1972) (sufficient evidence presented at trial to allow issue to go to jury of whether an enforceable agreement existed among shareholders for the annual distribution of net profit).

[206] Wabash Ry. Co. v. American Refrigerator Transit Co., 7 F.2d 335 (C.C.A. 8th Cir. 1925).

the corporation's net income "by way of salary or dividends."[207] The court apparently believed that to uphold the agreement it had to construe the one-fourth of net income provision to mean one-fourth of "whatever was left for distribution after the directors had in good faith set aside whatever they deemed wise."[208] A Georgia court dismissed counts of a complaint alleging breaches of the contract or fiduciary duty after the corporation offset the entire amount of the distribution against one shareholder's outstanding loan obligations to the company.[209]

Dispute resolution

Shareholders in a close corporation may enter into a contract to settle disputes that can arise within the enterprise, such as providing for an arbitrator or for a specific remedy like dissolution or buyout when dissension arises. Shareholders' agreements often contain a clause providing for the arbitration of disputes arising out of the agreement. Further, a pooling agreement, in which the shareholders agree to vote as a unit on all or specified corporate matters, not uncommonly contains a clause providing for the votes to be cast in accordance with the decision of an arbitrator if the parties themselves cannot agree on how the votes are to be cast.[210] An agreement may even provide for management decisions or decisions on changes in

[207] Clark v. Dodge, 269 N.Y. 410, 199 N.E. 641, 642 (1936). See also Weber v. Sidney, 19 A.D.2d 494, 244 N.Y.S.2d 228 (1st Dep't 1963), order aff'd, 14 N.Y.2d 929, 252 N.Y.S.2d 327, 200 N.E.2d 867 (1964) (oral agreement between two shareholders that they "would receive equal total amounts whether in form of salary, expense accounts, salaries to relatives or otherwise" was held enforceable against the parties but not against the corporation); Harris v. 42 E. 73rd St., Inc., 145 N.Y.S.2d 361 (Sup 1955) (agreement between two shareholders, each of whom owned half of the corporation's stock, that certain amounts were to be paid to each of the shareholders at specified times as compensation, was held for pleading purposes not to be an illegal restraint upon director discretion); Simonson v. Helburn, 198 Misc. 430, 97 N.Y.S.2d 406 (Sup 1950) (agreement among all shareholders sustained which contained a provision that assured two of the holders of common stock, who were also directors, that each would receive one-third of the net profits from corporate enterprises extending "beyond the narrow field of New York theatre"). Cf. Hartley v. Welsh, 23 Pa. C.C. 78, 8 Pa. Dist. 546, 23 (Pa. C.P. 1899) (agreement among majority shareholders to vote their stock so that corporation would convey to another company exclusive rights to use specified property).

[208] Clark v. Dodge, 269 N.Y. 410, 417, 199 N.E. 641, 643 (1936). See also Denny v. Guyton, 327 Mo. 1030, 1053, 40 S.W.2d 562, 570 (1931), where the court commented: "Certainly the agreement that the 'the profits realized to said parties from the operation of all such corporations, partnerships and trade names should be pooled and divided among the said joint adventurers' did not contemplate any unlawful interference with the right of the corporations to declare dividends, because no profits could be realized to said parties until such profits were lawfully distributed."

[209] Beale v. O'Shea, 735 S.E.2d 29 (Ga. App. 2012).

[210] See, e.g., Ringling Bros.-Barnum & Bailey Combined Shows v. Ringling, 29 Del. Ch. 610, 53 A.2d 441 (1947); Roberts v. Whitson, 188 S.W.2d 875 (Tex. Civ. App. Dallas 1945), writ refused w.o.m., (Oct. 3, 1945).

management personnel to be made by arbitration.[211] Shareholders in a close corporation may enter into a contract for the dissolution of the corporation in the event of a deadlock (the latter involving also the directors), or on the happening of specified contingencies perhaps different from those which otherwise would justify dissolution under the statutes. The list of topics authorized in a shareholders' agreement in Section 7.32 of the Model Business Corporation Act covers agreements which require dissolution and those that permit transfer of corporate power to a shareholder or any other person for the purpose of resolving a deadlock among directors or shareholders.[212]

Buy-sell and restricting share transfer agreements

One of the most common shareholders' agreements in a close corporation is a *buy-sell* or *share transfer* one. The former governs exit from an enterprise that otherwise might provide no way out for investors. The latter protects the intimate relationship in a closely held enterprise by regulating who can become members. In almost all states, there are separate statutory provisions that authorize these kinds of agreements that predated the Section 7.32 type agreements discussed earlier.[213] The Official Comment to Section 7.32 notes that the section supplements the other provisions of the statute, such that an agreement not in conflict with another section does not need 7.32 for validation. "[S]ection 7.32 would not have to be relied upon to validate typical buy-sell agreements among two or more shareholders or the covenants and other terms of a stock purchase agreement entered into in connection with the issuance of shares by a

[211] See Vogel v. Lewis, 25 A.D.2d 212, 268 N.Y.S.2d 237 (1st Dep't 1966), order aff'd, 19 N.Y.2d 589, 278 N.Y.S.2d 236, 224 N.E.2d 738 (1967) (arbitration agreement between two shareholders of a close corporation was used to determine whether the corporation should exercise a purchase option that it held); Long Park v. Trenton-New Brunswick Theatres Co., 297 N.Y. 174, 77 N.E.2d 633 (1948).

[212] Model Business Corporation Act §7.32(a)(6), (7). The transfer of power is not limited just to resolving deadlocks but can be done generally.

[213] See, e.g., Model Business Corporation Act §6.27, generally patterned after Del. Code Ann. tit. 8 §202.

corporation."[214]

[214] Model Business Corporation Act Ann. (4th Ed) at 7-266; Ansley v. Ansley, 307 Ga. App. 388, 705 S.E.2d 289 (2010) (declining to apply Georgia's version of Section 7.32 with its 20 year limit on shareholders' agreements to agreement imposing restrictions on transfers governed by separate statute that contained no time restriction).

VIII. SHAREHOLDERS' AGREEMENTS ON MATTERS WITHIN SHAREHOLDER'S DOMAIN

Voting for directors

Shareholders' agreements specifying how shareholders will vote their shares, including particularly agreements as to who are to be the corporate directors, have long been common in close corporations. In conjunction with a careful allocation of director seats, they provided an indirect way of controlling actions within the directors' realm without running afoul of the traditional common law limits on agreements that fettered the ability of directors to act. With the widespread adoption of statutes authorizing shareholders' control agreements as previously discussed, this "second best" solution to controlling directors' action is not as necessary. Yet, pooling agreements remain useful for shareholders who desire only to guarantee participation of various participants in board decisions without attempting to predetermine the result of collective discussion or for a group of less than unanimous shareholders who want to provide a method for their block to control the corporation.[215] Thus, shareholders often enter into agreements that contain the following undertakings by the contracting parties: (1) to vote their shares for specified persons as directors; (2) to vote as a majority of the shares in the pool may decide; and (3) to vote as an arbitrator may direct in the event of disagreement.

In a close corporation, where equality of control is often a feature of the business bargain, *all* the shareholders frequently agree to elect and continue themselves or their nominees

[215] They may also be useful in connection with the transfer of control to a purchaser. Thus the buyer and seller of a controlling interest in a corporation sometimes enter into an agreement designating some or all of the directors or provides a method for selecting directors. In 721 Corp. v. Morgan Guaranty Trust Co. of New York, 40 Misc. 2d 395, 243 N.Y.S.2d 198 (Sup 1963), the owner of a majority of the stock in Tiffany and Co. conditioned the sale of his stock on an undertaking by the purchasers that they would use their best efforts to continue on the board of Tiffany's two persons he would designate. The seller operated the Bonwit Teller department store and other retail establishments in the neighborhood, and he insisted on a right to designate two directors because he wanted to insure that the character and prestige of Tiffany's, which was of great value to the whole neighborhood, would be maintained. The court sustained the agreement. See also Essex Universal Corp. v. Yates, 305 F.2d 572, 13 A.L.R.3d 346 (2d Cir. 1962) (a provision in a contract between the seller and buyer of a 28.3 percent interest in a publicly held corporation that the buyer was to have an option to require a majority of the existing directors to replace themselves with his nominees does not on its face render the contract invalid).

as directors.[216] Sometimes, these agreements may provide more complex arrangements as for a family corporation involving three family siblings who wanted two directors from each family but a total of seven directors. In another provision, the agreement required that each shareholder must vote so that the resulting board would be comprised of a majority of "involved directors," the President must be part of the majority and the remaining members may be selected from other "management employees having significant business and management expertise deemed uniquely valuable to the corporation's business."[217]

Almost all states have a statute expressly authorizing shareholders' pooling agreements.[218] A majority of the states follow Section 7.31 of the Model Business Corporation Act, which authorizes agreements among shareholders as to how they will vote their shares, exempts such agreements from the requirements applicable to voting trusts, and declares such agreements shall be specifically enforceable.[219] A second group of states uses similar but not identical language to authorize voting agreements.[220] The remaining states with pooling agreement statutes recognize

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[216] See, e.g., Wasserman v. Rosengarden, 84 Ill. App. 3d 713, 40 Ill. Dec. 430, 406 N.E.2d 131 (1st Dist. 1980) (court upheld the validity of an oral agreement among all the shareholders in a close corporation which, among other things, provided for the election of the parties thereto as directors and officers of the corporation); Neuman v. Pike, 591 F.2d 191 (2d Cir. 1979), noted, 31 Syracuse L. Rev. 129, 144 to 145 (1980) (court enforced an agreement of the majority shareholders of a closely held corporation requiring them to vote their stock to elect three persons to the corporation's board of directors); Matter of Katz, 2 Misc. 2d 325, 143 N.Y.S.2d 282 (Sup 1955), judgment aff'd, 1 A.D.2d 657, 147 N.Y.S.2d 10 (1st Dep't 1955) and judgment aff'd, 1 A.D.2d 658, 147 N.Y.S.2d 11 (1st Dep't 1955) (an agreement that S and C should continue as directors as long as S or M holds stock of the corporation is not to be interpreted to mean that they shall be two of only three directors so as to preclude an increase in the number of directors). See also Ritchie v. McGrath, 1 Kan. App. 2d 481, 571 P.2d 17 (1977) (shareholders did not violate fiduciary duty by entering into pooling agreement with other shareholders to gain control of the corporation or by failing to disclose the existence of the agreement to minority shareholders). Shareholders frequently combine to elect directors in order to acquire and maintain an honest, independent and competent management. See Ballantine, Voting Trusts, Their Abuses and Regulation, 21 Tex. Law Review 139, 142–143 (1942).

[217] Miniat v. Ed Miniat, Inc., 315 F.3d 712 (7th Cir. 2002).

[218] Louisiana, Maryland, Missouri and the District of Columbia lack a statute as to pooling agreements. See Model Business Corporation Act Ann. at 7-254 (4th Ed). But see, Reynolds Health Care Services, Inc. v. HMNH, Inc., 364 Ark. 168, 217 S.W.3d 797, 803 (2005) (agreement that did not provide the manner in which shares are to be voted was held to be a revocable proxy agreement, not a voting agreement, and could therefore could be revoked by the shareholder).

[219] See Model Business Corporation Act §7.31 and Model Business Corporation Act Ann. 7-251 for a list of adopting jurisdictions.

[220] Cal. Corp. Code §706; New York Business Corporation Law §620. See also Ramos v. Estrada, 8 Cal. App. 4th 1070, 10 Cal. Rptr. 2d 833 (2d Dist. 1992), reh'g denied and opinion modified, (Sept. 11, 1992) (pooling agreements are valid not only for close corporations, but also among corporations with any number of shareholders as well).

voting agreements in a somewhat backhanded way by saying the voting trust statute does not apply to a voting agreement among shareholders[221] or simply by referring to voting agreements with no reference one way or the other to voting trust laws.[222]

In a few states, the statute limits these agreements to a specified term, usually the same 10-year term as for voting trusts.[223] Otherwise, the only statutory requirements are that the agreement be in writing and signed by participating shareholders.[224] Many statutes, as just mentioned, expressly exempt pooling agreements from the sometimes more stringent requirements applicable to voting trusts.[225] In most states, the statute authorizing pooling agreements applies only to agreements on how shareholders are to vote their shares, but in a few states the statute combines treatment of shareholders' voting provisions with provisions controlling functions that traditionally are within the province of the directors.[226] Even before the enactment of these statutes, the great weight of authority was that an agreement of some or all of the shareholders to combine their votes for directors is valid even in the absence of specific statutory sanction, at least as long as the agreement does not attempt to control the discretion of the directors, contemplate fraud, oppression or wrong against other shareholders, or otherwise

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221 See, e.g., Del. Code Ann. tit. 8, §218; MCLA §450.1461 RI Gen Laws §7-1.2-709.

222 Ark. St. §10.06,435(b); Nev. Rev. Sat. §78.365.

223 N.C. Gen. Stat. §55-7-31; R.I. Gen. Law §7-1.2-709. Cf. Ga. Code Ann. §14-2-731 (20-year limit).

224 See, e.g., 805 ILCS 5/7.70; MCLA §450.1461; New York Business Corporation Law §620(a); see also Sanders v. McMullen, 868 F.2d 1465 (5th Cir. 1989) (voting agreements held unenforceable because not in compliance with statute requiring such agreements be in writing, and other minority shareholders were unaware of the agreement; but plaintiff was allowed to make a fraudulent misrepresentation claim based on defendant's oral promise to include plaintiff's minority shares in control block in exchange for minority shareholder's promise to withdraw from a voting trust being used in an attempt to oust defendant).

225 See, e.g., 805 ILCS 5/7.70; Minn. Stat. §302A.455; N.M. Stat. Ann. §53-11-34; Va. Code Ann. §13.1-671.

226 See, e.g., Cf. Cal. Corp. Code §706(a) and New York Business Corporation Law §620(b) (limited to close corporations). See Fitch v. J.A. Tobin Const. Co., Inc., 829 S.W.2d 497 (Mo. Ct. App. W.D. 1992) (memorandum of understanding between majority shareholder and employee, whereby employee was hired as employee, officer, and director, did not provide that employee would be director of corporation for five years, as would violate three-year limit in corporate director statute).

have an illegal purpose.[227]

Some older opinions, containing language not in accord with this rule, can be explained or distinguished on the ground that the agreement attempted to bind the parties in their actions as directors[228] or was calculated to defraud creditors or shareholders not parties to it.[229] Many decisions, applying common law in the absence of a specific statute, enunciate the proposition that an agreement among a number of shareholders to combine their voting power in order to effectuate a particular corporate policy is lawful, in the absence of an intent to secure a private benefit for the contracting shareholders at the expense of the corporation or other

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[227] Mackin v. Nicollet Hotel, 25 F.2d 783 (C.C.A. 8th Cir. 1928); Smith v. San Francisco & N.P. Ry. Co., 115 Cal. 584, 47 P. 582 (1897); Ringling Bros.-Barnum & Bailey Combined Shows v. Ringling, 29 Del. Ch. 610, 53 A.2d 441 (1947) (agreement provided that the two parties should act jointly in voting and that in the event of disagreement a named arbitrator should decide); Weber v. Della Mountain Min. Co., 14 Idaho 404, 94 P. 441 (1908); Galler v. Galler, 32 Ill. 2d 16, 203 N.E.2d 577 (1964) (agreement, among other things, gave the widow of a shareholder who died the right to designate a director to replace her deceased husband); Thompson v. J.D. Thompson Carnation Co., 279 Ill. 54, 116 N.E. 648 (1917); Church Point Wholesale Beverage Co., Inc. v. Voitier, 706 So. 2d 1015, 1017 (La. Ct. App. 3d Cir. 1998), writ denied, 717 So. 2d 1145 (La. 1998) (rejecting challenge to voting agreement). Hayden v. Beane, 293 Mass. 347, 199 N.E. 755 (1936) (agreement under which two sole shareholders agreed to transfer to plaintiff 24 shares of common stock and to elect and continue plaintiff and his nominee as members of the board); Tomlin v. Farmers' & Merchants' Bank, 52 Mo. App. 430, 1893 WL 1678 (1893) (dictum); E.K. Buck Retail Stores v. Harkert, 157 Neb. 867, 62 N.W.2d 288, 45 A.L.R.2d 774 (1954); Davis v. Arguls Gas & Oil Sales Co., 167 Misc. 377, 3 N.Y.S.2d 241 (Sup 1938). "It is now well established that stockholders of a corporation may validly agree to elect specified persons as directors." In re Feinson's Estate, 196 Misc. 590, 592, 92 N.Y.S.2d 87, 90 (Sur. Ct. 1949). "Persons owning stock have the unqualified right to combine their interests to secure the management of the corporation when such management is fair to all stockholders alike." Winsor v. Commonwealth Coal Co., 63 Wash. 62, 73, 114 P. 908, 912 (1911). See also Ramos v. Estrada, 8 Cal. App. 4th 1070, 10 Cal. Rptr. 2d 833 (2d Dist. 1992), reh'g denied and opinion modified, (Sept. 11, 1992) (shareholder voting agreement among all shareholders requiring that shares be voted in accordance with majority of shareholders within the pooling agreement and providing for forced sale of shares in case of breach, was valid pooling agreement especially authorized by California Code, even though corporation was not closely held); Benintendi v. Kenton Hotel, 294 N.Y. 112, 60 N.E.2d 829, 159 A.L.R. 280 (1945) (dictum to the effect that an agreement by a shareholder to vote for specified persons as directors is not invalid as in conflict with statute requiring the directors to be elected by votes of a plurality of the shares); Boyer v. Nesbitt, 227 Pa. 398, 76 A. 103 (1910) (an agreement among majority shareholders and the directors sustained under which the shareholders conveyed to the directors as trustees for five years the legal title to their shares and the right to vote them, the intent being to secure a continuation of the policy inaugurated by the officers then in control of the company).

[228] See, e.g., Cone v. Russell, 48 N.J. Eq. 208, 21 A. 847 (Ch. 1891); Tremsky v. Green, 106 N.Y.S.2d 572 (Sup 1951) (although an agreement by shareholders to vote for stipulated directors is not unlawful, the shareholders are not bound by such an agreement to continue in office a director or officer who is derelict in his fiduciary obligations or whose activities are opposed to the interests of the corporation); In re Roosevelt Leather Hand Bag Co., 68 N.Y.S.2d 735 (Sup 1947) (agreement to elect and continue specified persons as directors is enforceable only as long as those persons are faithful and efficient).

[229] See Creed v. Copps, 103 Vt. 164, 152 A. 369, 71 A.L.R. 1287 (1930) (agreement by defendant to "at all times be controlled in his judgment and conduct of the affairs of the corporation and voting his stock by the desires, wishes and judgment" of the plaintiff, another shareholder, held contrary to public policy and fraudulent to nonparticipating shareholders). See Bradley, Toward a More Perfect Close Corporation—The Need for More and Improved Legislation, 54 Geo. L.J. 1145, 1174 (1966).

shareholders.[230]

As has been said by the New York Court of Appeals: "It is not illegal or against public policy for two or more stockholders owning the majority of the shares of stock to unite upon a course of corporate policy or action [...]."[231] The courts now seem to accept as completely justified the separation of voting power from the beneficial interest in shares if the purpose of the separation is to carry out some definite policy in the interest of the corporation or the shareholders as a whole.[232] Further, the courts rather readily accept an effort to assure continuity or stability of management in the corporation as this is deemed to be in the interest of the corporation and all the shareholders.[233] These decisions often support agreements that not only govern matters within the usual domain of shareholders but also matters that traditionally have been considered in the domain of directors.

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[230] Ecclestone v. Indialantic, Inc., 319 Mich. 248, 29 N.W.2d 679 (1947); Hart v. Bell, 222 Minn. 69, 23 NW2d 375 (1946). "An ordinary agreement, among a minority in number, but a majority in shares, for the purpose of obtaining control of the corporation by the election of particular persons as directors is not illegal. Shareholders have the right to combine their interests and voting powers to secure such control of the corporation and the adoption of and adhesion by it to a specific policy and course of business. Agreements upon a sufficient consideration between them, of such intendment and effect, are valid and binding, if they do not contravene any express charter or statutory provision or contemplate any fraud, oppression, or wrong against other stockholders, or other illegal object." Manson v. Curtis, 223 N.Y. 313, 319, 119 N.E. 559 (1918). See also Sanders v. McMullen, 868 F.2d 1465, 1467 (5th Cir. 1989) (court held that the Texas corporation law provision regulating voting agreements did not cover promises relating to, among other things, the minority shareholder's participation in all management decisions involving a baseball team owned by the corporation and receiving access to all operational information); Neuman v. Pike, 591 F.2d 191 (2d Cir. 1979), noted, 31 Syracuse L. Rev. 129, 144 to 145 (1980) (court strictly enforced the provisions of a shareholders' agreement providing that if the holders of 52 percent of the shares of a close corporation were unable to agree as to how such shares would be voted none of such shares would be voted, with the result that holders of the remaining 48 percent of the corporation's shares were able to determine corporate management policy). See generally Validity of Stockholders' Agreement Allegedly Infringing on Directors' Management Powers—Modern Cases, 15 ALR4th 1078.

[231] Manson v. Curtis, 223 N.Y. 313, 319, 119 N.E. 559, 561 (1918). See also Royster v. Baker, 365 S.W.2d 496, 500 (Mo. 1963): It is not wrongful for the stockholders of a corporation, who control or own a majority of the stock, to agree among themselves to vote their stock a certain way and to change the management of the corporation or its methods of doing business as long as their conduct does not violate the laws of the state, the articles or bylaws of the corporation, or infringe upon contractual or other rights of others.

[232] Ecclestone v. Indialantic, Inc., 319 Mich. 248, 29 N.W.2d 679 (1947).

[233] See, e.g., Ecclestone v. Indialantic, Inc., 319 Mich. 248, 29 N.W.2d 679 (1947). "Persons owning stock have the unqualified right to combine their interest to secure the management of the corporation when such management is fair to all stockholders alike." Winsor v. Commonwealth Coal Co., 63 Wash. 62, 73, 114 P. 908, 912 (1911).

Creation or preservation of a control block

Pooling agreements can be among a block of shareholders who together can establish a majority and wish to agree to elect themselves directors with a view to securing control and management of the corporation. Such an agreement is valid as long as the majority shareholders do not seek unfair advantages for themselves contrary to the best interests of the corporation.[234] Thus, in a leading California case, the court upheld a voting agreement entered into by three persons who were purchasing the controlling interest in a railway corporation that they would vote the shares (which they held in separate certificates in their respective names) as a unit for a period of five years and "that the vote which shall be cast by said shares, whether for directors or for any other purpose, shall be determined by ballot between them or their survivors."[235]

Disproportionate voting power disproportionate to shareholdings

Shareholders may desire to give voting power to a shareholder disproportionate to ownership, often to provide equal control between two shareholders who own different amounts of shares. A pooling agreement may provide a method to achieve such disproportionate voting as

[234] Weber v. Della Mountain Min. Co., 14 Idaho 404, 94 P. 441 (1908); Thompson v. J.D. Thompson Carnation Co., 279 Ill. 54, 116 N.E. 648 (1917); Venner v. Chicago City Ry. Co., 258 Ill. 523, 101 N.E. 949 (1913); Storer v. Ripley, 1 Misc. 2d 235, 125 N.Y.S.2d 831 (Sup 1953), judgment aff'd, 282 A.D. 950, 125 N.Y.S.2d 339 (2d Dep't 1953). "[I]t has been expressly held that a contract by the owners of more than one-half of the shares of stock of a corporation to elect the directors of the corporation so as to secure the management of its property, to ballot among themselves for directors and officers if they could not agree, to cast their vote as a unit as the majority should decide so as to control the election, and not to buy or sell stock except for their joint benefit, is not dishonest, violative of the rights of others, or in contravention of public policy." Venner v. Chicago City Ry. Co., 258 Ill. 523, 539, 101 N.E. 949, 953 (1913). "An ordinary agreement, among a minority in number, but a majority in shares, for the purpose of obtaining control of the corporation by the election of particular persons as directors is not illegal. Shareholders have the right to combine their interests and voting powers to secure such control of the corporation and the adoption of and adhesion by it to a specific policy and course of business. Agreements upon a sufficient consideration between them, of such intendment and effect, are valid and binding, if they do not contravene any express charter or statutory provision or contemplate any fraud, oppression, or wrong against other stockholders or other illegal object." Manson v. Curtis, 223 N.Y. 313, 319, 119 N.E. 559 (1918) (dictum). But see, Thomas v. Sanborn, 172 So. 2d 841 (Fla. Dist. Ct. App. 2d Dist. 1964), the court invalidated a voting pool among four of five shareholders who were parties to an existing shareholders' voting agreement (a voting pool within a voting pool). The five shareholders had agreed to vote their shares as a unit in accordance with the decision of the holders of a majority of the shares in the pool. A subsequent agreement among four of the shareholders provided that they would pool their votes for the purpose of voting as a unit in the five-person pool. The court held the later four-person agreement invalid on the ground that each of the parties to the five-person agreement was entitled to the free exercise of judgment by each of the other parties.

[235] Smith v. San Francisco & N.P. Ry. Co., 115 Cal. 584, 47 P. 582 (1897).

an alternative to other methods discussed herein. These other methods include: (1) provisions in the articles, authorized in most states for weighted voting, which can be used to provide one shareholder with a veto over corporate action;[236] (2) amending the corporation's articles to create one or more classes of stock without voting rights or with limited voting rights. Nonvoting stock or stock with limited voting rights could then be issued to some shareholders in exchange for part of their voting shares to achieve the desired distribution of voting strength; (3) a shareholders' control agreement, usually with a requirement for unanimity and a written agreement, explicitly authoring provisions which provide for weighted voting. If the shareholders use a shareholders' agreement instead of a provision in the articles to implement a disproportionate voting scheme, support often can be found in statutory provisions authorizing pooling agreements.[237]

The New York statute, for example, states that an agreement between two or more shareholders "may provide that in exercising any voting rights, the shares held by them shall be voted as therein provided, or as they may agree, or as determined in accordance with a procedure agreed upon by them."[238] Most courts have refused to invalidate shareholders' agreements solely because they give voting power disproportionate to shareholdings.[239] Further, a New Hampshire

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[236] Some ambiguity exists on whether departures from one-vote-per-share must apply evenly to all shares in a particular class, or may be made applicable to only some shares within a class. Most states provide for vote variation among shares regardless of class. See, e.g., Cal. Corp. Code §700; Del. Code Ann. tit. 8, §212; MCLA §450.1441; New York Business Corporation Law §612. Some state statutes are worded in ways that suggest that a vote variation must be established by class. See, e.g., 805 ILCS 5/7.40.

[237] More states have statutes authorizing voting agreements. Some statutes expressly authorize placing weighted vote provisions in a shareholders' agreement or the bylaws, respectively. See, e.g., Ga. Code Ann. §14-2-732; N.D. Cent. Code §10-19.1-77.

[238] New York Business Corporation Law §620(a). For a decision interpreting Section 620(a) of the New York Business Corporation Law, see Neuman v. Pike, 591 F.2d 191 (2d Cir. 1979), noted, 31 Syracuse L. Rev. 129, 144 to 145 (1980) (a shareholders' agreement provided that if the parties were not able to agree on how their shares in a close corporation were to be voted none of those shares would be voted; the court refused to infer that the parties contemplated that a party to the contract should not unreasonably withhold his consent to the election of another party's nominee for corporation's board of directors).

[239] Sankin v. 5410 Connecticut Ave. Corp., 281 F. Supp. 524, 551 (D. D.C. 1968), judgment aff'd, 410 F.2d 1060 (D.C. Cir. 1969) (sustaining an agreement by holder of two-thirds of the outstanding shares in a close corporation to refrain from voting one-half of his stock holdings so as to give the minority shareholder an equal voice in the management of the corporation, the court commenting that "it would seem that ownership of voting stock imposes

court,[240] sustained an agreement between a majority shareholder and two purchasers of shares from the corporation (the agreement being designed to obtain additional working capital for the corporation) in which the majority shareholder agreed that as long as either of the purchasers owned stock in the corporation he would not vote certain shares he held, the objective of this agreement being to enable the purchasers to control at least 50 percent of the shares voted at shareholders' meetings. The court concluded that a shareholders' agreement "reasonably intended to be beneficial to a corporation and injurious to no one save for the contemplated detriment to the contracting parties is valid." An early New Jersey decision[241] invalidated a shareholders' agreement giving the holder of 25 percent of the corporation's stock the power to exercise 50 percent of the shareholders' voting strength, on the grounds that (1) the arrangement

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no legal duty to vote at all"); Galler v. Galler, 45 Ill. App. 2d 452, 196 N.E.2d 5 (1st Dist. 1964), aff'd in part, rev'd in part, 32 Ill. 2d 16, 203 N.E.2d 577 (1964) (indicating that a clause in a shareholders' agreement was valid which provided that on the death of either of two principal shareholders of a close corporation the corporation would purchase as many shares of its stock in possession of the decedent's estate as was necessary to pay estate and inheritance taxes and any other administrative expenses of the estate, and that the voting power of the estate and the heirs in the corporation would not be altered as a result of this stock purchase arrangement; but sustaining the entire agreement); Trefethen v. Amazeen, 93 N.H. 110, 36 A.2d 266 (1944). Cf. Hladovec v. Paul, 222 Ill. 254, 78 N.E. 619 (1906) (contract among all shareholders which prohibited anyone from acquiring more than 10 shares of the corporation's stock sustained); Model, Roland & Co. v. Industrial Acoustics Co., 21 A.D.2d 70, 248 N.Y.S.2d 387 (1st Dep't 1964), order aff'd, 16 N.Y.2d 703, 261 N.Y.S.2d 896, 209 N.E.2d 553 (1965) (shareholders' agreement between majority and minority shareholders for minority shareholder to have parity on the board of directors sustained); Danzig v. Lacks, 235 A.D. 189, 256 N.Y.S. 769 (1st Dep't 1932) (plaintiff held to have stated a cause of action by alleging breach of a shareholders' agreement assuring him that he would never own less than 30 percent of the corporation). For a case in which the court resolved a conflict between bylaws and articles provisions, by deeming the bylaw to be a shareholders' voting agreement, see Delspina v. Woscha, Inc., 223 N.J. Super. 84, 538 A.2d 367 (App. Div. 1988) (court held that pursuant to a statute providing that the shareholders may agree that they will vote to elect directors named by a class of non-shareholders, the shareholders in a limited dividend nonprofit housing corporation in the bylaws could provide for the mayor and township council to appoint one member of the corporation's board of directors, even though the corporate articles provided for the appointment of the board of directors by the common shareholders; the bylaws constituted an agreement of the shareholders in advance as to how they would cast their votes). See also Street v. Vitti, 685 F. Supp. 379 (S.D. N.Y. 1988) (court held that a shareholders' agreement which named two directors and committed the parties thereto to vote their shares to implement the agreement, but which failed to specify a procedure for filling the seat of a retiring director did not, under New York law, require minority shareholder control of one-fourth or two-fifths of the board of directors).

[240] Trefethen v. Amazeen, 93 N.H. 110, 36 A.2d 266 (1944).

[241] Nickolopoulos v. Sarantis, 102 N.J. Eq. 585, 141 A. 792 (Ct. Err. & App. 1928). See also Piechowski v. Matarese, 54 N.J. Super. 333, 148 A.2d 872 (App. Div. 1959) (if a provision in a contract for the purchase of an interest in a corporation is construed to give the buyer voting power in excess of his proportionate shareholdings, it is void); Christal v. Petry, 275 A.D. 550, 90 N.Y.S.2d 620, 629 (1st Dep't 1949), judgment aff'd, 301 N.Y. 562, 93 N.E.2d 450 (1950) (dictum: agreement between holder of majority of the shares in a corporation and another shareholder that they will have equal control in corporation is invalid if there are other shareholders who are not parties to the agreement). Cf. Katcher v. Ohsman, 26 N.J. Super. 28, 97 A.2d 180 (Ch. Div. 1953).

violated statutes providing for an equality of voting strength among shares except as specified otherwise in the charter or bylaws, (2) the shareholders were powerless except for a method approved by statute to vary the voting power of any share of stock, and (3) the agreement set up a system of secret control[242] which was a fraud on the corporation, shareholders not party to the agreement, and on persons dealing with the corporation.[243]

Private benefit

The greater willingness of courts to uphold shareholders' agreements has not erased the traditional legal prohibition, particularly in public corporations, against vote buying. Vote buying is prohibited by statute in some states[244] and case law in others.[245] In the leading modern opinion on the topic, the Delaware Supreme Court refused to apply the traditional per se invalidity rule to vote buying, but did say that such agreements would be subject to judicial review for fairness.[246] In a public corporation setting, restrictions on vote buying support the alignment between the

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[242] In Katcher v. Ohsman, 26 N.J. Super. 28, 37, 97 A.2d 180, 185 (Ch. Div. 1953), the court in distinguishing Nickolopoulos v. Sarantis, stated: "It was the fact of 'a secret control' which caused the court in that case to pronounce the agreement invalid."

[243] Although the agreement apparently attempted to give the holder of 25 percent of the shares 50 percent of the voting power in directors' meetings as well as in shareholders' meetings, the court focused on what it considered the illegality of giving him extra voting power as a shareholder and did not limit its decision to the impropriety of the power given him over directors' decisions.

[244] N.Y. Business Corporation Law §609(e) provides: "A shareholder shall not sell his vote or issue a proxy to vote to any person for any sum of money or anything of value, except as authorized in this Section and Section 620 [...]." But see Morgenstern v. Cohon, 285 A.D. 1124, 140 N.Y.S.2d 427 (1st Dep't 1955), refusing to invalidate an agreement as inconsistent with a somewhat similar earlier New York statute. See also Lurie v. Kaplan, 31 A.D.2d 93, 295 N.Y.S.2d 493 (1st Dep't 1968), order aff'd, 29 N.Y.2d 532, 324 N.Y.S.2d 85, 272 N.E.2d 577 (1971), holding that a Pennsylvania statute prohibiting a shareholder's sale of his vote is not violated by a sale of stock above market price, where the stock is not to be delivered until after a specified shareholders' meeting, even though the sales agreement requires the seller to deliver to the buyer irrevocable proxies that can be voted at all meetings until delivery of the stock.

[245] "The rule which forbids the voting of purchased votes is not limited to instances where the consideration for the purchase is strictly a corporate office and its emoluments. Shareholder votes may not be purchased for any consideration personal to the stockholder [...]." Hall v. John S. Isaacs & Sons Farms, Inc., 37 Del. Ch. 530, 549, 146 A.2d 602, 613 (1958), aff'd in part, 39 Del. Ch. 244, 163 A.2d 288 (1960). See also Chew v. Inverness Management Corp., 352 A.2d 426 (Del. Ch. 1976) (in order to obtain written consents from shareholders sufficient to elect a new board of directors without holding a meeting of shareholders, as permitted by Delaware statute, the solicitors of the consents used a stratagem of paying ten cents a shares for options to purchase shares at a price greatly in excess of their value; the court held the consents invalid under the rule that an agreement by a shareholder to sell his vote or to vote in a certain way for a consideration personal to himself is contrary to public policy and void).

[246] Schreiber v. Carney, 447 A.2d 17, 25 (Del Ch. 1982).

incentives of individual shareholders and the collective benefit that permit shareholder voting to serve an effective monitoring of management in these entities.[247] On the contrary, in closely held entities, the smaller number of shareholders and the more intimate relationship among the parties ought to provide additional room for parties to make contracts that they think advantageous. But courts have still struck down some agreements by which a shareholder sells his or her vote or undertakes to vote in a specified manner in consideration of some strictly private benefit.[248]

Thus, a promise to pay money to a shareholder in consideration of his undertaking to vote his shares in a specified manner has been held unenforceable.[249] Similarly, an agreement providing for a shareholder to vote in a particular way in consideration of a promise by another party to the agreement to surrender or cancel the shareholder's promissory note has been held invalid.[250] Such a rule has sometimes been based on the right of shareholders to the unfettered judgments of the other shareholders.[251] The force of that argument has receded since the mid-twentieth century.[252] A host of decisions sustain voting agreements, such as those in which the

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[247] See Thompson & Edelman, Corporate Voting, 62 Vand. L. Rev. 2009) (discussing the theory that supports shareholder voting and prohibitions on vote buying).

[248] Stott v. Stott, 258 Mich. 547, 242 N.W. 747 (1932); Cone v. Russell, 48 N.J. Eq. 208, 21 A. 847 (Ch. 1891); Luedke v. Oleen, 72 N.D. 1, 4 N.W.2d 201 (1942); For a discussion of the validity under Kansas law of an agreement to vote in a designated way in consideration of a private benefit, see Logan, Methods To Control the Closely Held Kansas Corporation, U. Kan. L. Rev. 405, 433 to 435 (1959).

[249] Fuller v. Dame, 35 Mass (18 Pick) 472 (1836); Dieckmann v. Robyn, 162 Mo. App. 67, 141 S.W. 717 (1911).

[250] Palmbaum v. Magulsky, 217 Mass. 306, 104 N.E. 746 (1914); Stott v. Stott, 258 Mich. 547, 242 N.W. 747 (1932). See also Dieckmann v. Robyn, 162 Mo. App. 67, 141 S.W. 717 (1911) (undertaking by owner of property to pay shareholder a commission if shareholder caused corporation to buy the property).

[251] The rule has been said to be predicated "on the principle that such an agreement operates as a constructive fraud on the other shareholders who have a right to expect that a shareholder's judgment as to how to vote has not been influenced by the payment of a consideration to him." 17 Minn. L. Rev. 89 (1932). For a criticism of the rule, see Rohrlich, Corporate Voting: Majority Control, 7 St. John's L. Rev. 218, 225 (1933).

[252] See Oceanic Exploration Co. v. Grynberg, 428 A.2d 1, 7 (Del. 1981) (describing the change in judicial attitudes toward voting trusts and other agreements). The Restatement of Contracts seemingly adopted this earlier, more restrictive view in providing: "A bargain by an official or shareholder of a corporation for a consideration inuring to him personally to exercise or promise to exercise his powers in the management of the corporation in a particular way is illegal." Restatement, Contracts, §569. The Restatement (2d) Contracts uses more general language in providing: "A promise by a fiduciary to violate his fiduciary duty or a promise that tends to induce such a violation is unenforceable on grounds of public policy.". Restatement Second, Contracts, §193. The Comment to this Section states further that "[t]he rule applies by analogy to shareholders with reference to their voting powers, although it does not preclude agreements where the only advantage bargained for is one that will accrue to all shareholders through the ownership of shares." "The proposition so laid down is correct enough as to the sale of votes, or the

participating shareholders agree to keep themselves in directorships, even though the consideration for the promises to vote accrues directly and perhaps primarily to the private advantage of the contracting shareholders[253] A considerable number of cases have expressly determined that expectation by the contracting parties of "gain and advantage" does not invalidate an agreement as long as the gain is not at the expense of the corporation or the other shareholders.[254]

Irrevocable proxies

The parties to a shareholders' agreement, instead of merely binding themselves to vote their shares as a unit or in accordance with a predetermined plan, sometimes relinquish the power to vote their own shares and confer that power in the form of an irrevocable proxy upon one or

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making of voting agreements, by directors, who are fiduciaries in the exercise of their powers. It is a more doubtful proposition as to the sale of votes by shareholders, although there are authorities which support it." Ballantine, Voting Trusts, Their Abuses and Regulation, 21 Tex. L. Rev. 139, 145 (1942).

253 See Wolf v. Arant, 88 Ga. App. 568, 77 S.E.2d 116 (1953) (agreement held valid by which a shareholder agreed to vote his stock for dissolution in consideration of an undertaking by another shareholder to pay him the difference between the cost of his shares and the amount realized on liquidation).

254 "The fact that they [the contracting parties] expect 'gain and advantage' (in the words of the syndicate agreement) to accrue to them does not make the combination unlawful. That expectation and intent would have that effect only if the gain was to be at the expense of the corporation, or in some way was intended to work a wrong to the other stockholders." Brightman v. Bates, 175 Mass. 105, 110, 55 N.E. 809, 810 (1900). See also Harris v. Scott, 67 N.H. 437, 32 A. 770 (1893). "Generally speaking, a shareholder may exercise wide liberality of judgment in the matter of voting, and it is not objectionable that his motives may be for personal profit, or determined by whims or caprice, so long as he violates no duty owed his fellow shareholders." Ringling Bros.-Barnum & Bailey Combined Shows v. Ringling, 29 Del. Ch. 610, 622, 53 A.2d 441, 447 (1947); Wasserman v. Rosengarden, 84 Ill. App. 3d 713, 40 Ill. Dec. 430, 406 N.E.2d 131 (1st Dist. 1980) (court upheld the validity of an oral shareholders' agreement among all the shareholders in a close corporation providing for the election of the parties thereto as directors and officers and for an equal distribution of salaries and profits as long as the parties remained shareholders or the corporation remained in existence); Galler v. Galler, 32 Ill. 2d 16, 203 N.E.2d 577 (1964) (agreement by two principal shareholders of a close corporation "to provide income for the support and maintenance of their immediate families" sustained by the court); Davis v. Arguls Gas & Oil Sales Co., 167 Misc. 377, 3 N.Y.S.2d 241 (Sup 1938). In Miller v. Vanderlip, 285 N.Y. 116, 33 N.E.2d 51 (1941), the court in discussing an agreement pursuant to which a new management was to be brought into the company and the number of directors increased, stated: "But even if it were to be assumed that the defendants were stockholders, and even if it were to be assumed that the defendants would profit as a result of the adoption of the plan, would it necessarily follow that the agreement was illegal? There is nothing in the complaint from which it may be inferred that the profits which would flow to the proponents of the rehabilitation plan would not equally flow to all the other stockholders, except for the fact that the plaintiff would obtain the emoluments of an office, which obviously cannot accrue to more than one or, at most, to a very limited number. In this connection it is to be noted that not even the benefits which would accrue to the plaintiff would be obtained at the expense of any of the other stockholders."

more of them, or upon some person not a party to the agreement.[255] This form of agreement can be a way to empower one participant to make decisions[256] or a means of self-help enforcement of an agreement among a block of shareholders who have combined to exercise control.[257] A simple proxy[258] is just an authorization given by a shareholder to another to vote his or her shares.[259] As a proxy is usually thought of as a special form of agency, giving the relationship a transient quality in that agency status is generally held to be revocable at any time before the shares are voted, if not coupled with an interest.[260] On the other hand, in the absence of a controlling statute, if a

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[255] See, e.g., Smith v. San Francisco & N.P. Ry. Co., 115 Cal. 584, 47 P. 582 (1897). But see Ringling Bros.-Barnum & Bailey Combined Shows v. Ringling, 29 Del. Ch. 610, 53 A.2d 441 (1947). Further, even though an agreement does not expressly provide for it, an irrevocable proxy sometimes may be inferred from the content and purposes of the agreement. Lobato v. Health Concepts IV, Inc., 606 A.2d 1343 (Del. Ch. 1991) (property settlement agreement executed in connection with shareholders' divorce qualified as "proxy" allowing husband to vote wife's shares, even though agreement was not originally intended to serve as proxy). For a general discussion of the irrevocable proxy and voting control of small business corporations, see Logan, Methods To Control the Closely Held Kansas Corporation, 7 U. Kan. L. Rev. 405, 422 to 425 (1959); Thomas, Irrevocable Proxies, 43 Tex. L. Rev. 733 (1965).

[256] See also Ronnen v. Ajax Elec. Motor Corp., 88 N.Y.2d 582, 648 N.Y.S.2d 422, 671 N.E.2d 534, 536 (1996) (shareholders' agreement which gave brother certain rights to vote the stock of his sister and her children "with respect to any and all matters relating to Ajax's day to day operations and corporate management" gave to the brother an irrevocable proxy to vote for the board of directors as "[...] without the right to vote [the shares] to elect the directors of the corporation, the transfer of voting rights regarding 'corporate management' under subparagraph 8(a) of the agreement would be essentially meaningless since management control was vested in the directors and not the shareholders.").

[257] See Ringling Bros.-Barnum & Bailey Combined Shows v. Ringling, 29 Del. Ch. 610, 53 A.2d 441 (1947), where the purpose of the voting agreement was frustrated by the failure of the Delaware Supreme Court to require the recalcitrant party to vote her shares in accordance with the decision of the arbitrator. See also, Ramos v. Estrada, 8 Cal. App. 4th 1070, 10 Cal. Rptr. 2d 833 (2d Dist. 1992), reh'g denied and opinion modified, (Sept. 11, 1992) (no proxies created by shareholders' voting agreement for member of group to vote as majority determines). But see Kessler, The Revised New Jersey Business Corporation Act of 1988 As Amended and Its Effect On Close Corporations, 20 Seton Hall L. Rev. 130 (1989) (discussing amendment to New Jersey Business Corporation Act which provides that a proxy is irrevocable if coupled with an interest and held by a person designated pursuant to the terms of an agreement as to voting between two or more shareholders; noting that "the agreement rendered nugatory by the Delaware Supreme Court in Ringling Bros.-Barnum & Bailey Combined Shows v. Ringling, 29 Del. Ch. 610, 53 A.2d 441 (1947), can now be overruled by the simple device of giving the chosen arbitrator, or the 'willing parties,' (the ones willing to abide by the voting agreement) an irrevocable proxy on the shares of the parties refusing to do so").

[258] The term "proxy" is also used sometimes to refer to the document evidencing the authority to vote shares or to the person to whom the authority is given.

[259] Duffy v. Loft, Inc., 17 Del. Ch. 140, 147, 151 A. 223 (1930), aff'd, 17 Del. Ch. 376, 152 A. 849 (1930).

[260] See Calumet Industries, Inc. v. MacClure, 464 F. Supp. 19 (N.D. Ill. 1978) (revocable at the will of the shareholder, even though it was stated to be irrevocable subject to stated conditions); Williams v. Williams, 427 N.E.2d 727, 730 (Ind. Ct. App. 4th Dist. 1981), opinion corrected on reh'g, 432 N.E.2d 417 (Ind. Ct. App. 4th Dist. 1982), noted 16 Ind. L. Rev. 25, 39 to 41 (1983) ("A proxy is revocable unless coupled with an interest."); In re Fun Zones of Staten Island, Inc., 257 A.D.2d 575, 683 N.Y.S.2d 584 (2d Dep't 1999) (pledgee of stock who was entitled to shares after default was able to void a proxy that had been given by the pledgor). See generally, the Restatement (Third) of Agency §3.12, Official Comment (d) ("Designating a proxy creates a relationship of agency [...] unless the proxy is irrevocable.") Even though a principal has the power to revoke an agent's authority, the revocation may

proxy is coupled with an interest and stated to be irrevocable, courts have held the proxy to be irrevocable.[261]

Some of the decisions indicate that a proxy coupled with an interest is irrevocable even though not expressly stated to be so.[262] Every American jurisdiction has statutes that have codified or supplemented these common law rules, but not so completely that the statutes have occupied the field so as to entirely displace agency law. First, all states have a provision in the corporation statute authorizing the appointment of proxies.[263] Second, all states specify the duration of proxies if no term is specified, usually 11 months, unless a longer period is expressly provided.[264] Many shareholders, of course, desire their agreement to last longer than 11 months;

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constitute a breach of contract of employment or other agreement between the principal and agent. See State ex rel. Everett Trust & Sav. Bank v. Pacific Waxed Paper Co., 22 Wash. 2d 844, 157 P.2d 707, 712, 159 A.L.R. 297 (1945). Some courts have held this is so even though the proxy is in express terms stated to be irrevocable. Calumet Industries, Inc. v. MacClure, 464 F. Supp. 19 (N.D. Ill. 1978) (revocable at the will of the shareholder, even though it was stated to be irrevocable subject to stated conditions); In re Chilson, 19 Del. Ch. 398, 168 A. 82, 85 (1933); Luthy v. Ream, 270 Ill. 170, 110 N.E. 373 (1915); State ex rel. Breger v. Rusche, 219 Ind. 559, 39 N.E.2d 433 (1942); Axe, Corporate Proxies, 41 Mich. L. Rev. 225, 256 (1942). See also Wadman v. McBirney, 51 Md. App. 385, 443 A.2d 978 (1982) (court held that a proxy executed by one shareholder to another which would expire in 10 years and which was conditioned in part on the latter remaining as president of the corporation was not irrevocable).

261 Mobile & O.R. Co. v. Nicholas, 98 Ala. 92, 12 So. 723 (1893); Chapman v. Bates, 61 N.J. Eq. 658, 47 A. 638 (Ct. Err. & App. 1900); Hey v. Dolphin, 36 N.Y.S. 627 (Gen. Term 1895). See generally the Restatement (Third) of Agency §3.13, Official Comment (b) (A proxy made irrevocable in compliance with applicable legislation is not terminated by a manifestation of revocation).

262 Smith v. San Francisco & N.P. Ry. Co., 115 Cal. 584, 47 P. 582 (1897); Chapman v. Bates, 61 N.J. Eq. 658, 47 A. 638 (Ct. Err. & App. 1900). But see Eliason v. Englehart, 733 A.2d 944 (Del. 1999) (statement of irrevocability contained only in acknowledgement cannot be used to satisfy substantive requirement of statute that the proxy state is irrevocable; acknowledgment is not part of proxy).

263 See, e.g., Cal. Corp. Code §705; Del. Code Ann. tit. 8, §212; MCLA §§450.1421, 450.1422; New York Business Corporation Law §609; Ohio Rev. Code Ann. §1701.48; Tex. Bus. Org. Code §§21.367-21.371. Most states now authorize proxies by electronic communication. See Model Business Corporation Act Ann. 7-131-132 (4th Ed).

264 See, e.g., Cal. Corp. Code §705(b); 805 ILCS 5/7.50(l); New York Business Corporation Law §609(b). See Auto West, Inc. v. Baggs, 678 P.2d 286 (Utah 1984) (court held that where proxies did not state a time at which they would terminate the proxies were terminated by operation of law pursuant to the statutory provision which provides that no proxy shall be valid after 11 months from the date of execution unless otherwise provided in the proxy); Stein v. Capital Outdoor Advertising, Inc., 273 N.C. 77, 159 S.E.2d 351 (1968) (shareholders' agreement plus "stock voting proxy" held to be simply a proxy of unspecified duration which expired after 11 months). See also Schultz v. Schultz, 637 S.W.2d 1, 34 U.C.C. Rep. Serv. 1350 (Mo. 1982) (court held that even if the stock purchaser's letter giving the corporate president authority to vote the shares was considered a proxy, it became invalid 11 months after the date of its execution). But see Wadman v. McBirney, 51 Md. App. 385, 443 A.2d 978 (1982) (court held that a proxy executed by one shareholder to another which would expire in 10 years and which was conditioned in part on the latter remaining as president of the corporation was not revocable nor violative of the Maryland statutory provision providing that "unless a proxy provides otherwise, it is not valid more than 11 months after its date"); For a case interpreting the requirements of a Texas statutory provision, see Zollar v. Smith, 710 S.W.2d 155 (Tex. App. Eastland 1986), noted 41 S.W. L.J. 237 (1987) (court held that for a proxy to be irrevocable it must expressly provide

in most states this limitation can be avoided simply by writing a longer term into the agreement.[265] Third, and most significantly, almost all the statutes address the question of whether the appointment can be made irrevocable.

Most states provide that proxies are revocable unless stated to be irrevocable and the appointment is coupled with an interest.[266] Typically these statutes specify examples of appointments that will be irrevocable and include within that list an appointment under a shareholders' voting agreement.[267] The Model Business Corporation Act, which has been followed in a majority of the states, gives nonexclusive examples of appointments coupled with an interest that include many of the common situations in which a proxy is used in a close corporation, to wit: (1) a pledgee; (2) a person purchasing or agreeing to purchase shares; (3) creditors extending credit to the corporation under terms requiring the appointment; (4) employees whose employment contract with the corporation requires the appointment; and (5) parties to a shareholders' voting agreement under the shareholders' pooling agreement section of the Model Business Corporation Act.[268]

Some states which address the irrevocability question make that status turn on whether the appointment is "coupled with an interest" without providing examples.[269] In these states and the states that contain no provision for irrevocability or identify limited instances, the effectiveness of a shareholders' agreement that includes an irrevocable proxy turns upon the meaning of "proxy coupled with an interest," a concept just as vague and elusive as its

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that it is irrevocable and must otherwise be made irrevocable by law, which means it must be "coupled with an interest" or "given as security").

[265] Some state statutes authorize proxy appointments for three years unless otherwise stated. See, e.g., Del. Code Ann. tit. 8, §212(b); Kan. Stat. Ann. §17-6502(b); MCLA §450.1421.

[266] See, e.g., N.J. Rev. Stat. §14A.15-19(1); Ohio Rev. Code Ann. §1701.48(D).

[267] See, e.g., Cal. Corp. Code §705(e); New York Business Corporation Law §609(f).

[268] Model Business Corporation Act Ann. §7.22(d) (4th Ed).

[269] See, e.g., Del. Code Ann. tit. 8, §212(c); Mo. Rev. Stat. §351.245(4).

counterpart in agency generally, the notion of "power coupled with interest."[270] The statutory "coupled with an interest" concept, however, may be somewhat broader than the traditional common law concept.[271] For example, Delaware's statute specifies, "a proxy may be made irrevocable regardless of whether the interest with which it is coupled is an interest in the stock itself or an interest in the corporation generally."[272] A number of states – including New York and California – have very sensibly abandoned any reference to ambiguous terms such as "coupled with an interest" and simply define those proxy holders who may hold irrevocable proxies.[273] The New York list is very similar to that of the Model Business Corporation Act described above, and in particular includes a party to a written shareholders' voting agreement.[274]

Many of the statutes on revocability, both those that use the "coupled with an interest" terminology and those that do not, provide that if the existence of a proxy's irrevocability is not listed on the corporation's share certificates, the irrevocability cannot be enforced against a purchaser of the shares without knowledge.[275] In addition, some statutes take away the attribute

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[270] For discussion of the origin and scope of "power coupled with an interest," see Mechem, Outline of the Law of Agency §§264–272 (4th Ed 1952); Seavey, Studies in Agency 109-127 (1949).

[271] See also Mo. Rev. Stat. §351.245(4) (authorizes a proxy to be irrevocable if so provided therein, but only if the proxy is coupled with an interest sufficient in law to support an irrevocable power of attorney).

[272] Del. Code Ann. tit. 8, §212(c). According to the official reporter of the Delaware act, this "should be sufficient to validate an irrevocable proxy held by a creditor during the term of the loan, or by a key officer during his employment contract period, or by a shareholder as an ancillary feature of a voting agreement." Folk, The New Delaware Corporate Law 27 (1967). For a decision holding that the revocability of a shareholder's consent to having his shares voted in a particular way should be determined on the same basis as the revocability of a proxy authorization under Section 212(c) of the Delaware Corporation Law, see Calumet Industries, Inc. v. MacClure, 464 F. Supp. 19 (N.D. Ill. 1978).

[273] Cal. Corp. Code §705(e); New York Business Corporation Law §609(f). See also Bradley, Toward a More Perfect Close Corporation: The Need for More and Improved Legislation, 54 Geo. L.J. 1145, 1164 to 1167 (1966); Folk, Corporation Statutes: 1959 to 1966, 1966 Duke L.J. 875, 925.

[274] See New York Business Corporation Law §609(f). New York Business Corporation Law §620(a) provides: An agreement between two or more shareholders, if in writing and signed by the parties thereto, may provide that in exercising any voting rights, the shares held by them shall be voted as therein provided, or as they may agree, or as determined in accordance with a procedure agreed upon by them.

[275] See, e.g., New York Business Corporation Law §609(b). Unless a proxy complies fully with the terms of the statute, it may be held to be revocable. See New York Business Corporation Law §609(b) ("Every proxy shall be revocable at the pleasure of the shareholder executing it, except as otherwise provided in this Section"); In re Norton & Schneider, Inc., 137 N.Y.S.2d 269 (Sup 954) ("irrevocable proxy" given by one shareholder to another to vote stock in an election of directors not having been given for any purpose specified by statute was held invalid).

of irrevocability as soon as the proxy holder ceases to need the protection the proxy provides, for instance, if the shareholders' agreement establishing the proxy has terminated, the stock pledged to secure a debt has been redeemed or the employment of a person given the proxy has ended.[276] Most states have statutory provisions that the death or incapacity of a shareholder does not revoke the proxy's authority unless the corporation receives notice of the death or incapacity before the proxy holder exercises his authority.[277] Under traditional common law agency rules death or incapacity of either the maker or holder revokes the authority of the proxy,[278] although there is authority to the contrary.[279]

Most litigation as to proxies has related to irrevocability, and the trend has been toward a broader judicial interpretation of that term reflecting the statutes just depicted. According to the earlier conventional view, which now seems too narrow as applied in the corporate proxy context, the *interest* that the holder must have in order for the proxy to be irrevocable was either (1) a charge, lien or some property right in the shares themselves or (2) a security interest given to protect the proxy holder for money advanced or obligations incurred.[280] Under this view a "recognizable property or financial interest in the stock in respect of which the voting power is to

[276] See, e.g., N.Y. Business Corporation Law §609(g); S.C. Code Ann. §33-11-140(f)(2).

[277] See, e.g., Cal. Corp. Code §705(c); MCLA §450.1421; New York Business Corporation Law §609(c); Ohio Rev. Code Ann. §1701.48(E).

[278] Ballantine, Corporations §179 (Rev. ed. 1946); Stevens, Handbook on the Law of Private Corporations §118 (2nd ed. 1949).

[279] See State ex rel. Everett Trust & Sav. Bank v. Pacific Waxed Paper Co., 22 Wash. 2d 844, 157 P.2d 707, 159 A.L.R. 297 (1945) (agreement held to create a proxy coupled with an interest which was not revoked by the death of the shareholder who had given the proxy). N.C. Gen. Stat. §55-7-22(c) (proxy not revoked by the death or incapacity of the maker unless notice of death or incapacity received). The sale of shares by a person who had previously given a proxy to vote them has been held to revoke the proxy. Johnson v. Spartanburg County Fair Ass'n, 210 S.C. 56, 41 S.E.2d 599 (1947).

[280] See In re Chilson, 19 Del. Ch. 398, 168 A. 82, 85 (1933); Arcweld Mfg. Co. v. Burney, 12 Wash. 2d 212, 121 P.2d 350, 355 (1942). Sometimes the two elements in the "interest" concept are listed as separate exceptions to the rule that proxies are revocable. Then the proxy is said to be irrevocable (1) if it is coupled with an interest, or (2) if it "is given as part of a security or is necessary to effectuate such a security." See State ex rel. Everett Trust & Sav. Bank v. Pacific Waxed Paper Co., 22 Wash. 2d 844, 157 P.2d 707, 710, 159 A.L.R. 297 (1945). See also Zollar v. Smith, 710 S.W.2d 155 (Tex. App. Eastland 1986), noted 41 S.W. L.J. 237 (1987) (court held that for a proxy agreement to be coupled with an interest or given as security so as to be made irrevocable by law the agent or proxy holder must have "parted with value," incurred liability or assumed obligations at the principal's request or with his consent, and the agent or proxy holder must have looked to the exercise of the proxy power as a means of reimbursement, indemnity, or protection).

be exercised" that renders the proxy irrevocable, is said to be distinguishable from "an interest in the corporation generally" and from "an interest in the bare voting power or the results to be accomplished by the use of it," neither of which has that effect.[281] A Texas court adopted this narrow view of *interest* in holding unenforceable an agreement among majority shareholders by which they undertook to vote their shares collectively and in the event of disagreement to vote them in accordance with a decision of arbitrators.[282] Similarly, a South Carolina court held proxies to be revocable that had been signed by a majority of shareholders under an agreement to vote their shares in a specified manner to accomplish stated objectives, because the court concluded that the proxies were not coupled with an interest or based upon a legal consideration, the mutual promises of the parties to the agreement not being considered sufficient consideration to support the proxies.[283]

On the other hand, in a New York case, in which joint owners of inventions and applications for patents agreed among themselves (1) to transfer their inventions and applications to a corporation for shares in which each was to have an undivided one-half interest, (2) to refrain from alienating the shares for ten years unless both agreed, and (3) to create in one of the parties an irrevocable proxy to vote the shares for the ten-year period, the court concluded[284] that the proxy holder had the requisite interest in the shares themselves and that, therefore, the proxy was irrevocable. Further, courts have uniformly sustained irrevocable proxies given to secure

[281] See In re Chilson, 19 Del. Ch. 398, 168 A. 82, 86 (1933). Cf. Smith v. Biggs Boiler Works Co., 32 Del. Ch. 147, 82 A.2d 372 (1951).

[282] Roberts v. Whitson, 188 S.W.2d 875 (Tex. Civ. App. Dallas 1945), writ refused w.o.m., (Oct. 3, 1945). See also Zollar v. Smith, 710 S.W.2d 155 (Tex. App. Eastland 1986), noted 41 S.W. L.J. 237 (1987) (court held that for a proxy to be irrevocable it must expressly provide that it is irrevocable and must otherwise be made irrevocable by law, which means it must be "coupled with an interest" or "given as security").

[283] Johnson v. Spartanburg County Fair Ass'n, 210 S.C. 56, 41 S.E.2d 599 (1947). SC Code Ann §33-11-140(f)(1)(E) in effect overruling the Spartanburg case, explicitly authorizes use of an irrevocable proxy to enforce a voting agreement.

[284] Hey v. Dolphin, 36 N.Y.S. 627 (Gen. Term 1895). Whenever the proxy holder has been induced to become a substantial shareholder by the promise of voting control, the agreement is generally upheld. Note, 98 Pa. L. Rev. 401, 406 (1950).

persons who have made loans to the corporation or corporate creditors who have agreed to relinquish remedies against the corporation.[285] Many decisions in recent decades have held proxies to be irrevocable which instead would have been held revocable under the traditional concepts. These decisions have been reached either by departing from the "coupled with an interest" requirement or by broadening that concept, sometimes to such an extent hardly recognizable.

One of the first decisions to stray from the conventional path was a widely cited California one[286], which sustained an agreement among purchasers of stock in a corporation by which they undertook to vote their shares as a block for five years in order to prevent control of the corporation from passing out of their hands. The agreement was held to constitute an irrevocable proxy authorizing the stock to be voted in accordance with the decision of a majority of the parties to it. The court made only a slight curtsy to the conventional rule, suggesting that the proxy "was in the nature of a power coupled with an interest."[287] There can be no question that many decisions have broadened the *interest* concept. Some decisions indicate that if the proxy holder has a first option to purchase the shares subject to the proxy in the event of their sale, he has a sufficient interest to make the proxy irrevocable;[288] other decisions suggest that where the

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[285] Mobile & O.R. Co. v. Nicholas, 98 Ala. 92, 12 So. 723 (1893) (creditors of insolvent corporation relinquished decrees of foreclosure and orders of sale on condition that irrevocable proxies be given to trustees during life of debts); Chapman v. Bates, 61 N.J. Eq. 658, 47 A. 638 (Ct. Err. & App. 1900) (Ct Err & App 1900) (directors loaned money to corporation and incurred personal obligations in expanding corporation's facilities in reliance on irrevocable proxies); Craig v. Bessie Furnace Co., 19 Ohio N.P. (n.s.) 545, 27 Ohio Dec. 471, 1917 WL 1491 (C.P. 1917); Thompson-Starrett Co. v. E.B. Ellis Granite Co., 86 Vt. 282, 84 A. 1017 (1912).

[286] Smith v. San Francisco & N.P. Ry. Co., 115 Cal. 584, 47 P. 582 (1897). But see Simpson v. Nielson, 77 Cal. App. 297, 246 P. 342 (1st Dist. 1926), decided after modifications in the California statutes. See also Ballantine, Corporations §179 (Rev. ed. 1946), stating that the court in the Smith case was on doubtful ground both in implying a proxy from the terms of the agreement and in finding an interest to make the proxy irrevocable.

[287] "There was thus a sufficient consideration for the agreement granting the right to vote the stock. It was in the nature of a power coupled with an interest, and, being given for valuable consideration, could not be revoked at the pleasure of either." Smith v. San Francisco & N.P. Ry. Co., 115 Cal. 584, 600, 47 P. 582, 587 (1897).

[288] Brown v. Pacific Mail S.S. Co., 4 Fed Cas 420, No. 2025 (CC SD NY, 1867); Boyer v. Nesbitt, 227 Pa. 398, 76 A. 103 (1910) (interest sufficient to support a nonstatutory voting trust found in the trustees' first right to purchase); State ex rel. Everett Trust & Sav. Bank v. Pacific Waxed Paper Co., 22 Wash. 2d 844, 157 P.2d 707, 711, 159 A.L.R. 297 (1945).

proxy holder has a power to sell shares as well as a proxy to vote them, he has an adequate interest.[289] Further, where a shareholder, who had been a director and president of the company for a number of years, transferred his holdings in the company but reserved the right to vote the shares until the company was liquidated, it was held[290] that he had a proxy coupled with an interest, because both he and the corporation benefited from the proxy (the retention of his services being deemed to be important to the welfare of the corporation). One opinion distinguishes between an interest in the thing subject to the proxy and an interest in the subject matter of the proxy, and states that "it is sufficient that the proxy holder have an 'interest' in the subject matter upon which the power is to be exercised."[291]

The *thing itself* may refer to the tangible shares or certificates of stock, but the *subject* or *subject matters* may refer to the intangible voting right and the incidental control of the corporation."[292] Under this broadened conception of *interest*, court sustained an agreement between two shareholders[293] giving to each party, for a twenty-five year term, a "first option" to

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[289] Groub v. Blish, 88 Ind. App. 309, 152 N.E. 609 (1926) (irrevocable proxy given to persons to whom shares were assigned under scheme to sell shares over a 20-year period); Hall v. Merrill Trust Co., 106 Me. 465, 76 A. 926 (1910).

[290] Ecclestone v. Indialantic, Inc., 319 Mich. 248, 29 N.W.2d 679 (1947), noted 47 Mich. L. Rev. 547 (1949). But see Bamford v. Bamford, Inc., 279 Neb. 259, 777 N.W.2d 573, 583 (2010) (questioning if proxy given to owner for his lifetime could be coupled with an interest and rejecting proxy given to son, who was not a shareholder, to protect corporation from owner's wife, could satisfy coupled with an interest).

[291] State ex rel. Everett Trust & Sav. Bank v. Pacific Waxed Paper Co., 22 Wash. 2d 844, 157 P.2d 707, 159 A.L.R. 297 (1945). See also Deibler v. Chas. H. Elliott Co., 368 Pa. 267, 276, 81 A.2d 557, 561 (1951), where the court said: We know of no decision in Delaware, nor has any been cited, which holds that the interest necessary to make a proxy irrevocable must be in the stock itself rather than a general interest in the corporation or in what the exercise of the proxy may accomplish or secure. The rule in general is that the interest which will support an irrevocable proxy need not be in the stock itself but any property interest in the proxy-holder for which the stock is held as security.

[292] "In the situation we have before us Engle was more than a mere agent. In voting the stock he served purposes of his own in maintaining control of the corporation by the choice of directors and the determination of its policies and business affairs. This voting of the stock for these purposes was the subject matter of the agency." State ex rel. Everett Trust & Sav. Bank v. Pacific Waxed Paper Co., 22 Wash. 2d 844, 157 P.2d 707, 710, 159 A.L.R. 297 (1945). The court also accepted the rule that a proxy is irrevocable if it "is given as part of a security or is necessary to effectuate such security," and then gave a very liberal interpretation to that rule, stating that "the word 'security' as used in this connection is somewhat elastic and cases we later cite disclose that whenever the purpose to be served by the exercise of the power is to protect or further the interest of the proxy holder the authority given is regarded as a part of a security or something necessary to effectuate such a security."

[293] State ex rel. Everett Trust & Sav. Bank v. Pacific Waxed Paper Co., 22 Wash. 2d 844, 157 P.2d 707, 159 A.L.R. 297 (1945).

buy the other's shares in the event of their sale, and provided for cross proxies under which the survivor would vote a deceased's shares. There are indications that modern courts are abandoning the *interest* requirement altogether, or at most paying mere lip service to a doctrine so firmly established that they believe it cannot as yet be ignored completely. Language in the decisions suggests that an irrevocable option may be sustained if it is supported by consideration moving from the proxy holder to the maker,[294] where the proxy holder has changed his position in reliance on the proxy[295] or where the proxy was given to further or protect the interests of the proxy holder.[296]

This trend toward the abandonment of the interest requirement for irrevocable proxies in shareholders' agreements is to be commended: Even assuming that the concept of a power coupled with an interest is defensible in agencies generally, which is doubtful, there is certainly no justification for applying agency concepts to irrevocable proxies established by shareholders' agreements. The proxy holder under a shareholders' agreement is not a true agent; the holder does not act for and on behalf of the maker of the proxy. Almost invariably the proxy is given primarily, if not solely, for the benefit or protection of the proxy holder or some person other than the maker. A shareholders' agreement setting up irrevocable proxies has the same effect ultimately as a pooling agreement without proxies, assuming the latter will be specifically enforced; and therefore considerations governing the validity of the two types of contracts should be the same. In either instance, the agreement should be given effect in accordance with

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[294] See State ex rel. Everett Trust & Sav. Bank v. Pacific Waxed Paper Co., 22 Wash. 2d 844, 157 P.2d 707, 711, 159 A.L.R. 297 (1945).

[295] Chapman v. Bates, 61 N.J. Eq. 658, 47 A. 638 (Ct. Err. & App. 1900).

[296] See Ecclestone v. Indialantic, Inc., 319 Mich. 248, 257, 29 N.W.2d 679, 683 (1947), quoting with approval from Lane Mortg. Co. v. Crenshaw, 93 Cal. App. 411, 269 P. 672, 679 (1st Dist. 1928), to the effect that a power is coupled with an interest if it is a security "for the performance of any act which is deemed valuable." Cf. Carnegie Trust Co. v. Security Life Ins. Co. of America, 111 Va. 1, 68 S.E. 412 (1910) (25-year voting trust sustained on theory that the power to vote the stock was coupled with an interest, the interest being found in the control resulting from the agreement). See also Restatement Third, Agency §§3.13 to 3.14.

the intentions of the parties if it has a legitimate business purpose.[297] Statutes discussed earlier, which specifically define irrevocable proxies to include appointments made as a part of a shareholders' agreement, reflect the desirable trend of legal developments in this area. In addition, it is to be pointed out that irrevocable proxies might also be used as a mechanism for providing automatic enforcement of shareholders' agreements.

Voting trusts

A voting trust provides another method of allocating corporate control among shareholders. It is created by a trust agreement among all or some of the shareholders transferring title to their shares to voting trustees, who generally issue to the shareholders certificates of beneficial interest in return, usually called "voting trust certificates."[298] The trustees vote the shares in accordance with the terms of the trust agreement. The device of a voting trust gives to what is in essence a joint irrevocable proxy for a term of years the protective coloring of a trust, so that the trustees may vote as owners rather than as mere agents.[299] In legal theory, the principal difference between a voting trust and a proxy is that voting trustees get title to the shares, with the attendant rights to have the shares registered in their names on the books of the corporation and to vote the shares as principals rather than as agents.[300]

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[297] See Ballantine, Voting Trusts, Their Abuses and Regulation, 21 Tex. L. Rev. 139, 148 (1942).

[298] See generally, Fletcher Cyc Corp. §§2078 to 2081 (Perm Ed); Validity of Voting Trust or Similar Agreement for Control of Voting Power in Corporate Stock, 98 ALR2d 376.; Ballantine, Voting Trusts, Their Abuses and Regulation, 21 Tex. L. Rev. 139 (1942); Bradley, Toward a More Perfect Close Corporation—The Need for More and Improved Legislation, 54 Geo. L.J. 1145, 1167 to 1175 (1966); Burke, Voting Trusts Currently Observed, 24 Minn. L. Rev. 347 (1940); Finkelstein, Voting Trust Agreements, 24 Mich. L. Rev. 344 (1926); Wocloszyn, A Practical Guide to Voting Trusts, 4 U. Balt. L. Rev. 245 (1975). See also Blase, Assuring Long-Term Employment in a Missouri Close Corporation: The Need for Legislative Reform, 47 Mo. L. Rev. 471, 485 to 486 (1982). Voting trust certificates are ordinarily transferable just like share certificates. See Wormser, The Legality of Corporate Voting Trusts and Pooling Agreements, 18 Colum. L. Rev. 123, 124 (1918). Cf. State ex rel. Elish v. Wilson, 189 W. Va. 739, 434 S.E.2d 411 (1993) (ESOP participants do not hold voting trust certificates as contemplated by former W. Va. statute; ESOP participants did not actively place their shares in trust and ESOP had no time limit).

[299] Ballantine, Corporations §184 (Rev. ed. 1946).

[300] "The voting trust should be distinguished from the mere granting of proxies to vote the stock, from a trust of stock for the purpose of selling it with an incidental power to vote, and from various contracts between stockholders regarding the method in which stock will be voted." Bogert, Trusts and Trustees §251 (1964). A voting trust is a trust "in the accepted equitable sense and is subject to the principles which regulate the administration of

The voting trust is not just a "big business" instrument as is sometimes supposed,[301] but it also is a flexible device that can be exceedingly useful in working out control arrangements in a close corporation.[302] Apart from limitations imposed by statute or public policy, the parties to a voting trust agreement may adopt whatever provisions as to either substance or mechanics they desire.[303] For example, a trust agreement is valid even though it names as trustee a shareholder

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trusts [...]." H.M. Byllesby & Co. v. Doriot, 25 Del. Ch. 46, 12 A.2d 603 (1940). Early courts sometimes had difficulty drawing a line between voting trusts and some voting agreements. See, e.g., Abercrombie v. Davies, 35 Del. Ch. 599, 123 A.2d 893 (1956); Aldridge v. Franco Wyoming Oil Co., 24 Del. Ch. 126, 7 A.2d 753 (1939), determination sustained, 24 Del. Ch. 349, 14 A.2d 380 (1940); Galler v. Galler, 45 Ill. App. 2d 452, 196 N.E.2d 5 (1st Dist. 1964), aff'd in part, rev'd in part, 32 Ill. 2d 16, 203 N.E.2d 577 (1964); Wallace v. Southwestern Sanitarium Co., 160 Kan. 331, 161 P.2d 129 (1945).

[301] In this respect, voting trusts are also used as part of corporate reorganizations to concentrate control in particular shareholders, such as former creditors. See, e.g., Brown v. McLanahan, 148 F.2d 703, 159 A.L.R. 1058 (C.C.A. 4th Cir. 1945), in which voting trustees, faced with the prospect of losing control of the corporation upon expiration of the voting trust agreement, amended the articles under a reorganization plan to give voting rights to debentures which were largely owned or controlled by the trustees or corporations with which they were affiliated. The purpose of this action was to prevent the control of the corporation from passing to holders of preferred stock upon the termination of the voting trust. The court held the articles amendment invalid on the ground that the trustees violated their fiduciary duties to the holders of the preferred stock trust certificates.

[302] For situations (involving both publicly held and close corporations) in which voting trusts have proved useful, see Lang, Voting Trusts and Article Thirty-Two of the Proposed Texas Business Corporation Act, 30 Tex. L. Rev. 849 (1952). As statutes in many states give even nonvoting shares power to vote on certain fundamental corporate acts, such as articles amendment or merger, or on such acts when they would adversely affect the rights of the nonvoting shares, e.g., Cal. Corp. Code §903; La. Rev. Stat. Ann. §12:31(C), a voting trust of nonvoting stock, anomalous as that might seem, might be a useful arrangement in some situations. See Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp., Del. Ch., Dec. 30 (1991), published at 17 Del. J. Corp. Law 1099, 1155 (1992), which illustrates the use of a voting trust agreement in an effort to work out a complex corporate relationship in a high visibility case in the movie industry between an entrepreneur and his main bank. They agreed to a five-person board controlled by the entrepreneur but a three person executive committee was more responsive to the bank. A voting trust agreement gave the bank the right to vote controlling shares to ensure that the Agreement would be respected. After the bank exercised its rights to control the Corporation, the entrepreneur asserted the bank's management group breached a duty to him as shareholder. The case is best known for the Chancellor's statement that directors of a corporation "in the vicinity of insolvency." owe a duty to the creditors as residual owners. See also Shoen v. Shoen, 167 Ariz. 58, 804 P.2d 787 (Ct. App. Div. 1 1990) (dissident stockholders group was not entitled to preliminary injunction cancelling issuance of certain voting stock under key employee's stock ownership plan because of opponent group's failure to disclose their entry into voting trust agreement prior to board's decision to issue stock under plan; agreement gave member of opponent group irrevocable proxy over voting of shares as part of defensive measures taken to prevent corporate takeover; although information was not immaterial, directors could hardly have been ignorant of nature of opponent shareholder's interest in maintaining control, even if directors were not aware of precise extent to which that shareholder had formalized that control through voting trust agreement; moreover, board could withdraw proxy given to shareholder under employee stock purchase agreement).

[303] Tankersley v. Albright, 374 F. Supp. 538 (N.D. Ill. 1974), judgment aff'd in part, rev'd in part, 514 F.2d 956 (7th Cir. 1975) (duties of trustee of voting trust depend upon terms of trust instrument and with certain exceptions, parties are free to adopt any provisions they choose); Scott v. Arden Farms Co., 26 Del. Ch. 283, 28 A.2d 81, 84 (1942); State ex rel. Crowder v. Sperry Corp., 41 Del. 84, 15 A.2d 661, 664 (Super. Ct. 1940). See also De Marco v. Paramount Ice Corp., 30 Misc. 2d 158, 102 N.Y.S.2d 692 (Sup 1950) (provision in agreement fixing ownership of 50 percent of shares as qualification for trustee).

who was instrumental in creating the trust and benefits from it.[304] Besides, a trust agreement apparently can name the persons for whom the trustees are to vote in elections of directors,[305] or set up a board of trustees with an even number of members and provide for an arbitrator to cast the deciding vote in the event of an equal division.[306]

Some of the early decisions declared voting trusts to be invalid per se,[307] usually on the ground that the voting power of shares could not lawfully be separated from their beneficial ownership.[308] Later, however, the view was generally adopted, even in the absence of statute, that a voting trust was valid as long as it had a proper purpose.[309] The term for a voting trust was a

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[304] Grogan v. Grogan, 159 Tex. 392, 322 S.W.2d 514 (1959).

[305] Motherwell v. Schoof, [1949] 2 West Wkly R 529 (Alta) (trustees directed to vote shares as unit to accomplish specified objectives, one of which was that parties to the agreement should constitute a majority of the board of directors). See also Israels, The Close Corporation and the Law, 33 Cornell L.Q. 488, 495 (1948). Cf. Dougherty v. Cross, 65 Cal. App. 2d 687, 151 P.2d 654 (2d Dist. 1944) (agreement provided that trustee would vote shares as a majority of beneficial owners determined).

[306] Motherwell v. Schoof, [1949] 2 West Wkly R 529 (Alta).

[307] Warren v. Pim, 66 N.J. Eq. 353, 59 A. 773 (Ct. Err. & App. 1904). Cf. Bostwick v. Chapman, 60 Conn. 553, 24 A. 32 (Super. Ct. 1890); Luthy v. Ream, 270 Ill. 170, 110 N.E. 373 (1915). Most of the early voting trust litigation involved trusts with illegal purposes; thus it is not surprising that the courts declared many of them invalid. Burke, Voting Trusts Currently Observed, 24 Minn. L. Rev. 347, 349 (1940).

[308] Bradley, Toward a More Perfect Close Corporation—The Need for More and Improved Legislation, 54 Geo. L.J. 1145, 1175 (1966).

[309] Data Consultants, Inc. v. Traywick, 593 F. Supp. 447 (D. Md. 1983), judgment aff'd, 742 F.2d 1448 (4th Cir. 1984); Mackin v. Nicollet Hotel, 10 F.2d 375 (D. Minn. 1926), aff'd, 25 F.2d 783 (C.C.A. 8th Cir. 1928) (voting trust does not violate statute limiting duration of proxies); Mobile & O.R. Co. v. Nicholas, 98 Ala. 92, 12 So. 723 (1893); Bullivant v. First Nat. Bank, 246 Mass. 324, 141 N.E. 41 (1923); Foreman v. Bell, 56 N.C. App. 625, 289 S.E.2d 567 (1982); Boyer v. Nesbitt, 227 Pa. 398, 76 A. 103 (1910); Alderman v. Alderman, 178 S.C. 9, 181 S.E. 897, 105 A.L.R. 102 (1935) (trust valid, and not revocable though trustees had failed to hold shareholders' or directors' meetings but instead directed the business personally); Thompson-Starrett Co. v. E.B. Ellis Granite Co., 86 Vt. 282, 84 A. 1017 (1912); Carnegie Trust Co. v. Security Life Ins. Co. of America, 111 Va. 1, 68 S.E. 412 (1910) (voting trust held not to violate statute providing that each share of stock shall have one vote except to the extent otherwise provided in the articles or bylaws); Clark v. Foster, 98 Wash. 241, 167 P. 908 (1917); Morris v. The Broadview, 328 Ill. App. 267, 274, 65 N.E.2d 605, 609 (1st Dist. 1946) ("In short, the purpose for which a voting trust is created determines its legality"); Thresher v. Cuddy-Gardner Co., 53 R.I. 175, 165 A. 438 (1933) (however, the corporation, if it is not a party to a voting trust, is not bound by it). See also Dunbar v. Williams, 554 So. 2d 56 (La. Ct. App. 4th Cir. 1988) (upholding trial court's finding that establishment of a voting trust by corporate fiduciaries did not breach their fiduciary duties to the corporation, even though the purchase of shares by the group establishing the voting trust plus the subsequent voting trust agreement perpetuated and solidified the majority shareholders' control of the corporation). In Selig v. Wexler, 355 Mass. 671, 247 N.E.2d 567 (1969), the court terminated a voting trust under the doctrine of frustration even though it had been created for a proper purpose and complied with the statute. It found that the objectives for which the trust was created, namely, the breaking of deadlocks between the two fifty percent shareholders, had been frustrated as the alternative trustees, upon whom the election of new directors would depend, were not neutral. Cf. Lehrman v. Cohen, 43 Del. Ch. 222, 222 A.2d 800 (1966) (an additional class of stock with voting power but no proprietary rights was issued to a "neutral" to enable him to break deadlocks between factions with equal voting power).

factor which a court in the absence of statute considered in passing on its validity, with some voting trusts sustained carrying a term of twenty-five years[310] or longer.[311] All states now have statutes expressly authorizing the creation of voting trusts, and thus remove any doubt about their validity if the terms of the statute are met. The Model Business Corporation Act, the template for statutes in a majority of states, provides that one or more shareholders may create a voting trust by signing an agreement and transferring their shares to the trustee.[312] Most voting trust statutes place a maximum on the duration of such a trust, usually ten years.[313] Failure to state the 10-year limit in the agreement may itself void the agreement, as in a Nebraska case where the agreement was executed by the majority shareholder to prevent his wife's control of the corporation after his death following the wife's run-in with staff.[314] The court found that the clear intent was to ensure that "Donna *never* exercise shareholder voting rights, regardless of how long she survives James."[315]

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310 Carnegie Trust Co. v. Security Life Ins. Co. of America, 111 Va. 1, 68 S.E. 412 (1910). See also Clark v. Foster, 98 Wash. 241, 167 P. 908 (1917) (20 years).

311 Tankersley v. Albright, 374 F. Supp. 538 (N.D. Ill. 1974), judgment aff'd in part, rev'd in part, 514 F.2d 956 (7th Cir. 1975) (provision for expiration of voting trust 20 years after death of survivor of settlors or earlier by agreement upheld); Venner v. Chicago City Ry. Co., 258 Ill. 523, 101 N.E. 949 (1913) (trustees given voting power for lives of specified persons and twenty years thereafter); Alderman v. Alderman, 178 S.C. 9, 181 S.E. 897, 105 A.L.R. 102 (1935) (trustees given full authority to control corporation for lifetime of trustees or survivor); Day v. Hecla Min. Co., 126 Wash. 50, 217 P. 1 (1923) (indefinite time).

312 Model Business Corporation Act Ann. §7.30 (4th Ed). See also Tex. Bus. Corp. Act Ann. art 12.32(A)(6)(a) (authorizes shareholders of Texas close corporations to enter into shareholders' agreements concerning voting trusts that need not conform with the requirements of Article 6.251 of the Texas Business Organizations Code). For an interesting case concerning a voting trust created under Illinois law, see Disher v. Fulgoni, 161 Ill. App. 3d 1, 112 Ill. Dec. 949, 514 N.E.2d 767 (1st Dist. 1987) (court held that the trustees of a voting trust breached their fiduciary responsibilities to the beneficiary when they voted to amend the trust agreement by directing an early scheduled distribution of stock, but omitted the beneficiary from consultation and voting). See also Norton, Adjustment and Protection of Shareholder Interests in the Closely-Held Corporation in Texas, 39 S.W. L.J. 781 (1985).

313 E.g., Del. Code Ann. tit. 8, §218(a); New York Business Corporation Law §621(a); Ohio Rev. Code Ann. §1701.49(B) (maximum length of an "irrevocable" voting trust agreement is ten years "unless the voting or consenting rights granted thereby are coupled with an interest in the shares to which such rights relate"). Cf. Minn. Stat. §302A.453 subd 1 (voting trusts can be created for a period not exceeding 15 years unless connected with a debt of the corporation); Mo. Rev. Stat. §351.246 (indefinite duration); N.J. Rev. Stat. §14A:5-20(1) (21years). See also Model Business Corporation Act §7.30; Hall v. Staha, 303 Ark. 673, 800 S.W.2d 396 (1990) (limited partnership which granted general partners right to vote corporate shares held by limited partnership was in fact illegal voting trust, since partnership's term was longer than ten years and copy of fully executed written partnership agreement; including names of limited partners, was not filed with corporation).

314 Bamford v. Bamford, Inc., 279 Neb. 259, 777 N.W.2d 573 (2010).

315 Bamford v. Bamford, Inc., 279 Neb. 259, 777 N.W.2d 573, 580 (2010).

Most of the states placing a maximum on the duration of a voting trust also permit extension or renewal of the trust for varying periods of time.[316] Statutes typically require that the trustee delivers a copy to the corporation or otherwise file the agreement at the corporate office and be subject to inspection by shareholders.[317] Some older decisions suggest that these statutes do not legalize all voting trusts, irrespective of their aims or consequences, but instead in effect adopt the later common law rule that a voting trust is legal if its objective is proper.[318] The Model Business Corporation Act and most other voting trust statutes do not contain a *proper purpose* requirement.[319] As an intermediate position in the evolution of judicial interpretations of voting trust agreements, courts would declare the statute to be mandatory.[320] Thus, a voting trust

316 See, e.g., Cal. Corp. Code §706 (voting trust limited to a 10-year term; may be renewed for additional 10-year terms by written agreement of the beneficiaries and with written consent of the voting trustees; the renewal is limited to the shares of those beneficiaries agreeing to the renewal); Me. Rev. Stat. Ann. tit. 13-C, §741 (period not to exceed 21 years, may be extended for an additional 21 years). Smith v. Wembley Industries, Inc., 441 So. 2d 392 (La. Ct. App. 4th Cir. 1983) (court held that a 10-year extension of a 10-year voting trust entered into the same day that the trust was created did not violate the statutory limitation of voting trusts to ten years).

317 See, e.g., La Rev Stat Ann §12:78(H). In Goldblum v. Boyd, 341 So. 2d 436, 443 (La. Ct. App. 2d Cir. 1976), the court commented as follows: The requirement "shall be filed" [...] requires simply that, and its meaning should not be extended to prohibit removing the duplicate to a place of safekeeping, when a photocopy is kept available for immediate inspection. These circumstances constitute substantial compliance with the applicable law.

318 "Voting trusts are, therefore, legal in New York only when organized and existing under the statute for proper ends." In re Morse, 247 N.Y. 290, 299, 160 N.E. 374, 377 (1928). Cf. Tracey v. Franklin, 30 Del. Ch. 407, 61 A.2d 780 (1948), order aff'd, 31 Del. Ch. 477, 67 A.2d 56, 11 A.L.R.2d 990 (1949) (restriction on transferability of voting trust certificates set up in voting trust agreement held void as unreasonable); Ohio Nat. Life Ins. Co. v. Struble, 82 Ohio App. 480, 38 Ohio Op. 107, 51 Ohio L. Abs. 471, 81 N.E.2d 622 (1st Dist. Hamilton County 1948) (shows that courts will continue to police voting trusts even though they are authorized by statute).

319 See e.g., Md Corps & Ass'ns Code §2-510, which has been interpreted not to require an affirmative statement of a proper business purpose in a voting trust agreement. In Holmes v. Sharretts, 228 Md. 358, 360, 180 A.2d 302, 307, 98 A.L.R.2d 363 (1962) (The court failed to find merit in a contention that the voting trust agreement failed affirmatively to express a proper business purpose and for that reason was invalid. The court commented as follows: "It does not appear that the statute [...] embodies such a requirement. What it does require is a 'written voting trust agreement specifying the terms and conditions of the voting trust.' ". For a listing of proper and improper purposes under the older decisions, see Ballantine, Voting Trusts, Their Abuses and Regulation, 21 Tex. L. Rev. 139, 152 to 153 (1942). For a decision sustaining in a close corporation a voting trust with terms probably not contemplated by the voting trust statute, see Peck v. Horst, 175 Kan. 479, 264 P.2d 888 (1953), opinion adhered to on reh'g, 176 Kan. 581, 272 P.2d 1061 (1954) (agreement provided for conduct of the business by trustees and not by a board of directors, the trustees being paid for services as managing trustees of the business). For a case applying former Section 2231 of the superseded California Corporation Code to a voting trust agreement that was part of a divorce settlement, see Goss v. Edwards, 68 Cal. App. 3d 264, 137 Cal. Rptr. 252 (2d Dist. 1977) (court held the voting trust agreement to be irrevocable despite the language of Section 2231, since the wife had accepted substantial benefits under the divorce settlement, and revocation of the voting trust agreement would be seriously detrimental to the husband who had honored provisions of the divorce settlement for more than five years).

320 Smith v. Biggs Boiler Works Co., 32 Del. Ch. 147, 82 A.2d 372 (1951) (provisions of the voting trust statute are mandatory; even impossibility does not excuse noncompliance).

exceeding the maximum term set forth in the statute[321] or otherwise failing to comply with the provisions of the statute[322] was held to be invalid. The New York Court of Appeals wrote in 1928: "No voting trust not within the terms of the statute is legal, and any such trust, so long as its purpose is legitimate, coming within its terms, is legal. The test of validity is the rule of the statute. When the field was entered by the Legislature it was fully occupied and no place was left for other voting trusts."[323] The exclusivity of this position, however, was undercut by various judicial decisions upholding non-complying agreements,[324] or interpreting them so as to maximize their validity.[325] The modern view of permitting broad leeway to voting trusts as control

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321 Perry v. Missouri-Kansas Pipe Line Co., 22 Del. Ch. 33, 191 A. 823 (1937) (a trust exceeding the limit is void in toto); Christopher v. Richardson, 394 Pa. 425, 147 A.2d 375 (1959) (voting trust was held void because it was to remain in effect until all amounts due on an obligation were paid and thus might continue beyond the 10-year limit fixed by statute).

322 Abercrombie v. Davies, 36 Del. Ch. 371, 130 A.2d 338 (1957); Smith v. Biggs Boiler Works Co., 32 Del. Ch. 147, 82 A.2d 372 (1951) (voting trust was held void because the affected shares were not deposited with the trustee as required by statute); De Felice v. Garon, 395 So. 2d 658 (La. 1980) (court held that contract by which the owner of stock expressly conferred upon defendants the right to vote shares, with an implicit right to obtain a transfer of shares upon the books of the corporation, did not qualify as a valid voting trust under the Louisiana corporation law). See also Schneiderman v. Kahalnik, 200 Ill. App. 3d 629, 146 Ill. Dec. 371, 558 N.E.2d 334 (1st Dist. 1990) (in an action to compel the estate of deceased shareholder to specifically perform under the terms of a voting trust agreement, the court held that under New York law, corporate shareholders had not created a voting trust agreement where the alleged agreement contained blank portions, not filled in even after the agreement was signed, and the shareholders never completed the required New York steps of surrendering their stock for cancellation and reissuance in the name of the trustee, recording the existence of the voting trust agreement on the corporate books and filing a duplicate voting trust agreement in the office of the corporation).

323 In re Morse, 247 N.Y. 290, 299, 160 N.E. 374, 376 (1928).

324 In re Farm Industries, Inc., 41 Del. Ch. 379, 196 A.2d 582 (1963) (the court specifically enforced a voting trust agreement which had not been filed as required by the voting trust statute, commenting as follows: "The Delaware cases [...], while undoubtedly upholding the view that the provisions of §218 are mandatory, do not suggest that a voting trust agreement which otherwise contemplates full compliance with the terms of the statute may not be specifically enforced at the instance of a party thereto, especially where as here, there is no third-party interest involved [...]."); De Marco v. Paramount Ice Corp., 30 Misc. 2d 158, 102 N.Y.S.2d 692 (Sup 1950) (failure to file a voting trust agreement with the corporation as required by statute did not invalidate it but simply rendered it inoperative until the time of filing).

325 See Kittinger v. Churchill Evangelistic Ass'n, 151 Misc. 350, 271 N.Y.S. 510 (Sup 1934), judgment aff'd, 244 A.D. 876, 281 N.Y.S. 680 (4th Dep't 1935) (agreement containing a clause permitting renewal beyond the 10-year period held valid for ten years but renewal clause invalidated). In Holmes v. Sharretts, 228 Md. 358, 180 A.2d 302, 98 A.L.R.2d 363 (1962), the court held that a provision in a trust agreement that the agreement should "take effect and be construed in accordance with the laws of the State of Maryland" was a sufficient expression of intent to limit the trust to the statutory 10-year period in spite of a specific provision in the agreement that the trust would terminate five years after an event which might not occur within ten years. In Martin v. Graybar Elec. Co., 285 F.2d 619 (7th Cir. 1961), the court construed the 10-year statutory limitation on voting trusts as not prohibiting shareholders from agreeing before the end of the 10-year term to a new voting trust for an additional period of 10 years; and held that if a successor voting trust with a 10-year term is agreed to three weeks before the termination of the original voting trust and the successor trust thus has an effective duration of 10 years and three weeks, it is invalid only for the excess of three weeks. See also Smith v. Wembley Industries, Inc., 441 So. 2d 392 (La. Ct. App. 4th Cir. 1983)

agreements is reflected in a Delaware decision which upheld an agreement not complying with the Delaware voting trust statute on the ground that the statute was not designed to apply to every set of circumstances in which voting rights are transferred to trustees.[326] The Court was willing to extend the reach of the voting trust statute only to reach agreements sufficiently close to the purposes sought to be regulated by the statute, which it defined as to avoid secret uncontrolled combinations among shareholders.[327]

Trustees of a voting trust often have broad power to cast the votes held in the trust as set forth by the terms of the trust.[328] Yet, some courts are unwilling to permit that power to be used to effectively extend the duration of the trust or otherwise fundamentally alter the nature of the corpus of the trust.[329] A Massachusetts court refused to enforce the terms of a voting trust that banned derivative actions.[330] A Pennsylvania case illustrates the conflicting nature of precedent as

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(allowed a voting trust to be both created to run for a 10-year period on the same day and extended to run for another 10-year period).

[326] Oceanic Exploration Co. v. Grynberg, 428 A.2d 1 (Del. 1981) (agreement labeled as voting trust by parties found not to be the kind of agreement sought to be regulated by voting trust statute; agreement upheld even though it did not meet the requirements of statute). See also, Jackson v. Jackson, 178 Conn. 42, 420 A.2d 893 (1979) (court held that the Connecticut voting trust statute must be interpreted permissively so that other kinds of trusts and shareholder agreements otherwise legal will not be invalidated by reason of its terms). An Ohio court denied a probate court the authority to order a guardian to terminate a voting trust validly formed prior to the settler's incompetency. In re Guardianship of Lombardo, 86 Ohio St. 3d 600, 1999-Ohio-132, 716 N.E.2d 189 (1999). But see Bamford v. Bamford, Inc., 279 Neb. 259, 777 N.W.2d 573, 581 (2010) (refusing to apply Oceanic where the challenged trust fell squarely within the traditional requirement for a voting trust; if the statute "does not apply to the trust in this case, it does not apply to anything").

[327] Oceanic Exploration Co. v. Grynberg, 428 A.2d 1 (Del. 1981).But see, Hall v. Staha, 303 Ark. 673, 800 S.W.2d 396 (1990) (holding a limited partnership to be a disguised voting trust and illegal for failing to comply with the voting trust provisions). See also Rosenzweig, Protecting the Rights of Minority Shareholders in Close Corporations Under the New Arkansas Business Corporations Act, 44 Ark. L. Rev. 1, 41, 45 (1991) (noting that issue should not arise under the subsequent Arkansas corporations act which expressly authorizes shareholders' agreement, but that lawyers to be secure, "the lawyer should expressly state that the agreement is created under the [shareholder's agreement statute]."

[328] Warehime v. Warehime, 722 A.2d 1060, 1067 (Pa. Super. Ct. 1998), rev'd, 563 Pa. 400, 761 A.2d 1138 (2000) ("Not only did the settlors give the voting trustee a controlling interest in HFC, they conferred upon him virtually unrestricted voting powers. The trustee was vested with the authority to exercise all rights of every kind granted to the shareholders.").

[329] See, e.g., Brown v. McLanahan, 148 F.2d 703, 159 A.L.R. 1058 (C.C.A. 4th Cir. 1945); Warehime v. Warehime, 722 A.2d 1060, 1067 (Pa. Super. Ct. 1998), rev'd, 563 Pa. 400, 761 A.2d 1138 (2000).

[330] See Demoulas v. Demoulas Super Markets, Inc., 424 Mass. 501, 677 N.E.2d 159, 171 (1997) (even if voting trust agreement serves legitimate corporate purpose, provision that bars any shareholder derivative action is contrary to general principles of corporate law and thus unenforceable; to enforce such provision would exculpate corporate

to action taken just prior to the expiration of voting trusts that controlled a majority of the voting stock of the corporation.[331] The voting trust had concentrated voting power in one son of the deceased CEO of the company. The end of the voting trust provided greater uncertainty (e.g., the CEO's three children had not spoken to each other in three years). To provide a method of resolving disputes among family members, nonfamily board members proposed a new series of stock, to be issued to the company's 401(k) plan, that would have 35 votes per share "in the event of a dispute among members of the Warehime family with respect to the election of directors or other related matters during the five years after the issuance of the stock." The trial court struck down the trustee's casting the vote of the trust shares for this provision since it would "serve to perpetuate the control of the company by John Warehime for at least another five years and preclude the other shareholders, including the beneficiaries of the trust, from the ability and opportunity to make any meaningful decision concerning the management." The Pennsylvania Supreme Court reversed, saying the action should be measured against a good faith standard, as defined in the agreement, which the court said defines and limits the trustee's duties to the beneficiaries. In a subsequent proceeding the trial court found the trustee's voting of the voting trust shares in favor of the plan to be a violation of principles of corporate democracy, although not the fiduciary duty of the voting trustee. An earlier federal appellate decision in *Brown v. McLanahan* had struck down a trustee's vote for a charter amendment that would have prevented the loss of power at the end of the trust term. An earlier Pennsylvania state court decision involving a testamentary trust found that a conflict of interest did not prevent a trustee from voting the trust shares to redeem preferred stock.[332]

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officers from liability for serious violations of fiduciary duty; this shareholder dispute is chronicled in The Boston Globe Magazine, January 11, 1998 at 16).

331 Warehime v. Warehime, 722 A.2d 1060 (Pa. Super. Ct. 1998), rev'd, 563 Pa. 400, 761 A.2d 1138 (2000).

332 In re Flagg's Estate, 365 Pa. 82, 73 A.2d 411 (1950) (the challenged transactions in this case did not result in any diminution of the corpus of the trust, unlike Warehime, where the actions by the trustee fundamentally alter the corpus of the trust; under the rule of Flagg's Estate, the unrestricted powers granted to John Warehime would modify or displace his absolute duty of loyalty and the limitations against self-dealing).

IX. VETO PROVISIONS

Business needs and methods for the setting up of corporate vetoes

As already pointed out, participants in a close corporation often consider themselves partners as to each other with a right to share in decision-making and control: They may have chosen the corporate form to obtain limited liability or other corporate advantages but usually not to obtain the traditional corporate governance pattern, which gives control to holders of a majority of the outstanding voting shares and provides little or no voice for minority interests. As an alternative to an affirmative agreement spelling out the rights and obligations, the parties may be satisfied to provide to some participants a power to veto some or all of corporate decisions.[333] Veto provisions are used in agreements within corporations so as to change the usual default rules in corporate law that provide for action by majority vote. In some instances, a participant may only desire a power to veto a particular change in the corporate structure; in other instances, a veto over key policy decisions may be appropriate; and in still other situations, some participants may want a veto over day-to-day decisions of the corporation.[334]

Corporate law gives three different groups the power to speak and act for the corporation, and the default rules typically permit a majority shareholder to control each realm. Thus, a non-majority shareholder seeking a veto will need to consider a veto at each of the three levels. The board of directors normally has the authority to manage the corporation or to supervise its management so that minority shareholders almost always need an effective veto over action by the board. In addition, as shareholders usually vote on fundamental corporate acts – such as charter amendments or mergers – minority shareholders need a veto over action at the

[333] "Probably the paramount desire of each shareholder is to have a veto power over actions by the corporation." Cary, How Illinois Corporations May Enjoy Partnership Advantages: Planning for the Closely Held Firm, 48 Nw. U. L. Rev. 427, 430 (1953).

[334] O'Neal & Thompson, O'Neal and Thompson's Close Corporations and LLCs: Law and Practice, §4:19 (rev. 3rd ed. 2009, database updated July 2013.

shareholders' level as well. Finally, as officers may possess broad authority to act for the corporation in day-to-day operations, the absence of an effective veto over officers' action can negate the effectiveness of veto powers established at the other two levels.

Given the above, it is worth to focus the analysis on vetoes at each of the three levels and on the different methods that can be used to put them in place, including but not limited to: (1) requiring unanimity or concurrence of a high percentage of voting units for shareholders or directors' action; (2) providing some participants (shareholders and perhaps directors in some situations) with weighted votes of greater value than the votes provided to other participants; and (3) fixing high attendance requirements for quorums at meetings of shareholders or directors (statutory provisions discussed earlier, such as those authorized by section 7.32 of the Model Business Corporation Act, give way to these arrangements).[335] In many situations, charter or bylaws provisions of these types offer the easiest and most effective means of providing veto powers. Other devices can also be used to establish a veto: These arrangements include: (1) classification of the corporation's shares into voting and nonvoting shares, with voting shares distributed equally between two shareholders or two factions of shareholders, to give a balance of voting power and thus a veto to each shareholder or faction of shareholders; (2) classification of the corporations' shares into a number of classes of voting stock,[336] inclusion in the charter of a provision requiring a vote by classes of stock for shareholders' action of the kind over which a veto is desired,[337] and issuance of all of the shares or a majority of shares of a class of stock to

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[335] See Changes in the Revised Model Business Corporation Act—Amendments Pertaining to Closely Held Corporations, 46 Bus. Law 297 (1990).

[336] For examples of statutes authorizing the classification of shares into different classes of voting stock, see Cal. Corp. Code §400; Del. Code Ann. tit. 8, §151(a); Me. Rev. Stat. Ann. tit. 13-C, §§602, 612(3); MCLA §450.1301; Minn. Stat. §302A.401, subd (2)(b); N.J. Rev. Stat. §14A:7-2(1); New York Business Corporation Law §501(a).

[337] For examples of statutes authorizing the inclusion of such a provision in the articles of incorporation, see Cal. Corp. Code §202; Del. Code Ann. tit. 8, §102; MCLA § 450.1442; Minn. Stat. §§302A.111, 401; N.J. Rev. Stat. §14A:2-7, 5-11; New York Business Corporation Law §§402, 617. In many states a high vote by each class apparently can be required. See Model Business Corporation Act §§7.27(a), 10.21(a) (authorizing a high vote requirement by classes). See also Model Business Corporation Act §§7.26, 10.04 (requiring approval by a majority of a class of stock for an amendment to the articles which affects the rights of that class), Model Business Corporation Act §§11.04 and

each shareholder; (3)class voting for directors, with each of two classes of shares electing the same number of directors; (4) voting agreements and other shareholders' agreements; (5) voting trusts; and (6) irrevocable proxies. These arrangements can strengthen or support charter or bylaws clauses, which set high vote or high quorum requirements. Also, another way of protecting a shareholder's interests in a corporation is to require that person be notified in writing of any shareholders or directors' meeting and of matters that are to be considered at the meeting, a sufficient time in advance of the meeting to enable the shareholder to defend his or her interests.[338]

Vetoes on shareholders' action

A device structured to provide a veto over shareholders' action may result in being an effective tool for particular investors in order to control those decisions allocated to shareholders by statute or the company's charter or bylaws. Corporations' statutes typically require shareholders' approval of fundamental corporate changes such as mergers, charter amendments, voluntary dissolutions, and sales of all or substantially all corporate assets outside the ordinary course of business.[339] In addition, parties can by agreement or charter provision allocate more decisions to shareholders. A veto over such shareholders' decisions can be provided by requiring

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12.02 (class vote may be required, respectively, for merger, consolidation or a sale of all or substantially all of the assets of a corporation outside the ordinary course of business).

[338] See People *ex* rel. Krych v. Birnbaum, 101 Ill. App. 3d 785, 57 Ill. Dec. 294, 428 N.E.2d 974 (1st Dist. 1981): the court held that where a shareholder did not receive a notice of a shareholders' meeting at which another shareholder was allegedly elected to certain corporate offices, the election was void.

[339] For examples of statutes requiring shareholders' consent for the merger of two independent domestic corporations, see Del. Code Ann. tit. 8, §251(c); 805 ILCS 5/11.20; N.J. Rev. Stat. §14A:10-3(2); New York Business Corporation Law §903(a). See also Model Business Corporation Act §§11.01 et seq. For examples of statutes requiring shareholders' consent for the sale, lease, exchange or other disposition of all or substantially all of the assets of a corporation other than in the usual and regular course of business, see 805 ILCS 5/11.60; Minn. Stat. §302A.661; N.J. Rev. Stat. §14A:10-11(1); New York Business Corporation Law §909(a). See also Model Business Corporation Act §§12.01 et seq. For examples of statutes requiring shareholders' consent for the voluntary dissolution of a corporation, see Del. Code Ann. tit. 8, §275(b); 805 ILCS 5/12.15; N.J. Rev. Stat. §14A:12-4(4); New York Business Corporation Law §1001. See also Model Business Corporation Act §§14.01 et seq. For examples of statutes requiring shareholders' consent for the amendment of the corporate articles, see Del. Code Ann. tit. 8, §242(c); Cal. Corp. Code §903; 805 ILCS 5/10.20; N.J. Rev. Stat. §14A:9-2(4); New York Business Corporation Law §803(a). See also Model Business Corporation Act §§10.01 et seq.

a supermajority vote or quorum for shareholders' action by vote or written consent or providing weighted votes for some shares. A charter provision requiring unanimity for all shareholders' actions or for these particular acts (assuming the provision is properly protected against deletion by charter amendment) gives each shareholder an effective veto over fundamental corporate changes.[340]

Special care must be taken to assure that all matters over which the shareholders desire a veto will indeed have to be submitted to the shareholders for their approval. This is because even the fundamental changes for which shareholders' action is required are sometimes narrowed by statute or case law.[341] For instance, in many states today the directors can accomplish the sale of substantially all corporate assets in the usual course of business, without shareholders' participation.[342] Similarly, in most states the merger of a corporation into a parent company owning a high percentage of the corporation's stock does not require shareholders' approval that other mergers must receive.[343] Hence, to provide shareholders' participation in actions for which the statute does not require a shareholders' vote but over which minority shareholders care for a veto, using an agreement or charter provision which reserves to the shareholders or confers on them the power (to the exclusion of the board of directors) to take certain corporate actions, such as the issuance of new stock, fixing consideration to be received by the corporation for shares, or amending the corporation's charter or bylaws is to be considered.

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[340] High vote requirements usually are placed in a the articles of incorporation, and probably also in the bylaws. However, in the absence of articles or bylaws provisions to that end, high vote requirements in shareholders' agreements have sometimes been given effect. See, e.g., Nordin v. Kaldenbaugh, 7 Ariz. App. 9, 435 P.2d 740, 744 (1967) (shareholders' agreement requiring unanimous shareholder consent for the issuance of stock is normally not binding on the corporation, but such an agreement does bind a close corporation if the shareholders are also its directors, managers and officers).

[341] O'Neal & Thompson, O'Neal and Thompson's Close Corporations and LLCs: Law and Practice, §4:21 (rev. 3rd ed. 2009, database updated July 2013.

[342] See, e.g., 805 ILCS 5/11.55; N.J. Rev. Stat. §14A:10-10. See also Model Business Corporation Act §12.01.

[343] See, e.g., Del. Code Ann. tit. 8, §253(a); Minn. Stat. §302A.621; N.J. Rev. Stat. §14A:10-5(1); New York Business Corporation Law §905(a). See also Model Business Corporation Act §11.05. See, generally, O'Neal and Thompson's Oppression of Minority Shareholders and LLC Members §5:5 (Rev. 2nd ed.).

Statutes authorizing shareholders to exercise powers traditionally within the authority of the board of directors via a shareholders' control agreement represent a flexible approach to corporate control patterns, an approach which has largely replaced earlier legislative and judicial views hostile to shareholders' interference with the power of directors to manage the corporation.[344] While a few statutory provisions and some early judicial decisions can perhaps be read as limiting the extent to which a charter provision can give shareholders control of a corporation,[345] those authorities appear dated and are unlikely to be followed by modern courts. Almost all states permit charter amendments authorizing shareholders intrusions into the usual norm of directors' control of corporate decisions.[346] Delaware, for example, provides: "The business and affairs of (the) corporation [...] shall be managed by or under the direction of a board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation. If any such provision is made in the certificate of incorporation, the power and duties conferred or imposed upon the board of directors by this chapter shall be exercised or performed to such extent and by such person or persons as shall be provided in the certificate of incorporation."[347]

A third set of statutory authorization of shareholders' power is found in some states with

[344] See, e.g., McQuade v. Stoneham, 263 N.Y. 323, 189 N.E. 234 (1934).

[345] Some jurisdictions have statutes vesting management power in the board of directors with language suggesting that a provision in the articles that shifts control to the shareholders would be ineffective. See D.C. Code Ann. §29-101-332; Mo. Rev. Stat. §351.310. Other jurisdictions allow control to be shifted from the directors to the shareholders only if the corporation has elected to come under the state's close corporation statute. See 805 ILCS 5/8.05; R.I. Gen. Laws §7-1.1-51.

[346] For statutes authorizing shareholders to amend the bylaws, see Del. Code Ann. tit. 8, §109; Cal. Corp. Code §211; 805 ILCS 5/2.25; MCLA §450.1231; N.J. Rev. Stat. §14A:2-9; New York Business Corporation Law §601. See also New York Business Corporation Law §715(b) (articles may provide that all officers or specified officers shall be elected by the shareholders instead of by the board), New York Business Corporation Law §911 (amendment of the articles may require shareholders' consent).

[347] See Del. Code Ann. tit. 8, §141(a). Several states permit the elimination of the board in any corporation (see Minn. Stat. §§302A.201, 302A.457), or in corporations without shares listed on a national securities exchange or regularly traded in an over-the-counter market (see MCLA §§450.1463, 450.1501). These provisions are part of the general corporation law of the respective states. In some of these states, and others, special close corporation statutes permit elimination of the board of directors in statutory close corporations. States using the Model Business Corporation Act prior to changes made in 1991 as a basis for the revision of their corporate statute permit any corporation having 50 or fewer shareholders to dispense with or limit the authority of the board of directors. See, e.g., Ark. Stat. Ann. §4-27-801; Tenn. Code Ann. §48-18-101.

statutes which apply to statutorily-defined close corporations and clearly permit direct shareholders' control of a corporation; some of these statutes expressly authorize complete elimination of a corporation's board of directors.[348] In addition, in some states the close corporation statute itself requires unanimity or a supermajority vote for shareholders' action. This kind of statutory provisions may make the drafting of additional veto provisions less complicated or even unnecessary.[349] In most states with statutory provisions of this kind, a corporation meeting the statutory definition of a close corporation and seeking to take advantage of these provisions must elect to become subject to the special close corporation statute.

Unless the shareholders can be given exclusive power to take the action over which a veto is desired, an individual's power to veto *shareholders*' action may be circumvented: If the directors also have power to take that action, a majority of the board is in a position to avoid the veto. Hence, where there is a question about whether the corporation statute in a particular jurisdiction permits shareholders to be given the exclusive power to act in an area over which a participant desires a veto, the safest way to assure that a participant has a veto power is to set up an arrangement that gives the participant a veto over action by the board of directors as well as a veto over action by the shareholders.[350]

Vetoes on shareholders' action through supermajority vote requirement

A simple and direct method of giving one or more shareholders a veto over action by the other shareholders is to require approval of a high percentage (i.e., supermajority) of shares

348 See, e.g., Ala. Code §10-2A-308; Del. Code Ann. tit. 8, §351; 805 ILCS 5/2A.45; Kan. Stat. Ann. §17-7211; Model Corps. & Ass'ns Code Ann. §4-303; MCLA §450.1463; Mont. Code Ann. §35-1-515(1); N.J. Rev. Stat. §14A:5-2; Ohio Rev. Code Ann. §1701.591; R.I. Gen. Laws §7-1.1-51; Wis. Stat. §180.1801.

349 Model Corps. & Ass'ns Code Ann. §4-501 requires unanimous shareholder consent for the issuance of stock in close corporations. For an example of a statute requiring a two-thirds shareholder approval of an amendment of the articles of incorporation to delete a provision that the business of the corporation will be managed by the shareholders, see 805 ILCS 5/2A.45.

350 O'Neal & Thompson, O'Neal and Thompson's Close Corporations and LLCs: Law and Practice, §4:21 (rev. 3rd ed. 2009, database updated July 2013.

entitled to vote and set that vote requirement at a level that cannot be obtained without the votes of those shareholders who desire the veto.[351] Statutes in some states still require a supermajority vote (i.e., two-thirds) of all shares entitled to vote for approval of fundamental corporate changes such as mergers, sale of substantially all the corporate assets or voluntary dissolution.[352] The number of states specifying a supermajority vote has been declining; a few states specify two-thirds but permit the articles to lower the requirement to a majority.[353] In the other states, fundamental corporate changes can be accomplished with the approval of holders of only a simple majority of shares entitled to vote.[354]

Almost all states permit a corporation, by amendment of its charter,[355] to increase the vote otherwise required for shareholders' action. Thus, irrespective of whether a state statute fixes a two-thirds vote or a simple majority vote for merger or other fundamental changes, a corporation's charter can specify, say, an 80 percent vote and thus give a veto to any shareholder holding more than 20 percent of the corporation's stock. Note should be taken of the fact that statutes which require a two-thirds or other supermajority vote for fundamental corporate actions such as a merger, usually do not require a supermajority vote for shareholders' action on "non-

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351 For instance, a provision in the articles requiring an affirmative vote of holders of 75 percent of the voting shares outstanding gives a veto power to any shareholder or group of shareholders holding more than 25 percent of the shares.

352 See, e.g., Ohio Rev. Code Ann. §§1701.76, 1701.78, 1701.86. Cf. N.D. Cent. Code §10-19.1-05 (if the vote required for approval of amendment of the articles of incorporation, merger, consolidation, or sale of substantially all corporate assets, is not specified in the articles of incorporation, the holder of one-third of all shares entitled to vote can by written demand filed with the Secretary of State amend the articles of incorporation to require a two-thirds vote for those actions).

353 See, e.g., Mont. Code Ann. §35-1-815; Va. Code §§13.1-718, 725, 728.

354 See, e.g., Ga. Code Ann. §14-2-1103; Nev. Rev. Stat. §§78.453, 78.454, 78.456; Wis. Stat. §180.1103; N.J. Rev. Stat. §§14A:10-3, 14A:10-11, 14A:12-4.

355 See, e.g., Ohio Rev. Code Ann. §1701.76, 1701.78, 1701.86; Wis. Stat. §180.1103; Ind. Code §23-1-40-3. See also Whetstone v. Hossfeld Mfg. Co., 457 N.W.2d 380 (Minn. 1990) (when articles of incorporation and bylaws of a closely held corporation are amended in order to eliminate a minority shareholder's veto power, the shareholder is allowed to dissent from these amendments and obtain payment for the fair value of shareholder's shares). But see Georgia-Pacific Corp. v. Great Northern Nekoosa Corp., 731 F. Supp. 38 (D. Me. 1990) (tender offeror sought declaratory and injunctive relief against director removal and vacancy amendments to the target corporation's articles of incorporation and bylaws; provisions of target corporation's articles of incorporation requiring 75% vote to remove directors violated provision in Maine Business Corporation Act that requires two-thirds majority vote for removal of directors).

fundamental" corporate decisions; indeed the usual default rule in corporations statutes is that shareholders have no role in non-fundamental corporate decisions, leaving these matters to the directors—exclusively. If a statute, charter provision, a bylaw, or a shareholders' agreement reserves decisions on non-fundamental matters to the shareholders, most states' corporations codes require for shareholders' action on such matters only the affirmative votes of a majority of the voting shares represented at a meeting at which a quorum is present, unless a different number of votes is required by the corporation's charter or bylaws.[356] As a result, if a minority shareholder is to be given a veto over the determination of officers' salaries, for instance, the charter, bylaws, or both must provide that (1) the shareholders shall have the exclusive power to fix and change the salaries of designated officers, and also (2) that a designated supermajority vote is required for shareholders' action on all matters or at least on officers' salaries.[357]

The voting requirement should probably be phrased in terms of a percentage of all shares entitled to vote instead of a percentage of shares represented at a meeting at which a quorum is present, since the latter formulation would empower holders of a smaller portion of the total shares to take effective action.[358] Even when the corporation's certificate provides for a supermajority vote, the directors may be able to structure an economically similar transaction that

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[356] For examples of statutes allowing a provision in the articles requiring supermajority approval for shareholders' action, see Cal. Corp. Code §602; MCLA §450.1441; New York Business Corporation Law §614. For examples of statutes allowing such a provision to be placed in either the articles or the bylaws, see Del. Code Ann. tit. 8, §216; Fla. Stat. §607.094; See Chiulli v. Reiter, 173 A.D.2d 672, 570 N.Y.S.2d 820 (2d Dep't 1991) (corporation's board of directors has power to authorize mortgage of corporate property, notwithstanding clause in bylaws restricting corporate action without majority vote of shareholders, where certificate of incorporation did not specifically restrict authority of board to mortgage property and such grant of authority was set forth in state's corporation laws).

[357] Officer compensation is not usually a matter on which shareholders act. See LaFleur v. Guilbeau, 617 So. 2d 1362 (La. Ct. App. 3d Cir. 1993) (articles of incorporation and shareholders' agreement provided that salaries of certain officers could only be increased with 81% vote of the directors of the corporation; shareholders' agreement provided that any major changes in this percentage of distribution required the consent of 81% of the shareholders); Sutton v. Sutton, 84 N.Y.2d 37, 614 N.Y.S.2d 369, 637 N.E.2d 260 (1994) (statutory requirement that need for greater than two-thirds vote to amend certificate of incorporation to change or strike out supermajority provision be provided "specifically" in certificate of incorporation did not require discrete paragraph addressed solely to supermajority provision and explicitly declaring vote required for its amendment).

[358] In Fradkin v. Ernst, 571 F. Supp. 829 (N.D. Ohio 1983), the court refused to sanction a share option plan approved by approximately 54 percent of the shares present or represented at a shareholders' meeting, as those shares constituted only 37.33 percent of the total shares outstanding. The corporation's bylaws required the affirmative vote of a majority of shares outstanding for approval of share option plans.

is outside of the requirement.[359] Thus, in a Delaware case where the charter required a supermajority vote to approve any indebtedness for borrowed money exceeding $15 million, the court permitted the board to go forward with a $100 million expansion funded by operating leases that were said not to be borrowed money.[360] While supermajority vote requirements are permitted in almost every state, there are differences as to the instruments in which they must be placed to be effective, that is, whether they must be placed in the corporation's charter or may be included in its bylaws or in a shareholders' agreement instead.[361]

Supermajority voting requirements have become popular in publicly held corporations whose management is seeking to fend off hostile tender offers.[362] Such requirements often are directed at making it more difficult for shareholders to accept what appears to be an attractive cash offer.[363] To block this type of takeovers, a supermajority requirement for shareholders' action is combined with a *fair price* provision: A corporation's charter may require that a merger must receive the approval of a supermajority of the shareholders (sometimes 80 percent or

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359 In re Explorer Pipeline Co., 781 A.2d 705 (Del. Ch. 2001).

360 In re Explorer Pipeline Co., 781 A.2d 705 (Del. Ch. 2001).

361 See LaFleur v. Guilbeau, 617 So. 2d 1362 (La. Ct. App. 3d Cir. 1993) (provision that salaries of certain officers could only be increased with 81% vote of the directors of the corporation was set forth in both articles of incorporation and shareholders' agreement; moreover, shareholders' agreement provided that 75% of the positive cash flow would be distributed to shareholders each year and that any major changes in this percentage of distribution required the consent of 81% of the shareholders). Odenwald v. Bewajobe Corp., 824 So. 2d 494 (La. Ct. App. 4th Cir. 2002) (requirement for 80% shareholders' approval for sale of any corporate asset applied to immovable as well as moveable property).

362 See also Centaur Partners, IV v. National Intergroup, Inc., 582 A.2d 923 (Del. 1990) (target firm's articles were clear and unambiguous in requiring an 80% supermajority vote to amend its bylaws; accordingly, the bidder's attempt to amend the target's bylaws to allow a majority of the board to be elected at the annual shareholders' meeting is invalid).

363 Berlin v. Emerald Partners, 552 A.2d 482, 80 A.L.R.4th 641 (Del. 1988) (corporation's articles required a supermajority vote for any merger with an acquiring entity owning more than 30% of the company's stock). See also Centaur Partners, IV v. National Intergroup, Inc., 582 A.2d 923 (Del. 1990) (shareholders brought action seeking determination of percentage of outstanding shares required to amend bylaws; court held that the articles of incorporation were clear and unambiguous in requiring that 80% supermajority was needed to amend bylaws and thus presumption of majority rule was overcome); Bank of New York Co., Inc. v. Irving Bank Corp., 140 Misc. 2d 508, 531 N.Y.S.2d 730 (Sup 1988), judgment aff'd, 143 A.D.2d 1070, 533 N.Y.S.2d 411 (1st Dep't 1988) and order aff'd, 143 A.D.2d 1073, 533 N.Y.S.2d 412 (1st Dep't 1988) and order aff'd, 143 A.D.2d 1075, 533 N.Y.S.2d 412 (1st Dep't 1988), noted 40 Syracuse L. Rev. 56 to 61 (1989) (interpreting of N.Y. Business Corporation Law §614(b), which requires that any corporate action taken at a shareholder's meeting (other than an election of directors) must be authorized by a "majority of the votes cast," the court held that "votes cast" meant votes actually cast for or against a resolution and did not include abstentions).

higher), unless the merger gains the approval of the *unaffiliated* board members or gives shareholders a *fair price*, a term which is defined to provide so generous a price that the bidder either drops the two-step acquisition or negotiates with the corporation's board of directors.[364]

In a Delaware case,[365] a corporation's board of directors tried to establish a veto in a circuitous fashion: The board issued a new class of preferred stock and in defining the voting rights of this new class required a vote of greater than 80 percent of the new class for merger with an entity owning more than 20 percent of the corporation's shares. The result was to give holders of a minority of shares of the new class the power to block such a merger. The Delaware court – concerned about alteration of shareholders' voting power by action of the directors – issued a preliminary injunction against the issuance of the stock. Concern about board alteration of shareholders' rights also appears in subsequent Delaware decisions dealing with other defensive tactics against takeovers.[366] This concern suggests that courts will strictly scrutinize board of directors' efforts to impose veto arrangements in such a setting.[367] A supermajority requirement combined with a fair price or similar provision has been included in many "second generation" state takeover laws,[368] statutes which attempt to regulate the takeover process (usually for the benefit of local companies trying to fend off out-of-state suitors), without conflicting with

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364 See Seibert v. Milton Bradley Co., 380 Mass. 656, 405 N.E.2d 131 (1980), noted 69 Ky. L.J. 476 to 479 (1981), in which the court upheld as valid a provision in a corporation's bylaws that a vote of 75 percent of the shares of each class of its stock would be required to approve a merger of the corporation or to amend, modify or repeal that bylaw provision, unless two-thirds of the members of the board of directors voted to approve the merger or to amend or repeal the bylaw provision.

365 Telvest v. Olson, 1979 WL 1759 (Del. Ch. 1979).

366 See, e.g., Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 66 A.L.R.4th 157 (Del. 1985); Moran v. Household Intern., Inc., 500 A.2d 1346 (Del. 1985).

367 Harding v. Heritage Health Products Co., 98 P.3d 945 (Colo. Ct. App. 2004), cert. denied, 2004 WL 2334871 (Colo. 2004) (where bylaws authorized only board to change the number of directors and prevented change in bylaws without a supermajority shareholder vote, the provisions were inconsistent with statute that either shareholders or directors could set the number of directors within a range provided by the bylaws).

368 See, e.g., Model Corps. & Ass'n Code Ann. §§3-601 to 3-603; Ga. Code Ann. §14-2-231. The statutes are referred to as "second generation" because they follow earlier state takeover legislation which could not withstand constitutional scrutiny after Edgar v. MITE Corp., 457 U.S. 624, 102 S. Ct. 2629, 73 L. Ed. 2d 269 (1982).

federal regulation of tender offers under the Williams Act[369] or the constitutional restrictions on state regulation of interstate commerce.[370]

Vetoes on shareholders' action through shares with weighted votes

An alternative to a supermajority vote requirement for giving minority shareholders a veto over shareholders' action is an arrangement which gives some shares more votes than other shares, either on a particular issue or on all issues to be voted on by the shareholders.[371] An English decision involved such an arrangement:[372] a company's articles of association provided that had a resolution being proposed for the removal of a director, shares held by that director would have three votes per share. As the corporation had three shareholders each with one hundred shares, the effect of the weighted vote provision was to allow each director to veto his own removal. Another example of weighted voting, sustained by the Delaware Supreme Court, provided one vote for every share owned not exceeding fifty shares, and one vote for every twenty shares more than fifty, with a further limitation that no shareholder could cast more than one-fourth of the total number of shares outstanding.[373] This type of restriction on voting gives what might be thought of as a *collective veto*; the aim is to limit the power of one large shareholder

[369] 15 U.S.C.A. §§78m(d) to (e), 78m(d) to (f).

[370] U.S. Constitution Article I §8 cl. 3. The Supreme Court rejected preemption and interstate commerce arguments in upholding Indiana's second generation takeover statute. See CTS Corp. v. Dynamics Corp. of America, 481 U.S. 69, 107 S. Ct. 1637, 95 L. Ed. 2d 67 (1987).

[371] This alternative will not be available for many corporations that are not closely held because of stock exchange listing standards banning mid-stream changes that introduce dual class voting for listed company. These standards followed a federal appellate court decisions that struck down SEC's Rule 19c-4 that had limited the ability of companies listed on a national stock exchange to depart from one share/one vote. See Business Roundtable v. S.E.C., 905 F.2d 406 (D.C. Cir. 1990). Thus, listed companies have less freedom than close corporations in using weighted votes.

[372] Bushnell v. Faith [1970] 2 WLR 272.

[373] See Providence & Worcester Co. v. Baker, 378 A.2d 121, 3 A.L.R.4th 1198 (Del. 1977). Wis. Stat. §180.25(9), a so-called "second generation" takeover law applicable to an "issuing public corporation" (defined as a domestic corporation with at least 100 shareholders who are Wisconsin residents), limits the voting power of a person holding "in excess of 20 percent of the voting power in the election of directors" to "10 percent of the full voting power of those shares," until the shareholders vote to restore full voting rights.

rather than preserve the power of any minority shareholder.[374]

In early American corporations shareholders' voting was commonly on a per capita basis instead of a per share one,[375] and per capita voting is still occasionally used in close corporations.[376] Statutes in almost all states authorize weighted voting. The statute usually establishes a norm of one vote per share but permits a corporation's charter to provide otherwise.[377] In some states, however, the statute appears to authorize departures from the norm only if the differences in voting power are made applicable to entire classes of stock.[378] Judicial decisions have upheld per capita voting[379] and limits on the number of votes per share after the first 50 or 100 shares.[380] Shares with multiple votes are less likely to find judicial support if they are issued by the board of directors without shareholders' approval. In a Delaware case,[381] the management of a small publicly held corporation sought to defuse a takeover attempt by issuing to its chairman 52,500 shares of a new series of preferred stock having 120 votes per share. In addition, the company issued 100,000 shares of a second new series of preferred stock to two

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374 O'Neal & Thompson, O'Neal and Thompson's Close Corporations and LLCs: Law and Practice, §4:23 (rev. 3rd ed. 2009, database updated July 2013.

375 See generally, Ratner, The Government of Business Corporations: Critical Reflections on the Rule of "One Share, One Vote," 56 Cornell L. Rev. 1 (1970).

376 Deskins v. Lawrence County Fair & Development Corp., 321 S.W.2d 408 (Ky. 1959); Groves v. Rosemound Imp. Ass'n, Inc., 413 So. 2d 925 (La. Ct. App. 1st Cir. 1982), writ denied, 420 So. 2d 443 (La. 1982) (nonprofit corporation).

377 Model Business Corporation Act §7.21. Some ambiguity exists on whether the departure from one-vote-per-share must be done for all shares in a particular class, or may vary among shares within a class. Most states permit vote variation among shares regardless of class. See, e.g., Cal. Corp. Code §700; Del. Code Ann. tit. 8, §212; MCLA §450.1441; New York Business Corporation Law§ 612. Some statutes are worded in ways that suggest that a vote variation must be established by class. See, e.g., 805 ILCS 5/7.40; Wis. Stat. §180.1150. See Waggoner v. Laster, 581 A.2d 1127 (Del. 1990) (corporation's certificate of incorporation did not give its board of directors the authority to issue convertible preferred shares with supermajority voting rights, and that, in absence of such authority, those voting rights, used to oust other directors, were null and void).

378 See, e.g., 805 ILCS 5/7.40.

379 See, e.g., Deskins v. Lawrence County Fair & Development Corp., 321 S.W.2d 408 (Ky. 1959); Groves v. Rosemound Imp. Ass'n, Inc., 413 So. 2d 925 (La. Ct. App. 1st Cir. 1982), writ denied, 420 So. 2d 443 (La. 1982) (nonprofit corporation).

380 See Providence & Worcester Co. v. Baker, 378 A.2d 121, 3 A.L.R.4th 1198 (Del. 1977).

381 Packer v. Yampol, 1986 WL 4748, 54 USLW 2582, 12 Del. J. Corp. L. 332 (Del.Ch. 1986). This case, in which the court focused on board usurpation of shareholder suffrage rights, can be distinguished from the typical situation in a close corporation, where the weighted vote is established with approval of all the shareholders.

corporations controlled by an acquaintance of the company's chairman who had expressed support for current management. This second series had 114 votes per share and veto rights over fundamental corporate transactions. The Delaware court enjoined the issuance of the stock: It emphasized that action which may be technically within management's power will not be upheld if its purpose and effect are to entrench incumbent management.

Vetoes on shareholders' action through supermajority quorum requirements

Almost all corporation statutes authorize charter or bylaws provisions fixing high quorum requirements for shareholders' meetings,[382] and provisions of this kind are probably valid even in the absence of specific statutory authorization. Therefore, some drafters, with a view to giving a veto power to each shareholder or particular shareholders, insert in the corporation's charter or bylaws a provision requiring the presence of holders of a high percentage of shares to effectively resolve on the shareholders' meetings' agenda.[383] Some state statutes require a high quorum requirement to be in the corporation's charter, so that a similar provision in the bylaws may not be enforced.[384]

In such a setting, in order to protect shareholders against their appearing inadvertently at a meeting that is to consider actions they oppose, the high quorum requirement must be coupled with a requirement that notices of meetings state the agenda (i.e., the decision on which a resolution is to be taken). Otherwise a shareholder may attend a meeting, help form a quorum,

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382 In most states a high quorum requirement must be placed in the articles of incorporation. See, e.g., Cal. Corp. Code §602; Fla. Stat. §607.0725; 805 ILCS §5; New York Business Corporation Law §616; Tex. Bus. Corp. Act Ann. art. 2.28. In other states the statute authorizes such a requirement to be placed in either the articles or the bylaws. See, e.g., Del. Code Ann. tit. 8, §216; MCLA §450.1415; Ohio Rev. Code Ann. §1701.51.

383 See Dykstra, Molding the Utah Corporation: Survey and Commentary, Utah Law Review 1, 9 (1960), where the author comments that "it seems logical to assume that where ownership is concentrated in a handful of people, they in many instances would want two-thirds or three-fourths or even more of the stock to be represented at shareholder meetings."

384 See, e.g., Jones v. Wallace, 291 Or. 11, 628 P.2d 388 (1981). For a case in a public corporation takeover setting upholding the actions of the board of directors in amending a corporation's bylaws to increase the quorum requirements for shareholders' meetings from 40% to a majority of shareholders entitled to vote, see GAF Corp. v. Union Carbide Corp., 624 F. Supp. 1016 (S.D. N.Y. 1985).

and thus permit action on a matter he opposes.[385] This turns out to be particularly important in states with a statute or common law rule similar to the Model Business Corporation Act, which provides that once a share is represented for any purpose at a meeting, it is deemed present for quorum purposes for the remainder of the meeting.[386] A Delaware opinion held such a statute does not govern a corporation with 50/50 shareholders where exit of one is tantamount to adjournment.[387] In the absence of such a statute, some courts have held that the withdrawal of a shareholder from a meeting breaks the quorum.[388] A high quorum provision would be ineffective in providing a veto if courts were to hold that shareholders are under a duty to attend meetings and are not free to refrain from attending in order to block actions to which they object. A New

[385] Boisdore v. Bridgeman, 439 So. 2d 1266 (La. Ct. App. 5th Cir. 1983), writ denied, 444 So. 2d 1221 (La. 1984) (where a shareholder attended a shareholders' meeting, did not complain of insufficient notice of the meeting, and participated in a vote by which others were elected corporate officers, he could not attack the validity of the action taken at the meeting); Stough v. 501 Ranch, Inc., 421 So. 2d 1154 (La. Ct. App. 2d Cir. 1982) (a shareholder who has participated in and voted at a shareholders' meeting cannot complain of defects in the notice of the meeting); Ski Roundtop, Inc. on Behalf of Ski Yellowstone Inc. v. Hall, 202 Mont. 260, 658 P.2d 1071 (1983) (that minority shareholders voted at a shareholders' meeting to increase the number of authorized shares to include two new series of stock and to drop the par value of those shares operated to equitably estop them from seeking to roll back those issues because of the failure of officers to give statutory notice of the meeting). Cf. Jones v. Highway Inn, Inc., 424 So. 2d 944 (Fla. Dist. Ct. App. 1st Dist. 1983) (a notice of a special shareholders' meeting contained a fair summary of the proposed sale of the corporation's principal assets and was not fatally defective).

[386] Model Business Corporation Act Ann. §7.25(b). See also Berlin v. Emerald Partners, 552 A.2d 482, 493 (1988); Duffy v. Loft, Inc., 17 Del. Ch. 140, 151 A. 223 (1930), aff'd, 17 Del. Ch. 376, 152 A. 849 (1930) (a quorum, once established, cannot be destroyed by the subsequent withdrawal of some shareholders from the meeting or by revocation of proxies). A majority of states have similar statutory provisions. Such provisions do not specify the vote required for shareholder action subsequent to the withdrawal from the meeting, suggesting that the same percentage requirements apply, resulting in a lower numerical vote threshold for shareholder action. See, e.g., Fla. Stat. §607.0725; MCLA §450.1415; New York Business Corporation Law §608; Pa. Stat. Ann. tit. 15, §1756. California avoids this situation by providing that while withdrawal from the shareholders' meeting does not affect the required quorum, once established, subsequent shareholder action requires a vote of shares constituting a majority of the original quorum. The statute is unclear whether this requirement for majority approval is inflexible or can be raised by a supermajority vote requirement for shareholder action when a quorum is present. See Cal. Corp. Code §602.

[387] Testa v. Jarvis 1994 WL 30517 (Del. Ch. 1994), 19 Del. J. Corp. L. 1321 (1994) (distinguishing withdrawing by minority shareholder to prevent majority action from 50/50 shareholder who should not be put to an endurance test).

[388] See Levisa Oil Corp. v. Quigley, 217 Va. 898, 234 S.E.2d 257 (1977) (where the bylaws required the presence of shareholders representing a majority of the outstanding shares in order to transact business at the annual shareholders' meeting, the withdrawal of two shareholders from a shareholders' meeting in order to defeat a move to divest them of their control was not improper, and after their withdrawal all subsequent action taken at the meeting was void). Virginia has amended its statute since the Levisa case to follow the Model Business Corporation Act on this point. See also Textron, Inc. v. American Woolen Co., 122 F. Supp. 305 (D. Mass. 1954), in which the court held that because a shareholder has no legal duty to attend a shareholder's meeting, a shareholder present or represented by proxy *before* a quorum is established may withdraw, and his original presence may not then be counted for quorum purposes.

York decision imposed a duty on directors to attend meetings of the board,[389] but courts have been consistent in refusing to impose on shareholders any duty to attend shareholders' meetings.[390]

High quorum requirements for shareholders' meetings can be frustrated under a statute such as Delaware's,[391] which permits the Court of Chancery to summarily order a shareholders' meeting to be held upon application of any shareholder if a shareholders' meeting has not been timely held; the Court of Chancery may decree that shares represented at such a meeting shall constitute a quorum for the purposes of the meeting notwithstanding a contrary charter or bylaws provision. The Model Business Corporation Act contains language similar to that of the Delaware statute.[392] On the other hand, Virginia, the first state to revise its statute using the Model Business Corporation Act as a model, deleted the provision giving courts authority to set quorum or voting rules,[393] thus permitting high quorum requirements contained in corporate charters to perform a veto function. A high quorum requirement coupled with a high vote requirement may create the illusion of a double hurdle that objectionable action must clear before it becomes operative. However, if a shareholder refrains from attending a meeting in order to prevent formation of a quorum, that shareholder of course never gets an opportunity to veto a proposal by voting against it. In most situations, it is preferable to rely solely on a high vote

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[389] Gearing v. Kelly, 11 N.Y.2d 201, 227 N.Y.S.2d 897, 182 N.E.2d 391 (1962), noted 62 Colum. L. Rev. 1518 (1962), 14 Syracuse L. Rev. 235 (1962). But see the language of Chancellor Seitz in Campbell v. Loew's, Inc., 36 Del. Ch. 563, 587, 134 A.2d 852, 866 (1957): "While a concerted plan to abstain from attending directors' meetings may be improper under some circumstances, I cannot find that the fact that the so-called Vogel directors did not attend directors' meetings called to take action which would give an opposing faction an absolute majority of the board—solely because of director resignations—is such a breach of their fiduciary duty that they should be judicially compelled to attend board meetings. This is particularly so where stockholder action is in the offing to fill the board."

[390] See, e.g., Levisa Oil Corp. v. Quigley, 217 Va. 898, 234 S.E.2d 257 (1977); Hall v. Hall, 506 S.W.2d 42 (Mo. Ct. App. 1974) (50 percent shareholder had no duty to and could not be compelled to attend shareholders' meetings).

[391] Del. Code Ann. tit. 8, §211(c). See also Cal. Corp. Code §600; Kan. Stat. Ann. §17-6501; MCLA §450.1402; N.J. Rev. Stat. §14A:5-2.

[392] Model Business Corporation Act §7.03.

[393] Va. Code Ann. §13.1-656.

requirement as this permits shareholders in apparent disagreement to get together, discuss their differences, possibly discover areas of agreement and evolve policies or reach decisions satisfactory to all of them.[394]

On a final note, as all state statutes permit shareholders to act without a meeting upon the written consent of the shareholders,[395] under most of these statutes, such action must gain unanimous shareholders' consent[396] (thus providing a statutorily imposed veto that protects minority shareholders who object to the proposed corporate action). In a few states, like in Delaware, this informal procedure for shareholders' action is effective upon written consent of shareholders having the minimum number of votes necessary to take such action at a meeting.[397] Under Delaware law, a majority vote is ordinarily sufficient for any shareholders' action.[398] The Delaware statute permits the corporation's charter to increase the vote required for shareholders' action; if a supermajority vote requirement for shareholders' action is inserted in the charter, it should be so worded that it applies clearly to actions by written consent as well as actions at a meeting. A charter provision requiring, for example, 80 percent shareholders' approval to issue additional stock should also be made to apply to any effort to issue corporate stock by means of shareholders' written consent.[399]

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394 O'Neal & Thompson, O'Neal and Thompson's Close Corporations and LLCs: Law and Practice, §4:24 (rev. 3rd ed. 2009, database updated July 2013.

395 Model Business Corporation Act Ann. §7.04 at 7-45 (4th Ed).

396 See, e.g., Kan. Stat. Ann. §17-6518; New York Business Corporation Law §615; Ohio Rev. Code Ann. §1701.54.

397 Del. Code Ann. tit. 8, §228. See also Cal. Corp. Code §603; 805 ILCS 5/7.10; MCLA §450.1407; N.J. Rev. Stat. §14A:5-6. But see Keogh Corp. v. Howard, Weil, Labouisse, Friedrichs Inc., 827 F. Supp. 269, 272 (S.D. N.Y. 1993) (holding §228 of Delaware General Corporation Law not to be a substantive grant of power to shareholders; §228 only allows shareholders to use the written consent process to take action they are otherwise authorized to take at a meeting. In this case, the court denied shareholders the right to initiate litigation through consents because the shareholders did not possess, either through Delaware law or the corporate documents, the substantive right to initiate litigation).

398 Del. Code Ann. tit. 8, §216(1) & (2).

399 O'Neal & Thompson, O'Neal and Thompson's Close Corporations and LLCs: Law and Practice, §4:25 (rev. 3rd ed. 2009, database updated July 2013.

Vetoes on directors' action

The statutory norm of corporate governance found in all American jurisdictions presumes that a corporation's board of directors will make most policy and management decisions for it.[400] Fundamental corporate actions also require the approval of the shareholders,[401] but other corporate decisions, such as the selection of officers, changes in the officers' compensation, the making of basic policy decisions, and the declaration of dividends, are traditionally within the province of the board of directors or managers the board selects.[402] To provide a shareholder with a veto over these kinds of decisions, the shareholder must be assured of representation on the board and unanimity must be required for board's action. A minority shareholder usually can be guaranteed board representation by: (1) entering into a shareholders' agreement permitting the shareholder to designate a director; (2) installing cumulative voting for directors; or (3) classifying the corporations' shares, distributing a separate class to each shareholder, and providing for the election of a director or a specified number of directors by each class of shares.[403]

In a case with unusual facts,[404] a shareholders' agreement required an affirmative vote of 3 of 4 directors to act: The directors were split 2 to 2 on exercising preemptive rights in another corporation in which the first corporation was a large shareholder. The court struck down the issuance of the additional shares in the second corporation where those shares provided the votes necessary to approve a merger. The merger could not be approved without the new shares because the director split of the first corporation meant the corporation's shares could not be

400 See, e.g., Cal. Corp. Code §300; Del. Code Ann. tit. 8, §141; 805 ILCS 5/7.10; New York Business Corporation Law §701; Texas Bus. Corp. Act Ann. art 2.31.

401 See, e.g. Del. Code Ann. tit. 8, §§42, 251, 271, 275.

402 See Model Business Corporation Act §§6.40, 8.01, 8.40.

403 See 805 ILCS 5/2A-45, for an example of a statute authorizing agreements among shareholders of close corporations designating who shall be directors, officers or both. A voting trust may also be used to assure minority shareholders representation on the board of directors.

404 Ziegler v. American Maize-Products Co., 658 A.2d 219, 222 (Me. 1995).

voted for a merger.

The arrangement providing for a shareholder with board representation must also guard against removal of that director without the shareholder's consent. Statutes sometimes provide protection against removal of a director elected by cumulative voting;[405] if the statute does not offer sufficient protection, a protective provision can be inserted in the corporation's charter. To guard against the possibility that the board might otherwise take action while a shareholder's position on the board is vacant due to death or resignation, a provision can be placed in the charter or bylaws prohibiting board action until any vacancy has been filled (precautions should also be taken to make certain that the vacancy cannot be filled by other shareholders or their representatives on the board).[406]

The danger that the other shareholders or their directors may fill a vacancy and thus be in a position to achieve board's action over the objection of a minority shareholder is illustrated by a decision of the New York Court of Appeals.[407] In that case, after the resignations of two members of a five-person board of directors, the corporation continued to function for a number of years with only three directors. Finally, two of the directors, over the opposition of the other directors, with whom they were at odds, purported to elect a fourth director to fill one of the vacancies. The court in a highly questionable decision sustained the election, holding that a

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[405] See, e.g., Cal. Corp. Code §393; Del. Code Ann. tit. 8, §141(k); 805 ILCS 5/8.35; MCLA §450.1511; New York Business Corporation Law §706.

[406] See Strong v. Fromm Laboratories, Inc., 273 Wis. 159, 77 N.W.2d 389 (1956) (a bylaw barred directors from transacting business while vacancy remained unfilled). In the absence of a provision prohibiting directors' action while a vacancy on the board exists, the remaining directors can act for the corporation. See, e.g., Jacobs v. Ostow & Jacobs, Inc., 12 A.D.2d 613, 209 N.Y.S.2d 37 (1st Dep't 1960) (officers elected by two directors, who had continued in office when shareholders were unable to agree on new directors or on the filling of a vacancy, held validly elected). See also Reporter's Dissent, The Institute of Continuing Legal Education and the Corporate, Finance, and Business Law Section State Bar of Michigan, The Michigan Business Corporation Act: Statutes, Annotations, and Forms 163 (Miller and Holmes, eds, 1972), criticizing §§21.200(523) and 21.200(525) of the Michigan Business Corporation Act, which provide that a majority of the board *then in office* constitutes a quorum unless the articles or bylaws provide otherwise and that action may be taken by the board without a meeting if all the members consent thereto in writing. The reporter points out that, particularly in close corporations, remaining directors could take advantage of death or disability of a director to produce a quorum and vote on matters with a "rump" board. He recommended that a quorum be determined by the size of the entire board.

[407] Jacobson v. Moskowitz, 27 N.Y.2d 67, 313 N.Y.S.2d 684, 261 N.E.2d 613 (1970) (two judges dissented in a strong opinion).

bylaws providing that directors in office could fill vacancies on the board empowered two of three directors in office to fill existing vacancies, even though the corporation's charter required a three-fourths majority for the "transaction of any business" by the board. The effect of this decision was to frustrate the high vote requirement for directors' action, and probably circumvent the intentions of the incorporators. Section 705(a) of the New York Business Corporation Law at that time provided that "vacancies occurring in the board for any reason except the removal of directors without cause may be filled by vote of a majority of the directors then in office, although less than a quorum exists, unless the certificate of incorporation or the bylaws provide that such [...] vacancies shall be filled by vote of the shareholders." The New York Court of Appeals cited this statute as authorizing the bylaws to grant directors in office power to fill board vacancies.[408] The court did not discuss whether this statute itself, without the bylaws, would have empowered two of the three remaining directors to fill vacancies in the face of the provision in the corporation's certificate of incorporation requiring a three-fourths vote by the directors for the transaction of business. New York law was later amended to specifically state that the authority given to directors in Section 705(a) would not affect a provision of the corporation's certificate of incorporation specifying high vote requirements for directors' action or high quorum requirements for directors' meetings.

In most states, charter amendment requires board's approval before the change is submitted to shareholders,[409] but in some other states shareholders can independently amend the

[408] Jacobson v. Moskowitz, 27 N.Y.2d 67, 70, 313 N.Y.S.2d 684, 686, 261 N.E.2d 613, 614 (1970). For other cases applying N.Y. Bus. Corp. Law §705(a), see Petition of Caplan, 20 A.D.2d 301, 246 N.Y.S.2d 913 (1st Dep't 1964), order aff'd, 14 N.Y.2d 679, 249 N.Y.S.2d 877, 198 N.E.2d 908 (1964) (the election of seven members of a ten-person board had been invalidated, the court permitted the remaining three members to fill the seven vacancies thus created, notwithstanding a bylaw requiring a quorum of six directors); Avien, Inc. v. Weiss, 50 Misc. 2d 127, 269 N.Y.S.2d 836 (Sup 1966) (action by two of the three directors remaining in office to fill two director vacancies was upheld even though the bylaws required a quorum of three directors). Section 705 has been amended since these decisions to specify that the Section does not affect a provision in the articles that specifies high vote or quorum requirements for director action. But see Schmidt v. Magnetic Head Corp., 97 A.D.2d 151, 468 N.Y.S.2d 649 (2d Dep't 1983) (board can fill vacancy pursuant to authority in statute notwithstanding shareholders' agreement permitting owner of 45.5 percent of corporation's stock to select at least one-third of the board).

[409] See, e.g., Del. Code Ann. tit. 8, §242; 805 ILCS 5/10.20; New York Business Corporation Law §803.

charter or the bylaws without action by the board.[410] In the latter states a veto over shareholders' action is necessary to guard against the possibility that shareholders will amend the charter or bylaws to eliminate the veto over directors' action.

Methods for the setting up of vetoes on board of directors' action

The simplest and most direct means of providing a minority shareholder with power to veto directors' action is to assure the shareholder adequate representation on the board,[411] and then to require unanimity or a supermajority vote for board's action.[412] Most state corporation statutes permit the corporation to establish a vote requirement for board's action higher than that set forth in the statute.[413] The Model Business Corporation Act, for example, provides that "the affirmative vote of a majority of directors present is the act of the board of directors unless the articles of incorporation or bylaws require the vote of a greater number of directors."[414] A few statutes authorize such provisions only if placed in a particular instrument, e.g., only in the charter or only in the bylaws, or otherwise regulate the implementation of the provisions.[415] Like other veto arrangements, as we have already seen, a supermajority requirement for board's action must be protected from deletion or amendment.

Statutes in almost all states also permit a corporation to establish a supermajority quorum for directors' action, which would operate similar to the supermajority quorum for shareholders'

410 See, e.g., Mo. Rev. Stat. §§351.090, 351.290.

411 For a decision upholding a provision in a land development company's articles which gave two groups of shareholders equal representation on the corporation's board of directors so as to require unanimous shareholders' consent to develop the real estate held by one group of shareholders, see Bauman v. Hayes, 379 So. 2d 1251 (Ala. 1980).

412 For a set of bylaws requiring unanimity for directors' action and a high vote for shareholders' action, see Roland Park Shopping Center, Inc. v. Hendler, 206 Md. 10, 109 A.2d 753 (1954).

413 See, e.g., Cal. Corp. Code §204; Del. Code Ann. tit. 8, §141; 805 ILCS 5/8.51; MCLA §450.1523; New York Business Corporation Law §709.

414 Model Business Corporation Act §8.24(c).

See Cal. Corp. Code §204, New York Business Corporation Law §709 (articles of incorporation only). Louisiana, Nevada, and Pennsylvania do not have a statutory provision authorizing high vote requirements for boards' action.

action.[416] A provision establishing a supermajority quorum requirement usually can be placed in either the charter or the bylaws; but a few statutes sanction such requirements only if in the charter or if in the bylaws, as the case may be.[417] The supermajority requirement sometimes is applied to particular transactions. In a Pennsylvania corporation where the existing CEO sold 49% to a new shareholder, the parties agreed to heightened notice and voting requirements for "significant transactions" defined as transactions with a value of $500,000 or more, including extensions of employment agreements. When the CEO was terminated by board's action, including one director appointed by him pursuant to a shareholders' agreement, the court overturned a preliminary injunction that had found the removal to be a significant transaction.[418] A few statutes authorize giving directors more than one vote.[419] Most statutes, however, are silent on that question, and the traditional norm is one vote for each director. In a state without a statute authorizing the giving of multiple votes to a director, a charter clause for multiple votes might be upheld under general statutory provisions allowing a charter to include optional clauses for the corporation's governance, but a drafter cannot be absolutely certain that a court would allow this departure from the norm.[420]

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[416] See, e.g., Del. Code Ann. tit. 8, §141; 805 ILCS 5/8.15; MCLA §450.1523; Ohio Rev. Code Ann. §1701.62.

[417] For statutes requiring that provisions authorizing high quorum requirements for boards' action be placed in the articles, see Cal. Corp. Code §204; N.M. Stat. Ann. §53-11-40; New York Business Corporation Law §§707, 709. For statutes requiring that such a provision be placed in the corporation's bylaws, see Mass. Gen. Corp. Law 156B §57. The number of states permitting provisions requiring supermajority quorums for directors' meetings to be placed in either the articles or the bylaws is considerably higher than the number of states permitting shareholders' supermajority quorum requirements to be placed in either document. More states require that shareholders' supermajority quorum provisions be placed in the articles. See also Frantz Mfg. Co. v. EAC Industries, 501 A.2d 401 (Del. 1985) (court held that corporate bylaws amendments requiring attendance of all directors for a quorum and unanimous approval before board action could be taken, enacted by shareholders' consents obtained by an acquiring corporation, were permissible where they were intended to limit the board's antitakeover maneuvering after the acquiring firm had gained control in an attempt to avoid its disenfranchisement as the majority shareholder).

[418] Anchel v. Shea, 762 A.2d 346 (Pa. Super. Ct. 2000).

[419] See Wis. Stat. §180.1823(b) (weighted voting rights for directors); see also Md. Corps & Ass'ns Code Ann. §4-402(a) (unanimous shareholders' agreement may regulate any aspect of corporate affairs, including the exercise or division of voting power). See generally Kessler, The Revised New Jersey Business Corporation Act of 1988 As Amended and Its Effect on Close Corporations, 20 Seton Hall L. Rev. 130 (1989) (discussing amendments to the New Jersey Business Corporation Act which allows directors to have two or more votes).

[420] See Capital Investments, Inc. v. Whitehall Packing Co., Inc., 91 Wis. 2d 178, 280 N.W.2d 254 (1979) where two representatives of a venture capital firm were installed on a close corporation's board of directors with greater veto

Vetoes on actions by executives and other board's committees

State corporation statutes permit a board of directors to appoint an executive and other committees to exercise the power and authority of the board.[421] An executive committee in which each shareholders' group has representation and a veto can be a way of preserving minority input over corporate decisions.[422] Most of these statutes prohibit such committees from acting on fundamental corporate changes,[423] and in many states the statute specifically prohibits committees from authorizing dividends or other distributions to shareholders or from filling vacancies on the board of directors.[424] A few jurisdictions also restrict committees' powers to elect or remove officers or take certain other actions.[425] A number of states, however, do not specifically place limits on the authority of directors' committees.[426] Thus, a power to veto action by the full board conceivably might not protect a shareholder from undesired action by a committee of the board. To give a shareholder a veto over action a director committee might otherwise take, care must be

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and decision-making powers in certain areas of corporate management than the other directors; court asserted this might be an unlawful delegation of the board's powers).

421 See, e.g., Cal. Corp. Code §311; Del. Code Ann. tit. 8, §141(c); 805 ILCS 5/8.40; MCLA §450.1528; New York Business Corporation Law §712; Ohio Rev. Code Ann. §1701.63. New York's statute permits delegation of the board's authority to a committee if the delegation is in the corporation's articles or bylaws. However, there are judicial opinions in New York and elsewhere that recognize an inherent power in the board to appoint committees.

422 In Blount v. Taft, 29 N.C. App. 626, 225 S.E.2d 583, 585 (1976), noted 15 Wake Forest L. Rev. 531 (1979), 68 Ky. L.J. 520 to 523 (1980), a corporation's bylaws set up a three-person executive committee composed of one member from each of the three families that held shares in the corporation, and provided that the executive committee "shall have the exclusive authority to employ all persons who shall work for the corporation and that the employment of each individual shall be only after the unanimous consent of the committee and after interview." However, the veto power thus provided was not protected against elimination by amendment of the bylaws, and the court held that the bylaws, although they had been adopted by unanimous vote of the shareholders, did not constitute a shareholders' agreement and could be amended by majority director vote pursuant to the amendment process provided in the bylaws.

423 For an example of a statute precluding committee action on fundamental corporate changes, such as articles or bylaws amendment, merger or consolidation, issuance of stock, dissolution, and sale of substantially all the corporation's assets, see Neb. Rev. Stat. §21-2041.

424 For examples of statutes precluding executive committee action on dividend distributions or the filling of vacancies on the board, see Del. Code Ann. tit. 8, §141(c), Kan. Stat. Ann. §17-6301, Md. Corps & Ass'ns Code Ann §2-411 (dividend distributions), New York Business Corporation Law §712, Ohio Rev. Code Ann. §1701.63 (board vacancies); Cal. Corp. Code §311; MCLA §450.1528; N.M. Stat. Ann. §53-11-41; Va. Code Ann. §13.1-689 (committee cannot act on either distribution or vacancies).

425 See, e.g., N.J. Rev. Stat. §14A:6-9. Several state statutes restrict committee action in each of these areas of corporate management (fundamental changes, dividend declaration, filling of board vacancies, election or removal of officers). See e.g. 805 ILCS 5/8.40.

426 See, e.g., La. Rev. Stat. Ann. §12:81(B); Mo. Rev. Stat. §351.330; Okla. Stat. tit. 18, §1.36.

taken to deprive the committee of the power to act without full board's approval (thus relegating the committee to a recommending function), or provision must be made for the shareholder to have representation on the committee and for unanimity to be required for committee's action.

In the absence of a supermajority requirement for board's action, a majority of the board usually has the authority to appoint a committee.[427] The Model Business Corporation Act specifies that the appointment of a committee of directors must meet any supermajority vote required for directors' action.[428] Delaware's statute refers to appointment of committees by a majority of the whole board; but a general statutory provision authorizing charter and bylaws provisions requiring a supermajority vote for board's action should sanction a supermajority vote for board's action in appointing a committee.[429] In some jurisdictions a specific charter or bylaws provision requiring a supermajority vote for action taken by the executive committee and other director committees may be necessary. The Model Business Corporation Act specifies that the voting requirements of the board also apply to its committees; thus under that statute a supermajority requirement for board's action automatically applies to committees,[430] but under the statutes in many states it may be necessary to include, in either the charter or bylaws, a supermajority requirement for committee's action.[431]

Vetoes on officers' action

Corporate officers may have power to act on behalf of a corporation pursuant to

[427] Most states require the vote of a majority of all board members to appoint a committee. See, e.g., Del. Code Ann. tit. 8, §141(c); 805 ILCS 5/8.40; Kan. Stat. Ann. §17-6301; New York Business Corporation Law §712; Ohio Rev. Code Ann. §1701.63. North Dakota requires only a majority vote of the directors present at a board meeting. See N.D. Cent. Code §10-19.1-48.

[428] Model Business Corporation Act §8.25(b).

[429] Del. Code Ann. tit. 8, §141(b) and (c).

[430] Model Business Corporation Act §8.25(c).

[431] Only a few state statutes specify the vote required for committee's action. For examples of statutes requiring a majority vote for committee's action, but providing that the articles, bylaws or board resolution creating the committee may require a higher vote, see Minn. Stat. §302A.241; Ohio Rev. Code Ann. §1701.63. For examples of statutes providing that vote requirements for the board of directors, as set by statute, the articles or bylaws, shall apply to committees, see Cal. Corp. Code §307; Ind. Code §23-1-34-6; Va. Code Ann. §13.1-689.

authority derived from the state corporation statute, charter or bylaws provisions, resolutions of the board of directors, or common law of agency. State laws make clear, however, that officers are subject to the control of the directors.[432] Most state corporation statutes specify that officers shall have the authority granted to them by the board of directors, set forth in the bylaws or granted by methods set out in the bylaws.[433] In addition to this express authority, the judicial decisions make clear that a corporation's chairman or chief executive officer and perhaps other officers may also have implied authority merely by virtue of their position,[434] or may have apparent authority by reason of corporate conduct on which persons dealing with the corporation reasonably rely.[435]

If a shareholder wants to retain a veto over actions of officers, it may be necessary to include in the charter or bylaws provisions that narrowly define the authority and duties of

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[432] Corporate officers generally serve at the pleasure of the board of directors. Most state statutes provide for the removal of officers by the board if in the "best interest" of the corporation. See 805 ILCS 5/8.40; Mo. Rev. Stat. §351.365. Some states allow board removal of officers without cause. See Ohio Rev. Code Ann. §1701.64. Cf. Minn. Stat. §302A.341 and N.D. Cent. Code §10-19.1-58 (board removal of officers without cause, subject to contrary shareholders' agreement); Cal. Corp. Code §312 (officer removal by board without cause unless otherwise provided in the articles or bylaws). Some state statutes restrict the board's power to remove shareholder-chosen officers. See, e.g., S.C. Code Ann. §33-8-430 (removal by shareholders only); New York Business Corporation Law §716 and MCLA §450.1535 (shareholder-chosen officers may be suspended by the board). In Kansas only shareholders can remove officers. Kan. Stat. Ann. §17-6301.

[433] This authority, generally stated in the bylaws, may include a broad spectrum of management activities; for example, an officer may be authorized to initiate or settle litigation, conduct audits, execute notes, negotiate and execute commercial and employment contracts, receive and disburse corporate funds, or declare dividends. For examples of statutes providing for the authority of officers, see Cal. Corp. Code §312; Del. Code Ann. tit. 8, §142; 805 ILCS 5/8.50; MCLA §450.153; New York Business Corporation Law §715; Ohio Rev. Code Ann. §1701.64.

[434] Implied authority is a subdivision of an agent's actual authority and can be distinguished from authority expressly stated in the statute, articles, bylaws, or a resolution of the board of directors. See Restatement Second, Agency §8. The source of implied authority can be found in a previous course of conduct between the corporation and the officer. Some courts are willing to presume broad implied authority for officers, particularly the chief executive officer. See Western American Life Ins. Co. v. Hicks, 135 Ga. App. 90, 217 S.E.2d 323 (1975), cause dismissed, 235 Ga. 603, 221 S.E.2d 27 (1975); Quigley v. W.N. Macqueen & Co., 321 Ill. 124, 151 N.E. 487 (1926).

[435] Apparent authority differs from actual authority in that it turns on the relationship between the principal and a third party, rather than the relationship between the principal and the agent. Even if a corporation has not granted an officer actual authority through an express provision in the articles, bylaws or board's resolution or by a course of action from which the agent can imply authority, the corporation nonetheless can represent to a third party that the officer has authority to act for the corporation, thus creating apparent authority. See Restatement Third, Agency §2.03. See also Lee v. Jenkins Bros., 268 F.2d 357, 370 (2d Cir. 1959), where the court stated: "Apparent authority is essentially a question of fact. It depends not only on the nature of the contract involved, but the officer negotiating it, the corporation's usual manner of conducting business, the size of the corporation and the number of its stockholders, the circumstances that give rise to the contract, the amounts involved, and who the contracting third party is, to list a few but not all of the relevant factors."

corporate officers.[436] An alternative way to provide a veto over important actions – such as disbursing corporate funds or borrowing money for the corporation – is an arrangement requiring the signature of two persons for the execution of checks, promissory notes and perhaps other documents, and then specifying that each of the two signatories represent a different shareholder or faction of shareholders.[437] A variation of this type of arrangement limits a corporate officer's authority to transactions involving a relatively small dollar amount unless the officer obtains the concurrence of another officer or the advance consent of the board of directors. An express charter or bylaws limitation on officers' authority may also serve to guard against an expansive judicial review of an officer's implied authority.

In the absence of a limiting charter or bylaws provision, courts have often found that a corporation's chief executive officer has broad implied authority simply by virtue of the office. This implied authority has been said to extend only to ordinary business transactions,[438] but in

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[436] Officers may have broad powers to bind their corporation in the absence of restrictions on their authority. See Cal. Corp. Code §312; Del. Code Ann. tit. 8, §142; 805 ILCS 5/8.50; MCLA §450.1531; New York Business Corporation Law §715; Ohio Rev. Code Ann §1701.64. See also Zaubler v. West View Hills, Inc., 148 Conn. 540, 172 A.2d 604 (1961) (majority shareholder-directors cannot squelch suit instituted by shareholder-president by ousting him from office); Tenney v. Rosenthal, 6 N.Y.2d 204, 189 N.Y.S.2d 158, 160 N.E.2d 463 (1959) (director may continue a derivative suit brought while he was a director even if removed from office while the suit is pending); West View Hills, Inc. v. Lizau Realty Corp., 6 N.Y.2d 344, 189 N.Y.S.2d 863, 160 N.E.2d 622 (1959) (even though authority was not expressly granted to the corporation's president, he was held to have the power to bring suit against the corporation' majority shareholder-directors).

[437] See, Schrewe v. Scott Mfg. Corp., 258 So. 2d 668 (La. Ct. App. 4th Cir. 1972), for a bylaw requiring the signature of two corporate officers for the corporation to enter into an employment contract). See also Bloomingdale v. Cushman, 134 Minn. 445, 159 N.W. 1078 (1916), where the court held that neither the president nor secretary of the corporation has authority, either express or implied, to execute promissory notes where a bylaw required promissory notes of the corporation to be executed by both its president and its secretary. A shareholder's power to veto officer action may be lost by his failure to require compliance with the veto arrangement. See, e.g., Berdane Furs, Inc. v. First Pennsylvania Banking & Trust Co., 190 Pa. Super. 639, 155 A.2d 465 (1959), where the court held that a sustained course of corporate conduct contrary to a resolution requiring two signatures on a promissory note estopped the corporation from setting up noncompliance with the resolution as a defense. A veto arrangement of the kind discussed here of course increases the possibility of deadlock. See, e.g., Application of Sheridan Const. Corp., 22 A.D.2d 390, 256 N.Y.S.2d 210 (4th Dep't 1965), order aff'd, 16 N.Y.2d 680, 261 N.Y.S.2d 300, 209 N.E.2d 290 (1965), where the ownership and control of the corporation was held equally by two brothers, and a bitter dispute between the brothers eventually resulted in dissolution of the corporation.

[438] See, e.g., Buxton v. Diversified Resources Corp., 634 F.2d 1313 (10th Cir. 1980) (president's authority is limited to matters within the ordinary course of activities for the office, as determined expressly or implicitly by the board of directors); Lee v. Jenkins Bros., 268 F.2d 357 (2d Cir. 1959) 1959) (lifetime or permanent employment contracts are generally held not to be ordinary business transactions and therefore are not within the president's authority); Custer Channel Wing Corp v. Frazer, 181 F. Supp. 197 (S.D. N.Y. 1959) (litigation on behalf of the corporation is incidental to the regular course of activities conducted by the president).

some cases courts have taken a broad view of what constitutes an ordinary business transaction[439] or have recognized a presumption of broad authority and required the person challenging the officer's power to bind the corporation to show lack of authority.[440]

Participants concerned about retaining a veto over officers' action should prevent the board from engaging in a course of action that could create apparent authority in the officer, and they should guard against corporate ratification of unauthorized officers' action. As an additional protection against unauthorized officers' action, the participants can require the bonding of corporate officers: that requirement protects the corporation and derivatively the shareholders, if officers exceed their authority and thereby cause loss to the corporation.[441]

Precautions to observe in drafting veto arrangements

If the participants decide that a veto is the desired way of organizing their business relationship, the variety of choices available to the planner raises a series of issues, to wit:

Placement of the Veto. Shareholders' control agreements, now explicitly authorized in most states, authorize veto arrangements providing an alternative to the traditional placement in the corporation's charter or bylaws. Even in those states where such arrangements interfering with directors' control of the corporation must be in the charter, courts have been willing to uphold agreements among all the shareholders. Charter placement, the traditional location of veto language, can provide a clearer structural presentation of how the veto will work and reduce the need for judicial enforcement. Charter placement also will have an advantage for an arrangement

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439 See, e.g., New England Merchants Nat. Bank v. Lost Valley Corp., 119 N.H. 254, 400 A.2d 1178 (1979) (unauthorized contractual acts by an officer on behalf of the corporation are ratified by the corporation if the board of directors accepts benefits under the contract or fails to promptly disaffirm the acts).

440 See, e.g., Western American Life Ins. Co. v. Hicks, 135 Ga. App. 90, 217 S.E.2d 323 (1975), cause dismissed, 235 Ga. 603, 221 S.E.2d 27 (1975), cause dismissed 235 Ga. 603, 221 SE2d 27 (1975) (president is presumed to have authority to act for the corporation on matters within the scope of ordinary business); Quigley v. W.N. Macqueen & Co., 321 Ill. 124, 151 N.E. 487 (1926) (corporate president, who promised on behalf of the corporation to repurchase shares at the shareholder's request, is presumed, as head of the company and its general agent, to have authority to enter into any contract within the scope of the corporation's ordinary business).

441 O'Neal & Thompson, O'Neal and Thompson's Close Corporations and LLCs: Law and Practice, §4:29 (rev. 3rd ed. 2009, database updated July 2013).

by less than all of the shareholders or in a state where clear authority for shareholders' control agreements does not yet exist.

Who Enacts the Veto? Shareholders' control agreements usually require all shareholders to agree, and in the absence of statute, courts may impose a similar requirement, while charter and bylaws can usually be enacted by a majority, but not by all of the shareholders. Some states impose special provisions that require a supermajority provision in a charter to be enacted by a supermajority.

Notice to non-assenting or new shareholders. It is often necessary to provide a legend on the stock or otherwise give notice to potential purchasers of shares or non-assenting shareholders.

Breadth of the Veto: Unanimity or Supermajority. In an earlier period of corporate law, unanimity requirements were shunned because of the concern over the obvious potential for deadlock or the bias against departures from the traditional pattern of corporate management often shown by courts in earlier times.[442] These concerns are seldom mentioned in modern judicial opinions.[443] Some statutes expressly provide for unanimity requirements for shareholders

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[442] See, McQuade v. Stoneham, 263 N.Y. 323, 189 N.E. 234 (1934) (unanimity provision for altering the amount of capital, the bylaws, the number of shares, salaries, and business policies held invalid); Kaplan v. Block, 183 Va. 327, 336, 31 S.E.2d 893, 896–897 (1944). "To ask that directors be divested of all power and that without the consent of every stockholder no one should have the power to do anything is to ask too much." superseded by Va. Code Ann. §13.1-33, which authorizes articles provisions requiring unanimity or a high vote for shareholders' action.

[443] For examples of judicial decisions upholding unanimity provisions, see Adler v. Svingos, 80 A.D.2d 764, 436 N.Y.S.2d 719 (1st Dep't 1981) (upheld unanimous shareholders' agreement, not included in the articles, providing that all corporate operations, including changes in corporate structure, would require the unanimous consent of the shareholders); Zion v. Kurtz, 50 N.Y.2d 92, 428 N.Y.S.2d 199, 405 N.E.2d 681, 15 A.L.R.4th 1061 (1980) (court enforced as valid a shareholders' agreement providing that no business or activities of a closely held corporation could be conducted without the consent of the minority shareholder); Roland Park Shopping Center, Inc. v. Hendler, 206 Md. 10, 21, 109 A.2d 753, 758 (1954) (requirement of unanimous consent for shareholders' action is not unreasonable; "the potential tyranny of a minority, having a veto power, is no worse than the possible autocracy of a majority"). Cf. Nordin v. Kaldenbaugh, 7 Ariz. App. 9, 435 P.2d 740 (1967) (court held that while an agreement among shareholders requiring unanimous shareholders' consent for the issuance of stock is normally not binding on the corporation, such an agreement does bind a close corporation if the shareholders are also its directors, managers and officers). See Sutton v. Sutton, 84 N.Y.2d 37, 614 N.Y.S.2d 369, 637 N.E.2d 260 (1994) (upholding an unanimous provision in the certificate of incorporation; "there is nothing inherently unfair or improper about voluntary organizations' consensual decision to assure protection for minority shareholders, and shareholders are not without remedies where deadlocks do arise").

or directors' action,[444] and other statutes are phrased in language that clearly provides support for a veto provision phrased in terms of unanimity.[445] In most states, the statutory language authorizing charter provisions increasing the vote necessary for shareholders' action is phrased in terms of a "greater proportion of the shares" than is otherwise provided by law, language which could easily be interpreted to permit a requirement of unanimity rather than just a requirement of an affirmative vote by holders of some high percentage of the shares.[446]

Where there is any doubt about the acceptance of unanimity requirements in a particular jurisdiction, the drafter may be well advised to use a very high percentage requirement rather than a requirement of unanimity. For example, if a power of veto is to be given to a shareholder holding 11 percent of a corporation's voting stock, shareholders' action might better be conditioned upon concurrence of holders of 90 percent of the shares rather than unanimity. A requirement of unanimity, however, has at least one advantage over a high vote requirement: with a requirement of unanimity, minority shareholders do not have to establish special safeguards to prevent the issuance of new shares that will decrease their proportionate voting power below the percentage necessary to accomplish a veto. Estate planning is sometimes facilitated by use of a high vote requirement rather than a requirement of unanimity.

Limitation of veto to areas of business need. As a general proposition, the power to veto should be limited to those corporate activities over which a veto is needed to protect legitimate business

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444 See, e.g., N.J. Stat. Ann. §14A:6-12.

445 Several state statutes permit a corporation's articles or bylaws to require a "greater number of votes" for shareholders' action than prescribed by the statute. See, e.g., Va. Code Ann. §§13.1-666, 13.1-668. Cf. La. Rev. Stat. Ann. §12:75 ("except as otherwise provided" in the articles or bylaws). Delaware and Kansas permit a corporation to determine the vote and quorum needed for shareholders' action, subject to certain limitations. Del. Code Ann. tit. 8, §216 (subject to minimum statutory requirements for certain fundamental actions); Kan. Stat. Ann. §17-6506 (subject to inflexible statutory requirements for certain fundamental actions).

446 See, e.g., Cal. Corp. Code §204; MCLA §450.1455; New York Business Corporation Law §616; Ohio Rev. Code Ann. §1701.52. An early Delaware decision, however, suggested that a unanimity provision might be invalid under a former Delaware statute with the "greater proportion" language. See "reservation" in Sellers v. Joseph Bancroft & Sons Co., 23 Del. Ch. 13, 26, 2 A.2d 108, 114 (1938). Compare discussion in Investment Associates v. Standard Power & Light Corp., 29 Del. Ch. 225, 48 A.2d 501, 506 (1946), decree aff'd by, 29 Del. Ch. 593, 51 A.2d 572 (1947).

interests. In most situations, the conferring of a blanket power to veto any or all of corporate acts is inadvisable because the existence of the power increases the chance of deadlock and corporate paralysis.[447] In some situations, instead of giving each shareholder or a particular shareholder a power of veto, the wiser course may be to set the vote requirement somewhat lower so that two or three shareholders will have to combine to exercise a veto. For example, if each of the five shareholders in a corporation can place a representative on the corporation's five-person board of directors,[448] perhaps adequate protection can be given to minority interests against arbitrary action by the majority, by requiring the concurrence of four directors for effective action. Under this kind of an arrangement, the risk of corporate paralysis or of one director forcing unreasonable concessions from his colleagues is considerably reduced, because no one director is in a position to block directors' action. The drafter must also keep in mind that a court may find that veto provisions are to be strictly construed:[449] In a Delaware case where the charter required a supermajority vote to approve any indebtedness for borrowed money exceeding $15 million, the court permitted the board to go forward with a $100 million expansion funded by operating leases that were said not to be borrowed money.[450] At least one court has warned that charter provisions departing from majority rule will be given effect only if they are clear, explicit and susceptible of but one reasonable interpretation.[451] Therefore, veto provisions must be couched in language free from ambiguity. A provision requiring unanimity for shareholders' action, for

[447] See, Atlantic Properties, Inc. v. C. I. R., 519 F.2d 1233 (1st Cir. 1975) (corporation's accumulated earnings were unreasonable and corporation did not sustain burden of showing absence of purpose to avoid federal accumulated earnings tax, 26 U.S.C.A. §531, despite proof that 80 percent vote requirement for approval of corporate action had enabled holder of 25 percent of corporation's shares to prevent distribution).

[448] See, the shareholders' agreement before the New York Court of Appeals in Beresovski v. Warszawski, 28 N.Y.2d 419, 322 N.Y.S.2d 673, 271 N.E.2d 520 (1971), which provided, among other things, that each of three shareholders would be corporate directors and a fourth director would be elected annually by the three shareholders and that action by this four-person board would require the vote of three directors.

[449] In re Explorer Pipeline Co., 781 A.2d 705 (Del. Ch. 2001) (supermajority provisions strictly construed because they are at odds with fundamental principle of majority rule).

[450] In re Explorer Pipeline Co., 781 A.2d 705 (Del. Ch. 2001).

[451] Standard Power & Light Corp. v. Investment Associates, 29 Del. Ch. 593, 51 A.2d 572, 576 (1947). See also In re Brown's Estate, 130 Ill. App. 2d 514, 264 N.E.2d 287 (2d Dist. 1970), noted in 1971 Duke L.J. 821).

instance, should be so worded that there can be no questions that approval of all holders of shares outstanding is necessary, not just approval of holders of shares present or represented at a shareholders' meeting.[452]

Guarding against repeal or circumvention of veto provisions

If the decision is made to place veto provisions in the charter and bylaws, the drafter must give careful thought to safeguarding those provisions against repeal and against other circumvention by manipulation on behalf of majority interests. Most corporation statutes authorize charter amendment by a vote of the holders of a simple majority of the shares with voting power.[453] Similarly, the statutes often permit bylaws to be amended or repealed by a simple majority vote of shareholders[454] or by action of a majority of directors.[455] Thus, veto provisions in the charter or bylaws must be protected against the power of amendment and repeal ordinarily possessed by majority interests. Otherwise, the veto can be thwarted by a two-step process: first, amendment or repeal of the veto provisions; second, passage of a resolution by the shareholders or directors, as the case may be, authorizing the action which before the amendment would have

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[452] See Investment Associates v. Standard Power & Light Corp., 29 Del. Ch. 225, 48 A.2d 501 (1946), decree aff'd by, 29 Del. Ch. 593, 51 A.2d 572 (1947).

[453] See, e.g., Cal. Corp. Code §903; Del. Code Ann. tit. 8, §242; Kan. Stat. Ann. §17-6602; MCLA §450.1611; New York Business Corporation Law §803. But see 805 ILCS 5/10.20; Ohio Rev. Code Ann. §1701.71 (requiring approval of two-thirds of the outstanding shares entitled to vote for articles amendments). For an example of circumvention of a veto arrangement through amendment of the articles, see Morales v. Sevananda, Inc., 162 Ga. App. 854, 293 S.E.2d 387 (1982), noted 35 Mercer L. Rev. 44 to 45 (1983) (court held that the right of members of a nonprofit corporation's board of directors under the corporation's original articles of incorporation to be removed from office only by a two-thirds vote of the entire board did not preclude the board from amending the articles of incorporation to eliminate lifetime directorships).

[454] See, e.g., Del. Code Ann. tit. 8, §109; New York Business Corporation Law §601. For examples of the use of bylaw amendments to circumvent veto arrangements, see Rowland v. Rowland, 102 Idaho 534, 633 P.2d 599 (1981), noted 19 Idaho L. Rev. 303 to 305 (1983), 71 Ky. L.J. 279 (1982) (court upheld action of majority shareholders in amending a provision in the corporate bylaws to remove a requirement that actions by the corporation's board of directors be approved by the affirmative vote of at least 75 percent of the directors); Roach v. Bynum, 403 So. 2d 187 (Ala. 1981), noted 71 Ky. L.J. 282 (1982) (court refused to order dissolution of a corporation based on an assertion that its shareholders were deadlocked in conducting corporate business, because the bylaw which required a high vote for shareholder action and thus created the deadlock, could be amended, altered or repealed by a majority vote of the shareholders).

[455] See, e.g., Minn. Stat. § 302A.181. Several state statutes allow amendment of the bylaws by majority vote of either the shareholders or the board of directors. See, e.g., Cal Corp Code §211; 805 ILCS 5/2.25; MCLA §§450.1231, 450.1523.

been subject to veto.[456]

The corporation statutes of most states prevent majority shareholders from amending or repealing veto provisions in the charter by requiring the same supermajority vote to change or delete a veto provision as is required for corporate action under that provision.[457] In jurisdictions, however, that do not have a statute of that kind a high vote requirement in the charter can be protected by inserting in the charter a clause requiring unanimity or a high vote for amendment or repeal of the charter provisions establishing a veto; high vote requirements in the bylaws can

[456] See Driver v. Driver, 119 Wis. 2d 65, 349 N.W.2d 97 (Ct. App. 1984) (circumvention of a high vote requirement through a subsequent amendment of a corporation's bylaws); Blount v. Taft, 295 N.C. 472, 246 S.E.2d 763 (1978), noted 15 Wake Forest L. Rev. 531 (1979), 68 Ky. L.J. 520 to 523 (1980) (shareholders unanimously inserted into the bylaws a provision that an executive committee composed of one member of each of the three families owning shares of stock in the corporation had to unanimously approve all persons employed by the corporation; the bylaws also contained a standard clause that they might be amended by a majority of the shareholders; two of the families adopted new bylaws by a majority vote of the shareholders over the objection of the third family, eliminating the unanimous consent for employment provision; the court held that the bylaw provision on employment could be amended by majority vote (as permitted by the bylaws) in the same manner as any other bylaw provision; if the parties had desired to make the provision on employment subject to amendment only by unanimous vote, they should have expressly so stated in the bylaws or should have included prohibitions against amendment in a separate shareholders' agreement). See Aldridge v. Franco Wyoming Oil Co., 24 Del. Ch. 126, 7 A.2d 753 (1939), determination sustained, 24 Del. Ch. 349, 14 A.2d 380 (1940); Warren v. 536 Broad St. Corp., 4 N.J. Super. 584, 68 A.2d 175 (Ch. Div. 1949), judgment aff'd, 6 N.J. Super. 170, 70 A.2d 782 (App. Div. 1950)); Markovitz v. Markovitz, 336 Pa. 122, 8 A.2d 36 (1939). Cf. Miller v. Magline, Inc., 105 Mich. App. 413, 306 N.W.2d 533 (1981) (court upheld the validity of an amendment of a corporation's articles of incorporation to extend the corporation's life over objection of minority shareholders); Trout v. Olson Bros. Mfg. Co., 209 Neb. 477, 308 N.W.2d 522 (1981) (court held that provision prohibiting the board of directors from altering or repealing corporate bylaws made, altered or repealed by the shareholders did not apply when the directors amended the initial bylaws). But see Bechtold v. Coleman Realty Co., 367 Pa. 208, 79 A.2d 661 (1951), recognizing two classes of bylaws: (1) mere regulations governing the conduct of the internal affairs of the corporation, which may be repealed or amended by majority vote unless a greater vote is specified by the bylaws or by statute, and (2) provisions in the nature of a contract evidently designed to vest property rights, which cannot be repealed or changed without the consent of the parties whose rights are affected. In Sutton v. Sutton, 196 A.D.2d 411, 601 N.Y.S.2d 106, 108 (1st Dep't 1993), order aff'd, 84 N.Y.2d 37, 614 N.Y.S.2d 369, 637 N.E.2d 260 (1994), the appellate division court held that a unanimous requirement in a firm's certificate (which specifically mentioned any changes to the firm's articles) could not be amended by the 2/3 vote normally required by statute for articles amendments. Key to the court's holding was the "clear" language of the unanimity provision, the "crystal clear" intention of the parties and, most importantly, realizing that removing the unanimity provision by less than a unanimous vote would render the provision utterly meaningless. See LaFleur v. Guilbeau, 617 So. 2d 1362 (La. Ct. App. 3d Cir. 1993) (corporation's bylaws required 81% of the board of directors to change the number of directors; however, change in by laws was controlled by a majority of shareholders). See also Whetstone v. Hossfeld Mfg. Co., 457 N.W.2d 380 (Minn. 1990) (when articles of incorporation and bylaws of a closely held corporation are amended in order to eliminate a minority shareholder's veto power, the shareholder is allowed to dissent from these amendments and obtain payment for the fair value of shareholder's shares). See Kern v. Arlington Ridge Pathology, S.C., 893 N.E.2d 999 (Ill.App. 1 Dist. 2008) (where veto protection was contained in bylaws, majority of directors were able to remove minority shareholder by amending the articles to require a lower threshold for amending bylaws and for removal of employees and directors).

[457] See Cal. Corp. Code §706; Del. Code Ann. tit. 8, §242(c)(4); Minn. Stat. §302A.135(4); N.J. Rev. Stat. § 14A:5-12(2). See also New York Business Corporation Law §616(b), 709(b); Model Business Corporation Act §7.27(b). Cf. Ohio Rev. Code Ann. §1701.53.

be protected by inserting in the charter, bylaws, or in both instruments,[458] clauses requiring a unanimous or high vote by shareholders for the modification or repeal of veto provisions in the bylaws.[459] Most corporation statutes specifically permit unanimity or a high percentage vote to be required for charter or bylaws amendments.[460] In a few jurisdictions, however, apparent mandatory phrasing of the statutory provisions specifying the vote for charter or bylaws amendments[461] creates some doubt about the enforceability of a clause which sets the vote for charter or bylaws amendments higher than the figure fixed by statute. In these jurisdictions, perhaps veto provisions in the charter and bylaws can be protected against amendment by an agreement among all of the shareholders or between the corporation and its shareholders not to amend.[462]

A power of veto can also be lost through merger or consolidation; or shareholders

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[458] Provisions governing the amendment of bylaws often may be placed in either the articles or bylaws. Whenever the law permits, the provisions should be inserted in both. See Sunshine Villa Apartments, Inc. v. Haddad, 312 So. 2d 810 (Fla. Dist. Ct. App. 4th Dist. 1975) (bylaws may be merely declarative or repetitive of articles provisions but otherwise one bylaws provision cannot limit power to amend another bylaws provision, since limiting bylaws provisions is itself subject to amendment or repeal). See also Centaur Partners, IV v. National Intergroup, Inc., 582 A.2d 923 (Del. 1990) (shareholders brought action seeking determination of percentage of outstanding shares required to amend bylaws; court held the articles of incorporation were clear and unambiguous in requiring that 80% supermajority was needed to amend bylaws and thus presumption of majority rule was overcome).

[459] Of course, specific provisions of this kind are not necessary if an effective veto has been given over all amendments of articles and bylaws. See Seibert v. Milton Bradley Co., 360 Mass 656, 405 NE2d 131 (1980), noted 69 Ky. L.J. 476 to 479 (1981), for an example of how a high vote requirement in a corporation's bylaws can be protected by a bylaw provision specifically stating that any amendment, modification or repeal of the high-vote bylaw requires the same vote of the shareholders or directors as is required to approve the corporate action which was the subject of the high vote requirement.

[460] Even Benintendi v. Kenton Hotel, 294 N.Y. 112, 118–119, 60 N.E.2d 829, 159 A.L.R. 280 (1945), which declared invalid a number of veto provisions in the bylaws, sustained a bylaw requirement of unanimous approval of the shareholders for amendment of the bylaws.

[461] A majority of the state statutes either expressly allow provisions in the articles increasing the vote requirement for the latter amendment or contain language requiring "at least" majority or two-thirds approval for amendments, thus suggesting that a supermajority requirement for amendment would be valid. See, e.g., Cal. Corp. Code §903; 805 ILCS 5/10.20; MCLA §450.1611; Ohio Rev. Code Ann. §1701.71. But see Kan. Stat. Ann. §§17-6506, 17-6602 (majority approval required for articles amendment; supermajority vote provisions cannot alter statutory vote requirements for certain fundamental changes); Warren v. 536 Broad St. Corp., 4 N.J. Super. 584, 68 A.2d 175, 180 (Ch. Div. 1949), judgment aff'd, 6 N.J. Super. 170, 70 A.2d 782 (App. Div. 1950) (strong dictum suggesting that the two-thirds vote specified for articles amendments by statute formerly in effect in New Jersey was mandatory).

[462] In British Murac Syndicate, Ltd. v. Alperton Rubber Co., Ltd., [1915] 2 Ch. 186 (CA), the court restrained a company from violating a contract not to alter its articles of association, the contract having been entered into by the company and a syndicate holding some of its stock. But see views expressed in Aldridge v. Franco Wyoming Oil Co., 24 Del. Ch. 126, 7 A.2d 753 (1939), determination sustained, 24 Del. Ch. 349, 14 A.2d 380 (1940), on alleged oral agreement by shareholders not to amend articles.

attempting to exercise a veto may be "frozen out" by the dissolution of the corporation and the formation of a new corporation without the dissenters, or by the transfer of all the corporate assets to another enterprise.[463] Therefore, approval of all or of a high percentage of shareholders usually should be required for such fundamental corporate acts as merger, consolidation, voluntary dissolution of the corporation or the sale of all or substantially all corporate assets.[464] Veto provisions based on a high percentage vote of shareholders must be protected from circumvention occurring through the issuance of additional shares. Otherwise, majority interests may be able to deprive a minority shareholder of veto power simply by increasing the number of outstanding shares until the minority holdings are less than the fraction of outstanding shares required for a veto. Frustration of the veto by this procedure can usually be avoided by the insertion of appropriate provisions in the charter (e.g., clauses providing that treasury shares and authorized but unissued stock can be issued only with the approval of holders of a specified proportion of the shares outstanding, clauses requiring a unanimous or high shareholders' vote to increase the amount of authorized stock, clauses assuring shareholders a preemptive right to their proportionate part of new issues of shares,[465] or combinations of these).

Similarly, veto provisions requiring a high vote for action by the directors may be nullified by an increase in the number of directors.[466] Fixing the number of directors in the

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[463] Mordka v. Mordka Enterprises, Inc., 143 Ariz. 298, 693 P.2d 953 (Ct. App. Div. 2 1984) (court granted involuntary dissolution order sought by one of three shareholders; unanimous shareholders' agreement requiring unanimous consent for certain corporate action resulted in deadlock and threat of irreparable injury to the corporation). See Ward v. Colcord, 110 Ill. App. 2d 68, 249 N.E.2d 137 (1st Dist. 1969) (order of dissolution frustrated a high vote requirement and provided a means for squeezing out minority shareholders). But see Kavanaugh v. Kavanaugh Knitting Co., 226 N.Y. 185, 123 N.E. 148 (1919).

[464] See Young v. Valhi, Inc., 382 A.2d 1372 (Del. Ch. 1978) (court found merger unfair when used to circumvent a supermajority provision). For use of the statutory buy-out provision to thwart a veto power held by a minority shareholder in a closely held corporation over all board of director and corporate action, see Matter of Musilli, 134 A.D.2d 15, 523 N.Y.S.2d 120 (2d Dep't 1987).

[465] Preemptive rights alone are not a complete protection to a shareholder of limited means, because at the critical time he may not have funds available to exercise his preemptive rights. For other shortcomings of preemptive right as a device for protecting minority shareholders, see O'Neal and Thompson's Oppression of Minority Shareholders and LLC Members §3:2 (Rev. 2nd ed.).

[466] The danger that a veto arrangement may be circumvented by an increase in the number of directors is illustrated

charter or bylaws, and requiring unanimity or a high shareholders' vote to increase the size of the board can usually avoid this risk.[467] A shareholder with a veto must also be protected against the possibility of losing his veto over matters within the province of the directors through the death or incapacity of the director representing that shareholder's interests. The desired result can usually be achieved by stating in the charter or bylaws that the board cannot act until a vacancy has been filled, and requiring unanimous shareholders' approval to fill a vacancy. In some situations, it may be possible to give a minority shareholder exclusive power to fill a vacancy created by the death of that shareholder's representative on the board. If the corporation's articles or bylaws are amended to eliminate veto rights, a minority may be entitled to exercise dissenters' rights and obtain fair value for the minority's shares.[468]

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by Odman v. Oleson, 319 Mass. 24, 64 N.E.2d 439 (1946). See also Christal v. Petry, 275 A.D. 550, 90 N.Y.S.2d 620 (1st Dep't 1949), judgment aff'd, 301 N.Y. 562, 93 N.E.2d 450 (1950), holding that the bylaws may not restrict the statutory right of majority shareholders to increase the number of directors, but indicating that a restriction of that kind would be effective if inserted in the certificate of incorporation or if unanimously approved in writing by the shareholders.

[467] See Cal. Corp. Code §212 (number of directors may be increased by shareholder action only). But see Christal v. Petry, 275 A.D. 550, 90 N.Y.S.2d 620 (1st Dep't 1949), judgment aff'd, 301 N.Y. 562, 93 N.E.2d 450 (1950), holding that a bylaw provision requiring approval of 75 percent of the voting stock to increase the number of directors was void as inconsistent with a statute providing that the number of directors may be increased by the holders of a majority of the outstanding shares.

[468] See Whetstone v. Hossfeld Mfg. Co., 457 N.W.2d 380 (Minn. 1990) (shareholder owning 36% of closely held corporation's stocks brought action to assert rights of dissenting shareholder after provisions were eliminated from articles of incorporation and bylaws which gave him certain veto power; court held that when articles of incorporation and bylaws of closely held corporation are amended in order to eliminate minority shareholder's veto power, shareholder is entitled to dissent from those amendments and obtain payment for fair value of shareholder's shares).

X. IMPLEMENTATION OF SHAREHOLDERS' AGREEMENTS

Shareholders' agreements may be "free-standing" or they may be incorporated into a corporation's charter or bylaws. Most states have statutes, such as Section 7.32 of the Model Business Corporation Act, authorizing shareholders' control agreements; separate statutes authorizing pooling agreements, voting trusts or irrevocable proxies are almost universal among the states. As already discussed, the statutes like section 7.32 give a list of non-exclusive examples that cover most types of agreements participants in a close corporation would desire. Veto provisions are not mentioned explicitly by name but are covered within the listed example authorizing provisions relating to the exercise of voting power among shareholders or among directors.[469] Those states without a specific authorization of shareholders' control agreements almost always contain a statute authorizing the parties to carve out exceptions from the default rule of directors' control by including a provision in the corporation's charter (or bylaws).[470] In these states, particularly if there is no satisfactory case law, provisions in a shareholders' agreement setting up such arrangements should be implemented by appropriate charter or bylaws clauses. Alternatively, if all shareholders are not parties to the agreement, as specified in section 7.32, for example, the agreement should be included in the charter.

In addition to the statutes permitting charter exceptions to the usual directors' control of corporations, state statutes also contain specific provisions permitting changes to voting rules similar to setting up a veto provision to that end. Indeed such statutes usually authorize a veto arrangement to be placed in the charter,[471] and sometimes in the charter or bylaws.[472] New York's

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[469] See, e.g., Model Business Corporation Act §7.32(a)(5).

[470] A few statutes permit limitations on directors' actions to be included in the articles, bylaws or a shareholders' agreement. In several states, special close corporation statutes specifically provide that veto arrangements in shareholders' agreements are enforceable. See, e.g., Cal. Corp. Code §204(a)(9); cf. Md. Corps & Ass'ns Code Ann. §4-401; Ohio Rev. Code Ann. §1701.591(B).

[471] See, e.g., Cal. Corp. Code §204(9); 805 ILCS 5/2A-40; Md. Corps. & Ass'ns Code Ann. §4-401; Ohio Rev. Code Ann. §1701.591(B); Wis. Stat. §180.1801. See, generally, 2 Model Business Corporation Act Ann. §7.27 at 7-199 (4th ed.).

statute, for example, authorizes high quorum requirements for shareholders' or directors' meetings or high vote requirements for shareholders or directors' action only if they are contained in the corporation's charter.[473] In some cases, omission from the charter may be a conscious choice, because charters are public records, and shareholders may not want their control sharing arrangements be disclosed to outsiders. In the absence of statutory authorization, some courts have refused to enforce veto arrangements in shareholders' agreements.[474] Despite

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[472] For examples of statutes allowing provisions requiring supermajority votes to be placed in either the articles or the bylaws, see Del. Code Ann. tit. 8, §216; 805 ILCS 5/8.15; MCLA §450.1523 (supermajority for board's action). For examples of statutes permitting "superquorum" provisions to be placed in either the articles or the bylaws, see Del. Code Ann. tit. 8, §216; MCLA §450.1415; Ohio Rev. Code Ann. §1701.51 (superquorum for shareholders' meetings); Del. Code Ann. tit. 8, §141; (superquorum for board meetings); N.D. Cent. Code §10-19.1-77 (permits a provision granting a shareholder or class of shareholders more than one vote per share to be placed in either the articles or the bylaws). Almost all states that permit weighted voting by shareholders or directors permit such voting be provided for in the articles. See e.g., Del. Code Ann. tit. 8, §212, 805 ILCS 5/7.40; MCLA §450.1441; New York Business Corporation Law §612; Ohio Rev. Code Ann. §1701.44; or a shareholders' control agreement Ga. Code Ann. §14-2-732 (weighted vote provision may be placed in either the articles or a shareholders' agreement). Cf. ND. Cent. Code §10-19.1-77 (weighted vote provision may be placed in either the articles or the bylaws). North Carolina's Business Corporation Act requires shareholder veto procedures to be in the articles or in bylaws approved by the shareholders (N.C. Gen. Stat. §55-7-25).

[473] New York Business Corporation Law §§614, 616, 707, 709. Under an earlier New York statute, the New York Court of Appeals invalidated veto provisions in a corporation's bylaws, using language broad enough to suggest that veto provisions would be invalid, as violative of public policy, even if placed in the articles. Benintendi v. Kenton Hotel, 294 N.Y. 112, 60 N.E.2d 829, 159 A.L.R. 280 (1945). One other combination is requiring supermajority vote requirements for shareholders' action to be in the articles or bylaws but requiring a supermajority vote requirement for particular shareholder actions, such as articles amendment or merger, to be in the articles of incorporation.

[474] See, e.g., Roach v. Bynum, 403 So. 2d 187 (Ala. 1981), noted 71 Ky. L.J. 282 (1982) (under the Alabama corporation code a provision mandating a greater than majority shareholder vote may be included in a corporation's certificate of incorporation but not in its bylaws); Berkowitz v. Firestone, 192 So. 2d 298 (Fla. Dist. Ct. App. 3d Dist. 1966) (the court held that bylaws prescribing a high vote requirement for shareholder and director action were invalid, *inter alia*, because the statute which authorized high quorum requirements did not authorize high vote requirements); Waggoner v. Laster, 581 A.2d 1127 (Del. 1990) (in absence of authority in corporation's certificate of incorporation to issue convertible preferred shares with supermajority voting rights, those voting rights, used to oust other directors, were null and void); Somers v. AAA Temporary Services, Inc., 5 Ill. App. 3d 931, 284 N.E.2d 462 (1st Dist. 1972) (unanimous agreement among shareholders to amend the bylaws, reducing the number of directors from three to two, was invalid because the power to amend the bylaws had not been reserved to the shareholders); Jones v. Wallace, 291 Or. 11, 628 P.2d 388 (1981) (court held that bylaws provision defining a shareholder quorum as all outstanding shares entitled to vote was invalid where Oregon corporation law required super quorum provisions to be placed in the articles of incorporation).

Many of the states, e.g. Alabama, Florida and Oregon, have since enacted statutes patterned on Section 7.32 of the Model Business Corporation Act that permit shareholders' control agreement to determine voting and Florida's business corporation act now permits both supermajority vote requirements and super quorum provisions. For New York law, see also Chiulli v. Reiter, 173 A.D.2d 672, 570 N.Y.S.2d 820 (2d Dep't 1991) (where bylaws, but not certificate. restricted corporate action without majority vote of shareholders, board authorized to mortgage property); Model, Roland & Co. v. Industrial Acoustics Co., 16 N.Y.2d 703, 261 N.Y.S.2d 896, 209 N.E.2d 553 (1965) (bylaw requiring two-thirds majority to amend the bylaws held invalid and unenforceable under New York Business Corporation Law); Mook v. Berger, 6 N.Y.2d 833, 188 N.Y.S.2d 219, 159 N.E.2d 702 (1959) (affirming a judgment declaring invalid provisions in an agreement among shareholders of a Connecticut corporation requiring the company's bylaws to be amended so that board action could not be taken without the concurrence of six

the New York statute's apparent requirement that supermajority-voting requirements must be in the charter, decisions by New York courts suggest that courts in that state probably will specifically enforce high vote requirements established in shareholders' agreements.[475] In Adler v. Svingos,[476] a 1981 decision by the Appellate Division of the New York Supreme Court, the court ruled on the validity of a clause in a shareholders' agreement executed by all three of a corporation's shareholders, which provided that all corporate decisions (including changes in the corporate structure) would require unanimous approval. Even though the provision was not contained in the corporation's certificate of incorporation, the court held that the veto provision was valid and did not violate section 620(b) of the New York statute, since the court could order the corporation's certificate of incorporation reformed to include the veto provision.

The court relied heavily on the decision of the New York Court of Appeals in *Zion v. Kurtz*, which interpreted a provision of the Delaware General Corporation Law similar to section 620(b).[477] Under these decisions, shareholders of New York closely held corporations may be

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directors, and invalidating the bylaws adopted pursuant to the agreement); In re William Faehndrich, Inc., 2 N.Y.2d 468, 161 N.Y.S.2d 99, 141 N.E.2d 597 (1957) (bylaw requiring two-thirds of outstanding shares to be present to constitute a quorum to elect directors held invalid for contravening "an essential part of the State policy" as reflected in then Section 9 of the New York Stock Corporation Law which required such veto provisions to be included in the articles); Fromkin v. Merrall Realty, Inc., 30 Misc. 2d 288, 215 N.Y.S.2d 525 (Sup 1961), judgment aff'd, 15 A.D.2d 919, 225 N.Y.S.2d 632 (2d Dep't 1962), commented on in Kessler, Business Associations, 14 Syracuse Law Review 232 (1962) (shareholders' agreement not to sell corporation's land without unanimous consent held invalid under Section 9 of the Stock Corporation Law, since the arrangement was not embodied in the corporation's articles).

[475] Most authorities indicate that a shareholders' agreement will be sustained even though the shareholders had an alternative method of providing a veto through statutorily sanctioned articles or bylaws provisions; Moss v. Waytz, 4 Ill. App. 2d 296, 124 N.E.2d 91 (1st Dist. 1955) (corporations act expressly permitted articles and bylaws provisions requiring high votes for corporate action); De Boy v. Harris, 207 Md. 212, 113 A.2d 903 (1955). See also Note, 69 Harvard Law Review 565 (1956).

[476] Adler v. Svingos, 80 A.D.2d 764, 436 N.Y.S.2d 719 (1st Dep't 1981); noted 35 Syracuse Law Review 40 to 43 (1984). But see Gazda v. Kolinski, 91 A.D.2d 860, 458 N.Y.S.2d 387 (4th Dep't 1982), aff'd in part, appeal dismissed in part, 64 N.Y.2d 1100, 489 N.Y.S.2d 907, 479 N.E.2d 252 (1985) (court held that insofar as a shareholders' agreement provided that there could be no increase in salaries without unanimous shareholder approval, it was void and unenforceable where the certificate of incorporation did not provide for such a limitation). See also Beresovski v. Warszawski, 28 N.Y.2d 419, 322 N.Y.S.2d 673, 271 N.E.2d 520 (1971), (overturning dismissal of supermajority provisions protecting a 25% shareholder and "[i]n the event any of the provisions of this agreement shall be deemed illegal or against public policy, the validity or legality of any of the other provisions or any part thereof shall not be thereby affected"; but, "if any illegal provision can be cured by amending the certificate of incorporation, the parties agree to take such action immediately.").

[477] Zion v. Kurtz, 50 N.Y.2d 92, 428 N.Y.S.2d 199, 405 N.E.2d 681, 15 A.L.R.4th 1061 (1980), noted 33 Syracuse Law Review 15 to 17 (1982). See also Ench v. Breslin, 241 A.D.2d 475, 659 N.Y.S.2d 893, 895 (2d Dep't 1997)

able to set up veto arrangements without amending the corporation's charter, but the better practice, in the exercise of an abundance of precaution, is to amend the charter to insert the arrangements.[478] Outside New York the result is similar with most courts giving effect to veto arrangements if there are no non-assenting shareholders.[479] Thus, where shareholders in a corporation assured a purchaser of shares that the corporation's structure was such that neither the shareholders nor the directors could act without approval of holders of 90 percent of the stock, the court restrained the taking of action by the shareholders or directors unless persons voting affirmatively held at least 90 percent of the outstanding shares.[480] Similarly, an Illinois court sustained an agreement among the three shareholders of a corporation giving one of the shareholders power to veto any amendment to the bylaws, any change in corporate officers or their salaries, or any proposal to incur expense or declare dividends; this agreement, the court concluded, did not violate a statute providing that a majority of the directors elected should

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(shareholders' agreement is binding as between original parties to it and enforceable even though all formal steps required by statute to effectuate agreement have not been fulfilled); Kronenberg v. Sullivan County Steam Laundry Co., 91 N.Y.S.2d 144 (Sup 1949), order aff'd, 277 A.D. 916, 98 N.Y.S.2d 658 (3d Dep't 1950); Sutton v. Sutton, 84 N.Y.2d 37, 614 N.Y.S.2d 369, 637 N.E.2d 260, 263 (1994) ("[T]here is nothing inherently unfair or improper about a voluntary organization's consensual decision to assure protection for minority shareholders (by including a unanimity provision), and shareholders are not without remedies where deadlocks do arise.").

[478] An even better solution of course would be for the New York legislature to amend the statute to make shareholders' agreements and bylaws fixing high vote requirements valid and enforceable.

[479] Nordin v. Kaldenbaugh, 7 Ariz. App. 9, 435 P.2d 740, 744 (1967) (court upheld shareholders' agreement prohibiting the issuance of additional stock without unanimous shareholder consent); Moss v. Waytz, 4 Ill. App. 2d 296, 124 N.E.2d 91 (1st Dist. 1955); Fitzgerald v. Christy, 242 Ill. App. 343, 1926 WL 3943 (1st Dist. 1926); De Boy v. Harris, 207 Md. 212, 113 A.2d 903 (1955), noted in 69 Harvard Law Review 565 (1956); Katcher v. Ohsman, 26 N.J. Super. 28, 97 A.2d 180 (Ch. Div. 1953). A Louisiana court, citing precedent from 1854, viewed the articles of incorporation as a contract and applied contract interpretation rules to uphold an 80% supermajority procedure required for shareholder approval of the sale of corporate assets. Odenwald v. Bewajobe Corp., 824 So. 2d 494 (La. Ct. App. 4th Cir. 2002) (requirement for 80% shareholder approval for sale of any corporate asset applied to immovable as well as moveable property).

But see, Smith v. Atlantic Properties, Inc., 12 Mass. App. Ct. 201, 422 N.E.2d 798 (1981) (minority shareholder held liable for damages caused by unreasonable exercise of right to veto declarations of dividends). In the absence of a controlling statute, an agreement among less than all of the shareholders may be of doubtful validity if it gives one or more of the contracting parties a veto over shareholder or director action, especially if it gives a veto over director action; Harris v. Scott, 67 N.H. 437, 32 A. 770 (1893) (holding invalid an agreement between two shareholders which provided among other things that neither would vote for any change in the corporation either at shareholders' or at directors' meetings unless both agreed to it.).

[480] Katcher v. Ohsman, 26 N.J. Super. 28, 97 A.2d 180 (Ch. Div. 1953).

constitute a quorum for the transaction of business.[481] The decisions approving, in the absence of statute, veto arrangements set up by agreement of all the shareholders are proper, at least as long as the arrangements are confined to close corporations and there is no substantial danger of injury to creditors or to prospective shareholders unaware of the agreement.

As has been said, "[R]efusal to allow deviation from the statutory scheme of majority control may be desirable for public-issue corporations where the ability to reach effective corporation decision would be blocked by giving to large numbers of directors and shareholders an individual power to veto. But no public policy requires that the owner-manager-shareholders of a close corporation be prevented from unanimously limiting majority power."[482] If all of the shareholders of a corporation are parties to an agreement held to be valid, some courts will hold the corporation bound by the agreement even if the corporation is not formally a party to it.[483] Other courts will not hold the corporation bound. A Connecticut court refused to give effect, as against the corporation, to an agreement (entered into by three persons who constituted all the shareholders and all members of the board of directors), which provided that "all policies, management and operation" of the corporation's business would be by unanimous consent of the board. In addition, a Louisiana court has held that a proposed charter amendment not complying with the proper statutory formalities was enforceable as a contract.[484]

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[481] Fitzgerald v. Christy, 242 Ill. App. 343, 360, 1926 WL 3943 (1st Dist. 1926). "It may be that they included provisions in their agreement which could be called in question by creditors or by the corporation itself as a separate legal entity although not by any of the parties to the agreement as individuals." Cf. Moss v. Waytz, 4 Ill. App. 2d 296, 124 N.E.2d 91 (1st Dist. 1955), where the court indicated that the corporation as well as the contracting shareholders was bound by the agreement.

[482] 62 Harvard Law Review 526, 527 (1949).

[483] Nordin v. Kaldenbaugh, 7 Ariz. App. 9, 435 P.2d 740 (1967) (where stockholders who agreed to issuance of stock were also directors, managers, and officers of the corporation, their agreements were binding on the corporation); Merlino v. West Coast Macaroni Mfg. Co., 90 Cal. App. 2d 106, 111, 202 P.2d 748, 751 (1st Dist. 1949) ("There can be no question but that an agreement between stockholders who own substantially all of the stock of a corporation is enforceable against the contracting parties and the corporation."); Moss v. Waytz, 4 Ill. App. 2d 296, 124 N.E.2d 91 (1st Dist. 1955).

[484] See Dunham v. Dunham, 336 So. 2d 337 (La. Ct. App. 1st Cir. 1976), writ denied, 339 So. 2d 21 (La. 1976) (proposed amendment was not properly notarized and filed with the Secretary of State). For a case in which the court resolved a conflict between bylaws and articles' provisions by deeming the bylaws to be a shareholders'

Including a shareholders' agreement in a corporation's charter or bylaws may create an unexpected problem in that bylaws are easier to repeal or amend than agreements that require unanimous consent to change. In a North Carolina case[485] the shareholders had agreed that decisions to hire new employees had to receive the unanimous consent of the company's executive committee, which included membership from each of the three families who owned shares of the corporation. The families agreed to incorporate the agreement into the company's bylaws, although the statute did not require this step; North Carolina is one of the few states expressly recognizing that shareholders' control agreements may be embodied in the charter or bylaws or in a side agreement in writing and signed by all the parties thereto.[486] In this respect, a number of states sanction side agreements in corporations which elect to be governed by special close corporation statutes, but most general corporation codes contain express statutory sanction for restrictions on directors' power only if those restrictions are in the corporation's charter). In the North Carolina case, because the shareholders included their agreement in the company's bylaws, the court, in a highly questionable decision, ruled that the agreement could be amended by the usual bylaws amendment procedure, which in this corporation permitted amendment by the majority of directors.[487] The court recognized that if the provision had been in a side agreement signed by all shareholders and not been made part of the bylaws, it would have been plausible "to argue that absent an internal provision governing an amendment it could be

agreement determining in advance how all the shareholders would cast their votes, see Delspina v. Woscha, Inc., 223 N.J. Super. 84, 538 A.2d 367 (App. Div. 1988) (court enforced the bylaw provision).

485 Blount v. Taft, 295 N.C. 472, 246 S.E.2d 763 (1978), noted 15 Wake Forest L. Rev. 531 (1979), 68 Ky. L.J. 520 (1980) (the shareholders' agreement provided that the board of directors of the corporation by a majority vote would designate an executive committee composed of three members (one representative from each of three families owning stock in the corporation), and such executive committee would have the exclusive authority to select the corporation's employees by unanimous vote of its members).

486 N.C. Gen. Stat. §55-7-31(b). See also Cal. Corp. Code §300(b); Del. Code Ann. tit. 8, §354; Kan. Stat. Ann. §17-7214; Md Corps & Ass'ns Code Ann §4-104; S.C. Code Ann. §33-18-210.

487 Blount v. Taft, 295 N.C. 472, 487, 246 S.E.2d 763, 772 (1978).

amended only by unanimous consent of all shareholders."[488] Thus, if parties to a shareholders' agreement decide to put the terms of their agreement in the charter or bylaws, they should take special precautions to guard against amendment of the charter or bylaws to delete or modify those provisions.[489]

Whether all shareholders will participate in a control arrangement will impact the choice of options and also the likelihood of judicial enforcement. Shareholders' control agreements, authorized by statutes such as section 7.32 of the Model Business Corporation Act, extend only to agreements among all shareholders. In contrast, shareholders' pooling agreements and voting trusts can be entered into by less than all shareholders. Some statutory close corporations provisions provide a unanimity rule without the need for a separate agreement.[490] A simple majority can usually accomplish charter or bylaws provisions, such as those that provide a veto or those that authorize intrusions on director discretion to manage the corporation. The Model Business Corporation Act provides that an amendment to a corporation's articles of incorporation or bylaws "that adds, changes, or deletes a greater quorum or voting requirement must meet the same quorum requirement and be adopted by the same vote and voting groups required to take action under the quorum and voting requirements then in effect or proposed to be adopted, whichever is greater."[491] A number of states have similar statutory provisions.[492] A

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[488] Blount v. Taft, 295 N.C. 472, 486, 246 S.E.2d 763, 772 (1978).

[489] The court in Blount recognized the danger to close corporation shareholders' agreements posed by incorporating such agreements into the articles or bylaws without taking steps to protect the agreement from normal amendment procedures, but ruled that to avoid such risks shareholders must take it upon themselves to obtain "a well drawn" shareholders' agreement. Blount v. Taft, 295 N.C. 472, 488, 246 S.E.2d 763, 773 (1978) The court might better have considered the shareholders' agreement to be a contract by the parties thereto, and required the consent of all the parties for its modification.

[490] The Maryland close corporation statute requires unanimity, which has been characterized as its "outstanding policy feature." Bradley, A Comparative Evaluation of the Delaware and Maryland Close Corporation Statutes, 1968 Duke L.J. 525, 529. Delaware allows all the shareholders to dispense with the board of directors. The shareholders are then deemed to be the directors and may manage the corporation. A majority of shareholders may end the arrangement. Del. Code Ann. tit. 8, §351. See Ohio Rev. Code Ann §1701.591(A)(1) (authorizes all of the shareholders of Ohio close corporations to enter into shareholders' agreements); Wis. Stat. §180.1823 (requires all of the shareholders of a Wisconsin statutory close corporation to join a shareholders' agreement governing management of the business or the relations among the shareholders).

[491] Model Business Corporation Act §§7.27(b), 10.21, 10.22(c).

Connecticut decision sustained an agreement among majority shareholders that they would not vote to amend specified bylaws without the consent of all signatories to the agreement and held that the contracting shareholders could not accomplish amendment of those bylaws indirectly by conferring power on the directors to amend them.[493]

Agreement among all the shareholders (usually impractical in a publicly-held corporation) is often possible in a close corporation. At the time a closely-held enterprise is being organized, all the participants are generally able in their initial business bargain to agree on management and other questions involved in the operation of the proposed corporation; and not uncommonly the shareholders in a close company can still reach unanimous agreement long after incorporation on how the affairs of the entity are to be conducted. In the absence of statutes, a shareholders' agreement, particularly one that is restrictive of directors' powers, is considerably strengthened against attack by getting all the shareholders to become parties to it;[494] the weight of authority sustains such agreements if all the shareholders are parties.[495] Unanimous agreements have been

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[492] See, e.g., MCLA §450.1455; Minn. Stat. §302A.135; N.M. Stat. Ann. §53-18-6; New York Business Corporation Law §709; N.D. Cent. Code §10-19.1-19; Va. Code Ann. §13.1-688.

[493] Weil v. Beresth, 154 Conn. 12, 220 A.2d 456 (1966).

[494] The Massachusetts decisions illustrate this point. In Odman v. Oleson, 319 Mass. 24, 25, 64 N.E.2d 439, 440 (1946), the court in holding invalid a shareholders' contract naming directors and an officer, was concerned because "there was one stockholder not a party to the contract who might be injuriously affected by it." Woodruff v. Wentworth, 133 Mass. 309, 314, 1882 WL 11067 (1882), held that a shareholders' agreement to vote for a specified person as manager and for an increase in the salaries of corporate officers was void, at least "unless it was consented to by all the stockholders of the corporation." The court in Christal v. Petry, 275 A.D. 550, 560, 90 N.Y.S.2d 620, 629 (1st Dep't 1949), judgment aff'd, 301 N.Y. 562, 93 N.E.2d 450 (1950), overstates the point in saying that "in those cases where the courts give effect to agreements of stockholders which vitally alter the ordinary provisions of corporate procedure, such agreement is given effect only when it is by unanimous agreement of the stockholders." Query whether assent by non-contracting shareholders after there has been performance under an agreement is as effective as unanimous participation at the time of the making of the agreement. See Woodruff v. Wentworth, 133 Mass. 309, 1882 WL 11067 (1882), (1882). Cf. Seitz v. Michel, 148 Minn. 80, 181 N.W. 102, 12 A.L.R. 1060 (1921), (1921) (motion to amend pleading to show all shareholders ratified agreement denied). Inclusion in a shareholders' agreement of a *statement* that *all* the shareholders agree to do specified things creates a risk that the agreement will not be binding on those shareholders who sign the agreement if some of the shareholders do not sign, because courts generally hold that an instrument executed by only part of those between whom it purports to be made is not binding on those who have executed it. See, also, National Motor Club of Mo., Inc. v. Noe, 475 S.W.2d 16 (Mo. 1972); Scheurer v. Scheurer, 311 Minn. 546, 249 N.W.2d 181 (1976).

[495] See Galler v. Galler, 32 Ill. 2d 16, 203 N.E.2d 577 (1964) (agreement of two principal shareholders and their wives; a few shares were held by an employee who later sold them to one of the contracting parties); Wasserman v. Rosengarden, 84 Ill. App. 3d 713, 40 Ill. Dec. 430, 406 N.E.2d 131 (1st Dist. 1980) (court pointed to the fact that all the shareholders of a close corporation were parties to a shareholders' agreement as justifying enforcing its terms);

upheld which designated persons to serve as officers of the corporation and fixed their compensation and tenure,[496] provided for the distribution of corporate earnings in a prescribed manner, [497] or set up a method for dissolution different from that provided by statute.[498] Decisions sustaining unanimous shareholders' agreements are sometimes based in part on the proposition that all the shareholders, being the sole owners of the corporation, can do as they choose with it and its assets, at least as long as creditors and the public are not adversely affected,[499] and no mandatory statutory provision is violated.[500] As has been said in a New York decision, "the complete owners of a corporation may, by agreement among themselves, control

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Clark v. American Coal Co., 86 Iowa 436, 53 N.W. 291 (1892); Odman v. Oleson, 319 Mass. 24, 64 N.E.2d 439 (1946); Katcher v. Ohsman, 26 N.J. Super. 28, 97 A.2d 180 (Ch. Div. 1953); Application for Dissolution of Evening Journal Ass'n, 7 N.J. Super. 360, 71 A.2d 158 (Ch. Div. 1950), judgment aff'd, 5 N.J. 142, 74 A.2d 303 (1950); Clark v. Dodge, 269 N.Y. 410, 199 N.E. 641 (1936); Delaney, The Corporate Director: Can His Hands Be Tied in Advance?, 50 Colum. L. Rev. 52, 55 to 59, 66 (1950); Note, Close Corporations: Voting Trust Legislation and Resolution of Disputes, 67 Colum. L. Rev. 590, 596 (1967); Note, 43 Ill. L. Rev. 561 (1948).
In many of the leading cases, which condemned a shareholders' agreement, all of the shareholders were not parties. See, e.g., West v. Camden, 135 U.S. 507, 10 S. Ct. 838, 34 L. Ed. 254 (1890). See Bradley, Toward a More Perfect Close Corporation—The Need for More and Improved Legislation, 54 Geo. L.J. 1145, 1173, 1175, 1182 to 1189 (1966). But see Somers v. AAA Temporary Services, Inc., 5 Ill. App. 3d 931, 284 N.E.2d 462 (1st Dist. 1972) (sole shareholder unable to amend bylaws to reduce the number of directors because the power to amend the bylaws had not been reserved to the shareholders by the articles of incorporation).

496 See Kantzler v. Benzinger, 214 Ill. 589, 73 N.E. 874 (1905); Application of Kirshner, 81 N.Y.S.2d 435 (Sup 1948); Davis v. Arguls Gas & Oil Sales Co., 167 Misc. 377, 3 N.Y.S.2d 241 (Sup 1938); Miller v. E. & M. Theatre Corp., 134 Misc. 634, 235 N.Y.S. 595 (Sup 1929). It is questionable, however, that the shareholders even by unanimous agreement can deprive the directors of power to discharge an unfaithful officer or employee. In Fells v. Katz, 256 N.Y. 67, 72, 175 N.E. 516, 517 (1931) the court stated: "An agreement among stockholders whereby the directors are bereft of their power to discharge an unfaithful employee of the corporation is illegal as against public policy."; Tremsky v. Green, 106 N.Y.S.2d 572 (Sup 1951); Blum v. Oxman, 190 Misc. 647, 75 N.Y.S.2d 177 (Sup 1947); In re Roosevelt Leather Hand Bag Co., 68 N.Y.S.2d 735 (Sup 1947).

497 Wabash Ry. Co. v. American Refrigerator Transit Co., 7 F.2d 335 (C.C.A. 8th Cir. 1925). See also Wasserman v. Rosengarden, 84 Ill. App. 3d 713, 40 Ill. Dec. 430, 406 N.E.2d 131 (1st Dist. 1980); Lorillard v. Clyde, 86 N.Y. 384, 1881 WL 12994 (1881) (agreement sustained which gave one shareholder entire management of the company at a stipulated commission and the other a dividend of 7 percent per year for seven years); Eisenberg v. Rodless Decorations, 106 N.Y.S.2d 822 (Sup 1951) (agreement to which all shareholders consented giving one of them high commission on gross sales cannot be set aside as waste of corporate assets).

498 Leventhal v. Atlantic Finance Corp., 316 Mass. 194, 55 N.E.2d 20, 154 A.L.R. 260 (1944).

499 Manson v. Curtis, 223 N.Y. 313, 325, 119 N.E. 559, 562 (1918); Slonim v. Brodie, 109 N.Y.S.2d 440 (Sup 1951), judgment aff'd, 281 A.D. 861, 119 N.Y.S.2d 916 (1st Dep't 1953); In re Block's Will, 186 Misc. 945, 60 N.Y.S.2d 639 (Sur. Ct. 1946). Conway, J., dissenting in Benintendi v. Kenton Hotel, 294 N.Y. 112, 124, 60 N.E.2d 829, 834, 159 A.L.R. 280 (1945), stated: "The owners of 100% of the stock of a corporation may do with it as they will, even to giving it away, provided the rights of creditors are not involved and the public policy of the States is not offended."

500 "Those who own all the stock of a corporation may, so long as they conduct the corporate affairs in accordance with the statutory rules, deal as they will with the corporation's property (always assuming nothing is done prejudicial to creditors' rights)." Benintendi v. Kenton Hotel, 294 N.Y. 112, 118, 60 N.E.2d 829, 831, 159 A.L.R. 280 (1945).

the exercise of power and discretion by the directors of the corporation, provided that the interests of creditors of the corporation are not prejudiced and the public policy of the State is not offended."[501]

Implicit, too, in many of the decisions is a conclusion that the possibility of injury to minority shareholders is obviated or at least sharply reduced if all the shareholders are parties to the agreement.[502] Further, the chance that a court will find an agreement to be fraudulent or injurious to non-contracting shareholders is reduced by disclosing the contents of the agreement to all the shareholders who are not parties to it.[503] The courts are not in complete accord on whether agreements by holders of substantially all of a corporation's shares, but to which persons with very minor holdings are not parties, should be treated the same as unanimous agreements. A number of decisions [504] disregard inconsequential holdings in determining the validity of agreements. Thus, a California court,[505] in sustaining a shareholders' agreement dividing control between the two contracting parties and providing that each was to draw $9,000 a year from their consolidated enterprises, stated unequivocally that "there can be no question but that an

[501] In re Feinson's Estate, 196 Misc. 590, 592, 92 N.Y.S.2d 87, 90 (Sur. Ct. 1949). See also Kassel v. Empire Tinware Co., 178 A.D. 176, 164 N.Y.S. 1033, 1035 (2d Dep't 1917); Little v. Garabrant, 35 N.Y.S. 689 (Gen. Term 1895), aff'd, 153 N.Y. 661, 48 N.E. 1105 (1897).

[502] See, e.g., Glazer v. Glazer, 374 F.2d 390 (5th Cir. 1967); Galler v. Galler, 32 Ill. 2d 16, 203 N.E.2d 577 (1964). See also Bradley, A Comparative Evaluation of the Delaware and Maryland Close Corporation Statutes, 1968 Duke L.J. 525, 526; Meck, Employment of Corporate Executives by Majority Stockholders, 47 Yale L.J. 1079, n 15 (1938).

[503] Steadman, Maintaining Control of Close Corporations, 14 Bus. Law 1077, 1992–1993 (1959), suggests that a memorandum should be prepared and distributed to all the shareholders disclosing the contents of the agreement, its purpose, and the circumstances surrounding its execution.

[504] Merlino v. West Coast Macaroni Mfg. Co., 90 Cal. App. 2d 106, 202 P.2d 748 (1st Dist. 1949) (contracting parties owned through parent company substantially all the stock and the few remaining shares apparently were held by their wives); Galler v. Galler, 32 Ill. 2d 16, 203 N.E.2d 577 (1964); E.K. Buck Retail Stores v. Harkert, 157 Neb. 867, 62 N.W.2d 288, 45 A.L.R.2d 774 (1954) (a number of shares of stock were held by persons not signatory to the agreement); Trefethen v. Amazeen, 93 N.H. 110, 36 A.2d 266 (1944) (non-contracting parties held twenty-six shares but the contract reduced the voting power of one of the principal shareholders and thus in effect gave the non-contracting parties relatively greater voting power). Cf. Nordin v. Kaldenbaugh, 7 Ariz. App. 9, 435 P.2d 740, 744 (1967) (acquiescence by one of four equal shareholders in agreement signed by other three). See also Hart v. Bell, 222 Minn. 69, 23 NW2d 375 (1946). But see Odman v. Oleson, 319 Mass. 24, 64 N.E.2d 439 (1946) (one shareholder was not a party to contract); Flanagan v. Flanagan, 73 N.Y.S.2d 267, 270 (Sup 1947), judgment modified, 273 A.D. 918, 77 N.Y.S.2d 682 (2d Dep't 1948), judgment aff'd, 298 N.Y. 787, 83 N.E.2d 473 (1948) (suggestion that an agreement to which persons with small holdings are not parties should not be considered the same as a unanimous agreement).

[505] Merlino v. West Coast Macaroni Mfg. Co., 90 Cal. App. 2d 106, 111, 202 P.2d 748, 751 (1st Dist. 1949).

agreement between stockholders who own substantially all of the stock of a corporation is enforceable against the contracting parties and the corporation."[506] Policy considerations positively favor the enforcement of agreements among all the shareholders. Such agreements meet a widespread business need. Further, shareholders should have the same freedom to contract that the law favors for other competent persons.[507]

When it comes to implementation and interpretation of control and governance in the close corporation, it is certainly the case that should the corporation be a party to the shareholders' agreement, the likelihood that the latter will be enforced is much higher. This is especially true if the enforcement of the agreement may affect the corporation's rights, obligations, and or other legal relations. Hence, it would be fair to say that – as the legal relations of the participants in a close corporation usually tend to result intertwined with those of the corporation itself, given the respective intent in the carrying out of the corporate business – the parties to a pre-incorporation contract or shareholders' agreement should cause the corporation formally to become a party to it. A number of decisions ruled that the corporation is not bound by a contract to which it is not a party,[508] especially if all of its shareholders are not parties to it

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[506] But for a questionable decision declining to hold the corporation bound by a unanimous shareholders' agreement, see Bator v. United Sausage Co., 138 Conn. 18, 81 A.2d 442 (1951) (corporation as a separate entity is not affected by pre-incorporation agreement among incorporators who became sole shareholders and directors).

[507] "The fundamental principles of the law are all in favor of the right to enter into any lawful contract upon such terms and conditions as to the parties thereto may seem proper. With this privilege courts have no right to interfere unless fraud, coercion, or duress in some form is practiced and alleged, or where the contract is forbidden by some statute, or is contrary to good morals or public policy." White v. Snell, 35 Utah 434, 100 P. 927 (1909).

[508] See Camp v. Parks, 314 So. 2d 611 (Fla. Dist. Ct. App. 4th Dist. 1975) (court erred in granting to seller specific performance of contract for sale of shares in close corporation where terms of the contract required participation of the corporation and seller's wife and neither was party to the suit or to the agreement); Flanagan v. Flanagan, 273 A.D. 918, 77 N.Y.S.2d 682 (2d Dep't 1948), *aff'd*, 298 N.Y. 787, 83 N.E.2d 473 (1948) (agreement among principal shareholders; fact that corporation not a party given as additional or "makeweight" basis for decision); In re Long Island R. Co., 19 Wend. 37, 44, 1837 WL 2857 (N.Y. Sup 1837) ("Any private agreement or understanding between the individual holding the legal title to the stock in due form, and others, is a matter between themselves, with which the corporation have [sic] no concern"); Thresher v. Cuddy-Gardner Co., 53 R.I. 175, 165 A. 438 (1933). See also Insituform of North America, Inc. v. Chandler, 534 A.2d 257 (Del. Ch. 1987) (court held that a voting agreement, which restricted sale of shares and required a vote for existing directors, did not bind a corporate shareholder that did not sign the agreement); Smith v. Doctors' Service Bureau, Inc., 49 Ill. App. 2d 243, 250, 199 N.E.2d 831 (1st Dist. 1964) ("Without the corporation as a party, an agreement purporting to require the corporation to purchase its shares in certain circumstances would be fatally deficient in any event."); Garg v. Venkataraman, 54 Ohio App. 3d 171, 561 N.E.2d 1005 (9th Dist. Wayne County 1988) (oral joint venture contract guaranteeing employment of

either. Nevertheless, some other decisions held that the corporation – resulting an entity separate and apart from its shareholders – would not be tied in by the agreement even if all of its stockholders were parties to it.[509]

Along this same line, the company is prohibited from availing itself of a shareholders' agreement to which it is not a party until it has adopted the agreement.[510] Although courts have held that whenever the holders of all, or substantially all, of the shares are parties to an agreement, it is enforceable also against the corporation even if the latter has never formally become a party to it.[511] In addition, it may be argued that presumably these same courts would

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corporation's chief executive officer for 10-year period was subject to statute of frauds; promise by individual member of board of directors to guarantee chief executive officer's employment for 10-year period was not binding on corporation where director did not make promise on behalf of corporation; therefore, officer could be removed without cause).

[509] Bator v. United Sausage Co., 138 Conn. 18, 81 A.2d 442 (1951) (plaintiff brought action against corporation to dissolve it on ground that the shareholders and directors were unable to conduct it in manner contemplated by control agreement among shareholders; the court refused to enforce the agreement against the corporation, stating that it was a separate entity, but indicated that plaintiff might have had an action against the other shareholders); Broyles v. Johnson, 99 Ga. App. 69, 107 S.E.2d 851 (1959) (agreement between two shareholders, each of whom owned 50 percent of a corporation's stock, that corporate profits were to be divided equally was held not sufficient to state a cause of action against the corporation to require dividends to be paid). Cf. Weber v. Sidney, 19 A.D.2d 494, 244 N.Y.S.2d 228 (1st Dep't 1963), order aff'd, 14 N.Y.2d 929, 252 N.Y.S.2d 327, 200 N.E.2d 867 (1964) (oral shareholders' agreement enforceable between the parties but not against the corporation).

[510] Thresher v. Cuddy-Gardner Co., 53 R.I. 175, 165 A. 438 (1933). But see Lait v. Leon, 40 Misc. 2d 60, 242 N.Y.S.2d 776 (Sup 1963) (corporation held entitled to enforce as a third party beneficiary an agreement which assured it qualified management).

[511] Merlino v. West Coast Macaroni Mfg. Co., 90 Cal. App. 2d 106, 111, 202 P.2d 748, 751 (1st Dist. 1949) (holders of substantially all shares were parties to agreement); Bunnett v. Smallwood, 768 P.2d 736 (Colo. Ct. App. 1988), judgment rev'd in part on other grounds, 793 P.2d 157, 9 A.L.R.5th 1191 (Colo. 1990) (court held that the shareholders who own substantially all of the stock of a corporation may lawfully contract with one another concerning the management of corporate affairs; such an agreement is binding upon both the contracting parties and the corporation, provided the agreement does not involve rights of creditors, violate statutes, or contravene public policy); Moss v. Waytz, 4 Ill. App. 2d 296, 124 N.E.2d 91 (1st Dist. 1955) (all shareholders parties to agreement), criticized in Ill. L. Forum 323; Lane v. Abel-Bey, 70 A.D.2d 838, 418 N.Y.S.2d 25 (1st Dep't 1979), order aff'd, 50 N.Y.2d 864, 430 N.Y.S.2d 41, 407 N.E.2d 1337 (1980) (court granted specific performance of a unanimous shareholders' agreement, rejecting the argument that the corporation must also enter into the agreement). See also Application for Dissolution of Evening Journal Ass'n, 7 N.J. Super. 360, 71 A.2d 158 (Ch. Div. 1950), *aff'd*, 5 N.J. 142, 74 A.2d 303 (1950); Brewer v. First Nat. Bank of Danville, 202 Va. 807, 815, 120 S.E.2d 273, 280 (1961) (enforcing against a corporation an agreement of its shareholders with a former shareholder who had sold them his shares, that the corporation would pay him $40 per week for life; the court commented that by the agreement "the corporation was assured of younger, more active and better qualified management by those familiar with its operation. Under the new management its chances of financial success were greatly improved. This constituted valuable consideration to the corporation." M/V La Conte, Inc. v. Leisure, 55 Wash. App. 396, 777 P.2d 1061 (Div. 1 1989) (court held that a corporation's lack of formal acceptance of a pre-incorporation subscription agreement was irrelevant, and that the corporation would be deemed to have impliedly accepted and ratified the entire subscription agreement, including those provisions allegedly infringing on management powers, where the corporation was formed pursuant to a letter of understanding and acted pursuant to that agreement after formal incorporation). Cf.

also hold that such an agreement (to which the company is not party) is enforceable by the corporation itself. However, even if this was the case, the parties to a unanimous shareholders' agreement should – in an abundance of precaution, which is never enough – cause the corporation to become a party to it as well.[512]

Agreements' disclosure to third parties

Agreements that can be done with less than all shareholders raise questions of notice to those shareholders who are not included. The entire set of arrangements discussed herein raises questions as to notice to those who may purchase the shares. For voting trusts, the authorizing statute typically requires that a copy of the agreement and the list of beneficial owners must be filed with or delivered to the corporation.[513] The Official Comment to section 7.30 of the Model Act reads, "both documents are available for inspection by shareholders under section 7.20." This simple disclosure requirement eliminates the possibility that the voting trust may be used to create "secret, uncontrolled combinations of stockholders to acquire control of the corporation to the possible detriment of non-participating shareholders."[514] Section 7.20, however, addresses only a shareholders' list, but makes no mention of the voting trust agreement, creating confusion about accessibility of the agreement itself. Inspection of the shareholders' list is unconditional under section 7.20, but the right to copy the list requires compliance with the proper purpose requirement of the general inspection statute found in section 16.02(c) of the Model Business

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Nordin v. Kaldenbaugh, 7 Ariz. App. 9, 435 P.2d 740 (1967) (an agreement among shareholders for the issuance of stock is binding upon a closely held corporation where the shareholders are also directors, managers and officers); Petruzzi v. Peduka Const., Inc., 362 Mass. 190, 285 N.E.2d 101, 102 (1972) (no formal vote required to bind the corporation).

512 O'Neal & Thompson, O'Neal and Thompson's Close Corporations and LLCs: Law and Practice, §4:40 (rev. 3rd ed. 2009, database updated July 2013).

513 See, e.g., Model Business Corporation Act §7.30.

514 See Model Business Corporation Act Ann. (4th ed.) at 7-230-231 (quoting Lehrman v. Cohen, 222 A.2d 800, 807 (1966).

Corporation Act.[515]

All shareholders must sign shareholders' control agreements, such as those authorized by section 7.20 of the Model Business Corporation Act. Voting trust agreements and shareholders' pooling agreements are not required to be unanimous, and pooling agreements are not usually required to be filed or otherwise made available to other shareholders. The difference and incongruity of the requirements of the various statutes reflects the evolution of legal views as to shareholders' agreements and the different periods in which each type of statute was enacted rather than a specific policy difference.

Provisions designed to provide notice to potential transferees of shares also vary. Section 7.32 to the Model Business Corporation Act, which authorizes shareholders' control agreements covering a variety of matters of importance to shareholders in close corporations, requires that notice of the agreement be noted conspicuously on the front or back of the certificate.[516] Section 7.32 also specifically states that failure to comply with the notice requirement shall not affect the validity of the agreement or any action taken pursuant to it.[517] That is consistent with earlier case law.[518] Under the language of the Model Business Corporation Act, any purchaser who did not

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[515] Model Business Corporation Act §16.02(c). That Section conditions a shareholder's right to both inspect and copy specified records on a proper purpose as defined in that Section. The special rule for a shareholder list contained in Section 7.20 relaxes the requirement for mere inspection, which does not incorporate the proper purpose requirement, but a shareholder's right to copy the list does require satisfying that standard.

[516] Some of these statutes require that the certificates of shares subject to such an agreement contain a notation so indicating. See, e.g., Cal. Corp. Code §418(a)(3); Ohio Rev. Code Ann. §1701.591(G). See also 805 ILCS 5/2A-45, which requires that the existence of a provision in the articles of incorporation of a close corporation providing that the business of the corporation shall be managed by the shareholders be noted conspicuously on every certificate representing shares of stock issued by the corporation.

[517] Model Business Corporation Act §7.32(c), but the provisions also provide that a purchaser without notice can rescind.

[518] See R. H. Sanders Corp. v. Haves, 541 S.W.2d 262 (Tex. Civ. App. Dallas 1976) (voting agreement would not be invalidated for failure to strictly comply with statutory provisions designed to give notice to non-contracting shareholders and to purchasers of shares, where no outside parties were involved and all parties to the agreement had notice of its provisions). Cf. Sankin v. 5410 Connecticut Ave. Corp., 281 F. Supp. 524 (D. D.C. 1968), judgment aff'd, 410 F.2d 1060 (D.C. Cir. 1969) (a party to a fraudulent scheme who had knowledge of a shareholders' agreement is not entitled to assert that the agreement is invalid because it is not referred to on the share certificates). But see, Great Southern Oil & Gas Co. Inc. v. Century Mineral Corp., 535 So. 2d 1235 (La. Ct. App. 3d Cir. 1988) (court held that a voting agreement did not affect the transferability of non-legended stock not originally held by an original signatory party to the voting agreement, even though the pledgee was aware of the agreement and even

have knowledge of the agreement at the time of purchase would be entitled to rescind from it.[519] A few statutes expressly provide that whenever a corporation's charter or bylaws contains a provision increasing quorum or voting requirements for shareholders' or directors' meetings, the existence of such a provision shall be noted conspicuously on the face or the back of any certificate for shares issued by the corporation.[520] Even in states without such a statute a court may refuse to give effect to unusual charter or bylaws provisions that are not referred to on the share certificates, at least as against purchasers without notice.[521] There are, however, decisions enforcing such provisions even though notice is not provided on the certificates.[522] Given these statutes, certificates of shares subject to a shareholders' agreement should be printed with a legend to indicate that fact and preferably a copy of the agreement should be given to each person to whom any of the shares are subsequently transferred.

Where possible the provisions should be set forth verbatim on the certificates. In case the provisions are too lengthy to be reproduced in full, they should be summarized or paraphrased on the certificates, and a clear reference made to the charter or other document containing them. In an abundance of precaution, the agreement should perhaps include an undertaking by each of the parties not to transfer the shares except if stated otherwise in the agreement itself, and an undertaking by each to make certain that the transferee understands the agreement and consents

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though legended stock was also pledged, where the restriction on transfer was not imposed by the issuer of the stock certificates and the issuer was not a signatory to the voting agreement).

[519] See Changes in the Revised Model Business Corporation Act—Amendments Pertaining to Closely Held Corporations, 46 Bus. Law 297 (1990).

[520] See, e.g., N.Y. Business Corporation Law §616(c), 709(c). See also Ohio Rev. Code Ann. §1701.591(G) (special close corporation statutes providing that the existence of shareholders' agreements which establish high vote requirements for shareholder and director action shall be noted conspicuously on each share certificate).

[521] See, e.g., Del. Code Ann. tit. 8, §151(f); 805 ILCS 5/6.35; N.J. Rev. Stat. §14A:7-11(2); New York Business Corporation Law §508(b) (all to the effect that share certificates representing shares "issued by a corporation which is authorized to issue shares of more than one class shall set forth on the face or back thereof, or shall state that the corporation will furnish to any shareholder, upon request and without charge, a full statement of the designations and the powers, preferences and rights, and the qualifications, limitations, or restrictions of the shares of each class authorized to be issued").

[522] See, e.g., Doss v. Yingling, 95 Ind. App. 494, 172 N.E. 801 (1930); Trefethen v. Amazeen, 93 N.H. 110, 36 A.2d 266 (1944); Baumohl v. Goldstein, 95 N.J. Eq. 597, 124 A. 118 (Ch. 1924).

to be bound by it. Preferably, a transferee should be required to become a formal party to the agreement and expressly to assume obligations under it. If a transferee has full knowledge of a shareholders' agreement and the transfer is expressly made subject to the agreement, there of course can be little question that the transferee is bound by it and acquires the shares subject to the same voting restrictions that bound the transferor.[523] Although close corporation statutes often require the existence of close corporation status to be noted on every share certificate, an Ohio court held that donees of shares were bound, even without notice. In that case, the holders of majority shares, children of the company's founder, who had sought to take control of the company from another sibling, were met with a close corporation agreement, said to have been executed before the gift, that left important corporate powers in the hands of the father as the chairman of the board.[524]

Some statutes clearly address the relationship among different types of arrangements at issue. Shareholders' control agreements, for example, often provide that the agreement is effective "even though it is inconsistent with one or more other provisions of this Act."[525] Many shareholders' pooling agreement statutes provide such agreements are not subject to the voting trust statutes.[526] In the absence of statutes, case law has rejected the view that statutes authorizing voting trusts impliedly preclude the use of any other kind of voting arrangement among shareholders.[527] At one time the question of other agreements as disguised voting trusts was of

[523] See Trefethen v. Amazeen, 93 N.H. 110, 36 A.2d 266 (1944).

[524] Myocare Nursing Home, Inc. v. Fifth Third Bank, 98 Ohio St. 3d 545, 2003-Ohio-2287, 787 N.E.2d 1217 (2003) (statute provides more comprehensive protection to shareholders who do not obtain their shares by gift, bequest or inheritance).

[525] Model Business Corporation Act §7.32(a).

[526] Model Business Corporation Act §7.31(a). See, e.g., Minn. Stat. §302A.455; Va. Code Ann. §13.1-671. See also Cal. Corp. Code §706(c) (a voting agreement among shareholders in a close corporation shall not be held invalid on the ground that it is a voting trust which does not comply with the formalities regulating voting trusts). Alaska's statute specifies that the voting trust Section does not invalidate an irrevocable proxy described in the Code. See Alaska Stat. §10.06.425(a).

[527] Ringling v. Ringling Bros.-Barnum & Bailey Combined Shows, 29 Del. Ch. 318, 49 A.2d 603 (1946), order modified, 29 Del. Ch. 610, 53 A.2d 441 (1947); Wallace v. Southwestern Sanitarium Co., 160 Kan. 331, 161 P.2d 129 (1945). Among the many decisions sustaining shareholders' voting agreements in jurisdictions with voting trust

considerable concern to courts: *Abercrombie v. Davies* decided by the Delaware Supreme Court in 1957 prior to enactment of a statute specifying that the voting trust statute "shall not be deemed to invalidate any voting or other agreement among stockholders or any irrevocable proxy which is not otherwise illegal"[528] struck down an agreement on the ground that it was in effect a voting trust which did not conform to statutory requirements.[529] A Delaware case that followed the statute's broadening illustrates the modern attitudes toward voting trusts that are less restrictive than earlier views. It saw the voting trust statute as primarily concerned with preventing secret combinations of shareholders formed to gain control of a corporation;[530] agreements not raising that fear are not likely to be held subject to the requirements of the voting trust statute. Other cases indicate a similar willingness to interpret voting trust statutes permissively so that other

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statutes are the following: Galler v. Galler, 32 Ill. 2d 16, 203 N.E.2d 577 (1964); Trefethen v. Amazeen, 93 N.H. 110, 36 A.2d 266 (1944); State ex rel. Everett Trust & Sav. Bank v. Pacific Waxed Paper Co., 22 Wash. 2d 844, 157 P.2d 707, 159 A.L.R. 297 (1945).

528 Del. Code Ann. tit. 8, §212(e). See also Del. Code Ann. tit. 8, §218(c) (specifically validating shareholders' voting agreements).

529 Abercrombie v. Davies, 36 Del. Ch. 371, 130 A.2d 338 (1957), noted and criticized in 46 Calif. L. Rev. 124 (1958); 36 Tex. L. Rev. 508 (1958). See also Note, 10 Stan. L. Rev. 565 (1958). The court then listed as essential features of a voting trust the following: (1) voting rights are separated from the other attributes of stock ownership, (2) the grant of voting rights is irrevocable for a definite and perhaps protracted period of time, and (3) the principal object of the arrangement is voting control. Although the court in *Abercrombie v. Davies* did not expressly say that all agreements containing the three essential characteristics are voting trusts and must comply with the voting trust statute, some parts of the opinion certainly suggest that. At the same time, the court distinguished other cases sustaining voting agreements having all three of the characteristics. Ringling Bros.-Barnum & Bailey Combined Shows v. Ringling, 29 Del. Ch. 610, 53 A.2d 441 (1947), was distinguished on the ground that in that case there "was no deposit of the stock with irrevocable stock powers conferring upon a group of fiduciaries exclusive voting powers over the pooled stock," and that the agreement there did not provide for a proxy empowering one person to vote another's shares. Aldridge v. Franco Wyoming Oil Co., 24 Del. Ch. 126, 7 A.2d 753 (1939), determination sustained, 24 Del. Ch. 349, 14 A.2d 380 (1940), was distinguished on the ground that under the agreement in that case each shareholder retained full control over his stock in that he could withdraw the stock at any time or could obtain a proxy to vote it.

530 Oceanic Exploration Co. v. Grynberg, 428 A.2d 1 (Del. 1981) (court held that not all trusts of corporate stock which either expressly or by implication give voting rights to a trustee are voting trusts). See also Lehrman v. Cohen, 43 Del. Ch. 222, 222 A.2d 800, 807 (1966) (voting trust disclosure requirement is designed to eliminate the possibility that a voting trust will be used to create "secret, uncontrolled combinations of stockholders" to acquire control to the detriment of excluded shareholders). See Folk, The New Delaware Corporation Law 26 (1967): Thus, the similarity to a voting trust is no longer a ground, as it was under prior case law [citing Abercrombie v. Davies], to strike down an arrangement which complies with the relevant statute. This is a logical application of the Delaware doctrine that if there are two or more ways of doing the same thing, or achieving the same goal, the parties may choose either way, and will not be subject to limitations or restrictions with respect to the way not chosen.

kinds of trust and shareholders' agreements otherwise legal will not be invalidated.[531]

[531] See Jackson v. Jackson, 178 Conn. 42, 420 A.2d 893 (1979) (court held that, since a trust indenture which vested in its trustees power to vote stock of a corporation allowed the trustees to sell the stock at any time and did not separate the voting rights from other incidents of stock ownership, the trust indenture was not a voting trust and did not violate Connecticut corporate law when it continued in existence for a period longer than ten years); Wasserman v. Rosengarden, 84 Ill. App. 3d 713, 40 Ill. Dec. 430, 406 N.E.2d 131 (1st Dist. 1980) (court upheld the validity of an oral agreement among all the shareholders in a close corporation which, among other things, provided for the election of the parties thereto as directors and officers of the corporation); De Felice v. Garon, 395 So. 2d 658 (La. 1980) (court held that a contract by which the owner of stock expressly conferred upon respondents the right to vote shares, with an implicit right to obtain a transfer of the shares on the books of the corporation, was not invalid as a contract which separated voting rights from ownership interests). But see, Hall v. Staha, 303 Ark. 673, 800 S.W.2d 396 (1990) (limited partnership which granted general partners right to vote corporate shares held by limited partnership was in fact illegal voting trust, since partnership's term was longer than ten years and copy of fully executed written partnership agreement including names of limited partners, was not filed with corporation). Cf. Tankersley v. Albright, 374 F. Supp. 538 (N.D. Ill. 1974), judgment aff'd in part, rev'd in part, 514 F.2d 956 (7th Cir. 1975) (court upheld as a voting trust a shareholders' agreement which gave the trustees powers beyond merely the power to vote the stock, powers pursuant to which the trustees approved articles amendments that allegedly benefited the trustees individually to the detriment of the trust beneficiaries).

XI. DURATION OF SHAREHOLDERS' AGREEMENTS

Statutes authorizing different types of shareholders' agreements sometimes, but not always, address the maximum length permitted for the agreements. Restrictions on the contractual freedom of participants occur in statutes that limit the duration of shareholders' agreements to a period of ten years.[532] Such a limitation on the term of a shareholders' agreement makes it difficult for a person joining a close corporation in a minority position to contract for adequate protection against the power normally held by majority shareholders under the principle of majority rule. Often the first years of a business enterprise are lean years in which the business has to struggle to survive, making little, if any, profit. If a shareholders' agreement is limited to ten years, its effectiveness may lapse just as the business is developing into a highly profitable operation and seems assured of future success, a stage in the development of an enterprise when majority shareholders may well be tempted to *squeeze out* a minority shareholder, that is, eliminate the shareholder as a co-owner of the business.[533] In other words, the interests that participants in a close corporation seek to protect through such agreements are not usually time limited, but rather extend to the time of their investment in the close corporation. Even those statutes that permit a renewal of such agreements do not protect minority shareholders if consent of all parties is required for renewal, since the dominant shareholders can simply withhold consent.

Probably shareholders' agreements have been limited in duration to ten years in some states in an effort to conform to the ten-year limitation generally applied to voting trusts,[534] but even assuming that adequate reasons exist for limiting voting trusts to ten years when used in a

[532] See, e.g., Del. Code Ann. tit. 8, §218(c) (10 years with provision for renewal, any time within 2 years before expiration, provided all parties to the original agreement agree); N.C. Gen. Stat. §55-7-31 (10 years with provision for renewal).

[533] For techniques used to squeeze out shareholders, see O'Neal and Thompson's Oppression of Minority Shareholders and LLC Members chapters 2, 3, 5, and 6 (Rev. 2nd ed.).

[534] See Folk, The Model Act and the South Carolina Corporation Law Revision, 18 Bus. Law 351, 383 (1963). "A close corporation statute should free all of these devices [voting trusts, shareholder voting agreements, and irrevocable proxies] from any time limitation." Bradley, Toward a More Perfect Close Corporation—The Need for More and Improved Legislation, 54 Geo. L.J. 1145, 1173 (1966). In some states the permissible duration of voting trusts is now longer than 10 years. See, e.g., N.J. Rev. Stat. §14A:5-20 (not more than 21 years).

public-issue corporation, there clearly is no justification for such a limit on a shareholders' agreement used in a close corporation, at least if all the corporation's shareholders are parties. Under some recent statutes, such as those following section 7.32 of the Model Business Corporation Act, a shareholders' agreement is valid for ten years unless provided otherwise. This default rule requires participants to plan for a longer-lived agreement by inserting an extended term at the time of agreement.[535]

Duration limitations in the voting trust statutes do not apply to other types of shareholders' agreements, and in the absence of a statute fixing a time limit for shareholders' voting agreements, such a pooling agreement will be sustained even though it exceeds the term fixed by statute for voting trusts.[536] As a result, courts have sustained agreements that correspond to the person's interest in the corporation.[537] Numerous decisions have sustained shareholders' agreements that were to remain in effect for twenty years,[538] or even for an indefinite period.[539]

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[535] Model Business Corporation Act §7.32.

[536] Wallace v. Southwestern Sanitarium Co., 160 Kan. 331, 161 P.2d 129 (1945) (15-year agreement between holders of mortgage bonds carrying voting rights). See also Jackson v. Jackson, 178 Conn. 42, 420 A.2d 893 (1979) (court held that, since a trust indenture which vested in its trustees power to vote stock of a corporation allowed the trustees to sell the stock at any time and did not separate the voting rights from other incidents of stock ownership, the trust indenture was not a voting trust and did not violate Connecticut corporate law when it continued in existence for a period longer than ten years); Galler v. Galler, 32 Ill. 2d 16, 32, 203 N.E.2d 577, 586 (1964) ("While defendants argue that the public policy evinced by the legislative restrictions upon the duration of voting trust agreements should be applied here, this agreement is not a voting trust, but [...] is a straight contractual voting control agreement which does not divorce voting rights from stock ownership [...]. While limiting voting trusts since 1947 to a maximum duration of ten years, the legislature has indicated no similar policy regarding straight voting agreements although these have been common since prior to 1870.)".

[537] See also Wasserman v. Rosengarden, 84 Ill. App. 3d 713, 40 Ill. Dec. 430, 406 N.E.2d 131 (1st Dist. 1980) (court upheld the validity of an oral agreement among all the shareholders in a close corporation providing for the election of the parties thereto as directors and officers and for the equal distribution of salaries and profits as long as the parties remained shareholders or the corporation remained in existence).

[538] See, e.g., Groub v. Blish, 88 Ind. App. 309, 152 N.E. 609 (1926).

[539] See, e.g., Glazer v. Glazer, 374 F.2d 390 (5th Cir. 1967); Weil v. Beresth, 154 Conn. 12, 220 A.2d 456 (1966) (statute limiting shareholders' voting agreement to ten years, enacted after agreement was entered into, held inapplicable); Compton v. Paul K. Harding Realty Co., 6 Ill. App. 3d 488, 285 N.E.2d 574, 579 (5th Dist. 1972); Galler v. Galler, 32 Ill. 2d 16, 203 N.E.2d 577 (1964) (shareholders' agreement enforced as long as one of the contracting parties was alive); Leventhal v. Atlantic Finance Corp., 316 Mass. 194, 55 N.E.2d 20, 154 A.L.R. 260 (1944); E.K. Buck Retail Stores v. Harkert, 157 Neb. 867, 62 N.W.2d 288, 45 A.L.R.2d 774 (1954) ("It is also contended that the control agreement is void because it was to remain in effect so long as Buck retained any stock in the corporation. We think not. The purpose of the agreement was to give Buck such protection against mismanagement as to induce him to bring needed money into the corporation. It is reasonable that such protection should be afforded so long as he is a stockholder. It is not a contract which binds the parties in perpetuity), as

Cases imposing a time limit on such agreements in the absence of a statute tend to reflect older concerns about interference with director management of the corporation,[540] sometimes ruling an agreement invalid even though it was in effect for as short a term as five years.[541] Even though a court recognizes the initial validity of a long-term contract, it may seize upon waiver, laches or some such doctrines to relieve a party from performance if it concludes that the long-term feature of the contract is unduly oppressive.[542]

Further, some courts have held that when a voting agreement was silent as to its duration, the agreement incorporated the statutory time limit.[543] In a Tennessee case, a court held that provisions of the Corporations Act which addressed shareholders' agreements and which said agreements whose duration exceeded twenty years were deemed invalid did not govern a stock redemption agreement.[544] The court held that the stock redemption agreement was governed by a specific provision of the Act, which deals with shareholders' agreements that restrict the transfer of shares, and therefore, the general limitation on the duration of shareholders' agreements did

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defendants allege. It is definite as to the term of its existence."); Clark v. Dodge, 269 N.Y. 410, 199 N.E. 641 (1936); 721 Corp. v. Morgan Guaranty Trust Co. of New York, 40 Misc. 2d 395, 397, 243 N.Y.S.2d 198, 200 (Sup 1963) ("The fact that the agreement [to vote shares of stock in the corporation in a particular manner] does not contain a termination date does not make it any less valid.").

[540] See, e.g., Odman v. Oleson, 319 Mass. 24, 64 N.E.2d 439, 440 (1946), where the court, in holding invalid a contract among all the shareholders except one, which named the directors and one of the officers, stated that "the contract was not restricted as to time, in which respect if not in others the case differs from Mansfield v. Lang, 293 Mass. 386, 200 N.E. 110 (1936)." Cf. Sherman & Ellis v. Indiana Mut. Casualty Co., 41 F.2d 588 (C.C.A. 7th Cir. 1930), in which the court held invalid a 20-year management contract between two corporations but made the following comment: "That corporations may, at least, for a limited period, delegate to a stranger certain duties usually performed by the officers, is clear." 41 F2d at 590. One commentator has stated that only Morel v. Hoge, 130 Ga. 625, 61 S.E. 487 (1908), and Rosenkrantz v. Chattahoochee Brick Co., 147 Ga. 730, 95 S.E. 225 (1918), have invalidated shareholders' agreements primarily on the ground of excessive duration. Logan, Methods To Control the Closely Held Kansas Corporation, 7 U. Kan. L. Rev. 405, 418 (1959).

[541] See, e.g., Harvey v. Linville Imp. Co., 118 N.C. 693, 24 S.E. 489 (1896) (5 years). See also Roberts v. Whitson, 188 S.W.2d 875 (Tex. Civ. App. Dallas 1945), writ refused w.o.m., (Oct. 3, 1945) (10 years). Cf. Knickerbocker Inv. Co. v. Voorhees, 100 A.D. 414, 91 N.Y.S. 816 (1st Dep't 1905) (directors delegated to individuals other than directors and officers exclusive power to manage corporation for a period of 5 years).

[542] Glazer v. Glazer, 374 F.2d 390 (5th Cir. 1967).

[543] R. H. Sanders Corp. v. Haves, 541 S.W.2d 262 (Tex. Civ. App. Dallas 1976).

[544] See Pearson v. Hardy, 853 S.W.2d 497 (Tenn. Ct. App. 1992) (interpreting the language of then Tenn. Code Ann. §48-17-302).

not apply.[545] After the case, the Tennessee corporations code was amended to remove the 20-year duration limitation on shareholders' agreements.[546]

[545] See Pearson v. Hardy, 853 S.W.2d 497 (Tenn. Ct. App. 1992).

[546] Tenn. Laws 1994, 776, deleting (c) from §48-17-302.

XII. SEVERABILITY OF ILLEGAL PARTS OF SHAREHOLDERS' AGREEMENTS

The principles governing the severability of valid from invalid provisions in contracts generally are applicable to shareholders' agreements.[547] The intentions of the parties to an agreement control whether valid provisions will be given effect where part of the agreement is held invalid.[548] In this respect, the intention of the parties "must be determined from the terms and subject matter of the contract, together with any pertinent explanatory circumstances."[549] The test is whether the parties would have entered into the agreement as set forth in its valid provisions had they known that some of the terms were invalid,[550] and that question is usually answered in the affirmative if the purpose of the agreement can substantially be achieved by giving effect to the valid provisions.

The results reached in applying these principles to typical shareholders' agreements have perhaps not been entirely consistent: In several cases, a court has refused to enforce provisions binding the parties to vote their shares as a unit where the agreement also contained provisions unlawfully depriving the directors of their powers.[551] These decisions were based on the ground

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[547] For a discussion of the principles applicable to the severability of contracts generally, see 6 Williston, Contracts §§1779 to 1782 (Rev Ed 1938). "The general rule is that, if the obnoxious features of a contract can be eliminated without impairing its symmetry as a whole, the courts will be inclined to adopt this view as the one most likely to express the intention of the parties; but, if the good and the bad are so interwoven that they cannot be separated without altering or destroying the general meaning and purpose of the contract, the good must go with the bad, and the whole contract be set aside." Newport Rolling Mill Co. v. Hall, 147 Ky. 598, 603, 144 S.W. 760, 762 (1912). "Enforcement in part will never be granted if such enforcement enables a party to attain his illegal purpose, even in part. But if such attainment is wholly avoided, if the degree of illegality is not great, and if enforcement in part is not unfair and unreasonable, the court may be justified in declaring that the transaction is divisible and in enforcing the lawful part. In such cases as these, the court may feel aided by an express provision that if any provision shall be found to be illegal it shall be disregarded and the remainder enforced." 6A Corbin, Contracts §1520.

[548] Orenstein v. Kahn, 13 Del. Ch. 376, 119 A. 444 (1922). The following clause was included in the shareholders' agreement before the court in Beresovski v. Warszawski, 28 N.Y.2d 419, 423, 322 N.Y.S.2d 673, 675, 271 N.E.2d 520, 521 (1971): "[i]n the event any of the provisions of this agreement shall be deemed illegal or against public policy, the validity or legality of any of the other provisions or any part thereof shall not thereby be affected."

[549] Equitable Trust Co. v. Delaware Trust Co., 30 Del. Ch. 118, 128, 54 A.2d 733 (1947).

[550] Tracey v. Franklin, 31 Del. Ch. 477, 487, 67 A.2d 56, 61, 11 A.L.R.2d 990 (1949).

[551] Teich v. Kaufman, 174 Ill. App. 306, 315, 1912 WL 2785 (1st Dist. 1912) ("[I]t is manifest that the mutual promise binding the parties, as directors, to vote for and to secure the salaried positions as aforesaid, entered into the entire agreement as a consideration therefor. 'Nothing is better settled in the law of contracts than if any part of the consideration upon which a promise rests is illegal the entire promise fails.' "); Manson v. Curtis, 223 N.Y. 313, 324, 119 N.E. 559, 562 (1918) ("The contract was single and indivisible, and the illegal part cannot be expunged. Its

that the agreement was entire and indivisible, or that the illegality of the unlawful undertakings permeated the whole contract. On the other hand, some decisions have severed valid provisions in a shareholders' agreement from invalid provisions controlling directors' action and have enforced the valid provisions.[552] The severability of valid from invalid terms in a contract has also been raised in a number of decisions involving voting trust agreements. In one case, two shareholders conveyed their stock to themselves as voting trustees, agreeing to vote the shares jointly to insure good management and agreeing further not to transfer their shares except by mutual consent; the court held the share transfer restriction invalid as an unreasonable restraint on alienability and refused to give effect to the other provisions of the agreement on the ground that the transfer restriction was an integral part of the agreement and that the parties would not

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main purpose being illegal, and the secondary stipulations fall with it."). See also Smith v. California Thorn Cordage, 129 Cal. App. 93, 18 P.2d 393 (3d Dist. 1933) (part of contract relating to transfer of stock held not severable from provisions unlawfully vesting directors' powers in a finance committee); Marvin v. Solventol Chemical Products, 298 Mich. 296, 298 N.W. 782, 783 (1941) (loan contract giving the lender control of the corporation and the privilege of buying shares of stock in it for a period of five years said to be incapable of division). In Galler v. Galler, 45 Ill. App. 2d 452, 465, 196 N.E.2d 5 (1st Dist. 1964), aff'd in part, rev'd in part, 32 Ill. 2d 16, 203 N.E.2d 577 (1964), the intermediate appellate court refused to enforce any part of a shareholders' agreement, commenting: The fact that all shareholders were parties to the agreement encourages divisibility, but [...] [w]e feel that the undue duration, stated purpose and substantial disregard of the provisions of the corporation act outweigh any considerations which might call for divisibility and that the public policy of this state demands voiding this entire agreement. On appeal the Illinois Supreme Court held the entire agreement to be valid. Galler v. Galler, 32 Ill. 2d 16, 203 N.E.2d 577 (1964).

[552] Motherwell v. Schoof, [1949] 2 West Wkly R 529 (Alta). In Abercrombie v. Davies, 35 Del. Ch. 599, 123 A.2d 893 (1956), the Chancellor separated provisions controlling shareholder action from those controlling the action of directors and upheld the former provisions while striking down the latter. On appeal, the Supreme Court of Delaware declared the provisions relating to shareholder action invalid also, but on independent grounds. See also Noel v. Kline, 325 F.2d 496 (5th Cir. 1963) (a provision in an agreement settling litigation concerning the management of a family corporation which assured a particular shareholder representation on the board of directors was held invalid under Louisiana law, but its invalidity was held not to vitiate other provisions in the agreement); Reilly v. Korholz, 137 Colo. 20, 320 P.2d 756 (1958) (a shareholder transferred part of his shares to a lender in return for the lender's advancing necessary financing to the corporation and in the transfer agreement promised to vote his remaining shares for the lender's election to the corporation's board; the court held that even assuming the promise to vote was invalid the remainder of the agreement was severable); Triggs v. Triggs, 46 N.Y.2d 305, 413 N.Y.S.2d 325, 385 N.E.2d 1254 (1978) (shareholders' agreement contained provisions for election and compensation of officers and a provision for stock purchase options; court held that the fact that the provisions concerning officer elections and compensation were illegal did not preclude the enforcement of the stock purchase option provision, because the former provisions had not been utilized and were considered independent of the latter); Burnett v. Word, Inc., 412 S.W.2d 792 (Tex. Civ. App. Waco 1967), writ dismissed by agreement, (July 26, 1967) (shareholders' agreement included a provision that bound the parties as directors; court held invalid a provision that the corporation could not incur debt in excess of $40,000 except with the unanimous approval of the directors, but refused to invalidate a clause which plaintiff said required the shareholders to approve an amendment to the articles containing such spending limits).

have entered into the agreement if they had known of its invalidity.[553] In another case, shareholders had entered into an agreement giving themselves equal control of the corporation and had simultaneously executed a voting trust agreement to effectuate the purpose of the control agreement.[554] On the expiration of the two agreements, the parties agreed orally to extend them for a period of one year. The court held that, even assuming the oral extension of the voting trust to be unenforceable, the provisions in the agreement stipulating equality of control could be given effect. The control provisions were treated as severable from the clauses providing for the execution of a voting trust, because the voting trust was only a means of carrying out the primary object of the control agreement, and the purpose of the agreements could be achieved by enforcing the provisions of the agreement on equality of control.

A particularly interesting use of the doctrine of severability occurred in *Glazer v. Glazer*,[555] where three brothers had entered into an agreement to continue their relationship as directors and officers of numerous family corporations. Most of the corporations had been organized under the law of Tennessee, but a number had been organized under the laws of other states, including one under West Virginia law. Some of the corporations contained minority shareholders who were not parties to the agreement. Although the validity of the agreement under West Virginia law was doubtful in the absence of consent by shareholders who were not parties to it, the court, adopting a state-by-state process in passing on the agreement's validity, held that its doubtful validity as applied to the West Virginia corporation did not prevent its enforcement as to corporations domiciled in other states.

On the subject of conflict of laws rule governing validity of shareholders' agreements and voting trusts as a whole, shareholders sometimes execute a voting agreement or a voting trust in a

[553] Tracey v. Franklin, 31 Del. Ch. 477, 67 A.2d 56, 11 A.L.R.2d 990 (1949).

[554] Wygod v. Makewell Hats, 265 A.D. 286, 38 N.Y.S.2d 587 (1st Dep't 1942).

[555] Glazer v. Glazer, 374 F.2d 390 (5th Cir. 1967).

state other than the state of incorporation of the company whose shares are involved, and thus the question arises whether the validity of the agreement or the voting trust is to be determined by the law of the place where the agreement was executed or by the law of the state of incorporation of the company whose shares are affected. What authority there is on this question indicates rather clearly that the validity of both voting agreements[556] and voting trusts[557] will be tested in accordance with the law of the state of incorporation.

[556] Glazer v. Glazer, 374 F.2d 390 (5th Cir. 1967); Deibler v. Chas. H. Elliott Co., 368 Pa. 267, 81 A.2d 557 (1951). See also Davis v. Rondina, 741 F. Supp. 1115 (S.D. N.Y. 1990) (under New York law shareholder's agreements are to be interpreted according to the law of the state of incorporation). Fletcher Cyc Corp. §2067 (Perm Ed). Restatement Second, Conflict of Laws §305 (1971) (voting of shares governed by law of state of incorporation except in unusual case in which another state has a more significant relationship); Restatement, Conflict of Laws §183 (participation in management and profits determined by law of the state of incorporation). "It appears to be settled, and is an almost necessary rule of convenience, that in such a situation the validity of an agreement affecting such voting rights is tested by the law of the state of incorporation [...]. Thus the nature of the subject matter of the Agreement renders the usual rule governing the validity of contracts inapplicable [...]." Ringling v. Ringling Bros.-Barnum & Bailey Combined Shows, 29 Del. Ch. 318, 326, 49 A.2d 603, 607 (1946), order modified, 29 Del. Ch. 610, 53 A.2d 441 (1947).

Cf. Palmer v. Chamberlin, 191 F.2d 532, 533, 27 A.L.R.2d 416 (5th Cir. 1951). In Glazer v. Glazer, an agreement among the principal owners of various family enterprises involved corporations organized under the laws of several different states. The court took a state-by-state approach in determining the validity of the agreement as applied to the various corporations. McQuade v. Stoneham, 263 N.Y. 323, 189 N.E. 234 (1934), held invalid an agreement among the shareholders of a New Jersey corporation on the ground that it violated corporation statutes of New York. In Long Park v. Trenton-New Brunswick Theatres Co., 297 N.Y. 174, 77 N.E.2d 633 (1948), the parties to a management agreement (relating to shares in a New Jersey corporation) stipulated that the contract was to be construed according to the laws of New York; the court indicated that the agreement was illegal under both the New York and New Jersey corporation statutes; Fuld, J., dissented on the ground that the court in accepting jurisdiction was interfering with the internal affairs of a foreign corporation. Cf. Rosenmiller v. Bordes, 607 A.2d 465 (Del. Ch. 1991) (Delaware has a greater interest than New Jersey in regulating stockholder voting rights in a Delaware corporation despite a unanimous shareholder vote authorizing the application of New Jersey law); Manderson & Associates, Inc. v. Gore, 193 Ga. App. 723, 389 S.E.2d 251 (1989) (in a suit arising under employment agreements and stock transfer agreements, court held Georgia courts will normally enforce a contractual choice of law provision in absence of contrary public policy, as parties by contract may stipulate that laws of another jurisdiction will govern the transaction).

[557] In re O'Gara Coal Co., 260 F. 742 (C.C.A. 7th Cir. 1919); Tankersley v. Albright, 374 F. Supp. 538 (N.D. Ill. 1974), judgment aff'd in part, rev'd in part, 514 F.2d 956 (7th Cir. 1975).

XIII. BREACH OF SHAREHOLDERS' AGREEMENTS AND AVAILABLE REMEDIES

As statutes and case law recognize shareholders' agreements, it is not unusual for courts to state that these agreements should be enforced like any other agreement.[558] Many modern statutes expressly provide for specific enforcement of shareholders' agreements, particularly pooling agreements.[559] Thus, the Connecticut statute states that a voting agreement shall be specifically enforceable.[560] Similarly, the Maryland statute provides that an agreement among all the shareholders of a statutory close corporation "may, in the discretion of a court of equity, be enforced by injunction or by such other relief as the court may determine to be fair and appropriate in the circumstances."[561] Yet, when it comes to the remedy courts provide, the shareholders' agreements cases may not be typical of contracts cases generally. Suits based on shareholders' agreements are much more likely to result in a judicial order of specific performance rather than damages.[562]

Although the breach of a valid shareholders' agreement gives rise to an individual right of

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[558] E.g., Blount v. Taft, 295 N.C. 472, 246 S.E.2d 763, 771 (1978), noted 15 Wake Forest L. Rev 531 (1979), 68 Ky. L.J. 520 to 523 (1980) ("Since consensual arrangements among shareholders are *agreements*—the products of negotiation—they should be construed and enforced like any other contract so as to give effect to the intent of the parties as expressed in their agreements, unless they 'violate the express charter or statutory provision, contemplate an illegal object, involve [...] fraud, oppression or wrong against other stockholders, or are made in consideration of a private benefit to the promisor' "); Hughes v. Sego Intern. Ltd., 192 N.J. Super. 60, 469 A.2d 74 (App. Div. 1983) (court stated that shareholders' agreements are generally enforceable). See, generally, Chayes, Madame Wagner and the Close Corporation, 73 Harvard Law Review 1532, 1535 (1960), comments as follows: Thus far, the controversy has centered on the *validity* of agreements or arrangements among enterprisers in the closely held concern, which violate the presumed corporate norms. The assumption, unspoken as well as unexamined, has apparently been that if the arrangement survives the validity objection, it will, as a matter of course, be enforced according to its terms, especially if it is embodied in a charter or by-law provision. The assumption is not warranted. The question of the relief to be granted for violation of such an arrangement raises problems more vexing, difficult, and real than ever were to be found on the validity side. (Emphasis added.)

[559] See, e.g., Model Business Corporation Act Ann. §7.31(b). Delaware leaves specific performance to the courts, which have not settled the matter. Bradley, A Comparative Evaluation of the Delaware and Maryland Close Corporation Statutes, 1968 Duke Law Journal 525, 527. See also Bradley, Toward a More Perfect Close Corporation—The Need for More and Improved Legislation, 54 Georgia Law Journal 1145, 1162 (1966) (a provision for specific enforcement of shareholders' voting agreements is as essential to a satisfactory corporation statute as a provision validating such agreements).

[560] Conn. Gen. Stat. §33-716. See also Cal. Corp. Code §706(a).

[561] Md. Corps. & Ass'n Code §4-104(d).

[562] Agreeing with such a conclusion under Italian law, also by specifically mentioning the U.S. approach, is Santini, *Esecuzione specifica di accordi parasociali?*, in *Archivio Giuridico Filippo Serafini*, 1968, 487. See also Lombardi, *I patti parasociali nelle società non quotate e la riforma del diritto societario*, in *Giur. comm.*, 2003, 3, 272; Macrì, *Patti parasociali e attività sociale*, Torino, Giappichelli, 2007, 227.

action for breach of contract or direct cause of action by a shareholder in a close corporation, damages are often speculative, such that an order to pay damages may not be a satisfactory remedy.[563] Parties to a shareholders' voting agreement have been able to obtain an adjudication of their rights under the agreement by bringing an action for a declaratory judgment[564] or specific performance. This trend has supplanted more restrictive opinions as to enforcement based on a general dislike of voting agreements that existed in an earlier era.[565] There can be no question that in most instances a suit for damages does not furnish an adequate remedy to the aggrieved party for a breach of a shareholders' agreement and that usually the denial of specific enforcement of the agreement or an injunction against its breach is virtually tantamount to declaring the

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563 E.K. Buck Retail Stores v. Harkert, 157 Neb. 867, 62 N.W.2d 288, 45 A.L.R.2d 774 (1954). After the trial court held that a shareholder control agreement was valid, it authorized plaintiff to institute ancillary proceedings for damages. Plaintiff's supplementary petition included the following: fees the corporation had paid an attorney and an accountant during the litigation, excessive expenditures by the corporation while under defendant's control, corporate property lost after being devoted to unauthorized activities and waste and mismanagement which decreased the corporation's profits. Plaintiff's theory was that these expenditures and losses would not have occurred if defendant had not breached the agreement and that plaintiff, being the owner of 40 percent of the corporation's stock, was entitled to a personal judgment for 40 percent of the corporation's losses. The trial court granted the damages, but on appeal this decree was reversed on the ground that a shareholder's right to sue for damages under the facts plaintiff pleaded was derivative only. See also Smith v. Bramwell, 146 Or. 611, 31 P.2d 647, 648 (1934). But see Ritchie v. McMullen, 79 F. 522, 533 (C.C.A. 6th Cir. 1897), where the court said: "But we are of opinion that this principle has no application where the wrongful acts are not only wrongs against the corporation, but are also violations by the wrongdoer of a duty arising from contract or otherwise, and owing directly by him to the stockholders."

564 Moss v. Waytz, 4 Ill. App. 2d 296, 124 N.E.2d 91 (1st Dist. 1955) (action for declaratory judgment establishing rights among shareholders and the corporation); E.K. Buck Retail Stores v. Harkert, 157 Neb. 867, 62 N.W.2d 288, 45 A.L.R.2d 774 (1954). See also Long Park v. Trenton-New Brunswick Theatres Co., 297 N.Y. 174, 77 N.E.2d 633 (1948) (action for declaratory judgment; agreement declared invalid).

565 Haldeman v. Haldeman, 176 Ky. 635, 651 197 S.W. 376 (1917) ("If the contract be treated as valid, innumerable complicated and difficult questions must arise in its enforcement. As an instance: Has the court power to direct stockholders how they shall vote in their selection of directors, and can it instruct directors how to vote in the election of officers of the corporation?" [...] "It is the consideration of such difficult questions of administration as these that has made the rule which necessarily limits the power and functions of a court of equity in the enforcement of contracts."); Sullivan v. Parkes, 69 A.D. 221, 74 N.Y.S. 787 (1st Dep't 1902); Gage v. Fisher, 5 N.D. 297, 304, 65 N.W. 809, 811 (1895) ("We are satisfied that, both on principle and under sound authority, the true rule is that a court of equity should never specifically enforce a contract by which one person agrees that another should control his stock without purchasing it, where the sole ground of the appeal to equity is the desire of the party making the appeal to secure control of a corporation through the use of the stock he is thus seeking to control."); Gleason v. Earles, 78 Wash. 491, 139 P. 213 (1914). Cf. Kennedy v. Monarch Mfg. Co., 123 Iowa 344, 98 N.W. 796 (1904). See also Fletcher Cyc Corp §2067 (Perm Ed). Authority for the rule denying specific performance of voting agreements, however, has been said to be "of doubtful origin, being derived from dictum, and cases in which the agreement either was itself totally invalid or was a form of voting agreement which expressly attempted to limit the directors in the independent exercise of their judgment." 96 U. Pa. L. Rev 121 to 22 (1947). See also Joio v. Rubenheimer, 37 Misc. 2d 318, 234 N.Y.S.2d 882 (Sup 1962), where the court refused to issue a temporary injunction when there was an issue of fact as to the existence of the agreement.

agreement invalid. It is perhaps for this reason that most of the decisions[566] recognize shareholders' voting agreements to be enforceable by injunction or a decree of specific performance.[567] This includes: voiding corporate actions taken in violation of an agreement;[568] reforming the agreement,[569] the charter[570] or bylaws[571] to reflect the parties' original

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[566] Smith v. San Francisco & N.P. Ry. Co., 115 Cal. 584, 47 P. 582 (1897) (decree had same effect as specific performance); In re Farm Industries, Inc., 41 Del. Ch. 379, 196 A.2d 582 (1963) (specific enforcement of a voting trust agreement); Galler v. Galler, 32 Ill. 2d 16, 203 N.E.2d 577 (1964) (granting specific performance of a contract between two brothers and their wives); Trefethen v. Amazeen, 93 N.H. 110, 36 A.2d 266 (1944); Clark v. Dodge, 269 N.Y. 410, 199 N.E. 641 (1936); Adler v. Svingos, 80 A.D.2d 764, 436 N.Y.S.2d 719 (1st Dep't 1981), noted 35 Syracuse L. Rev 40 to 43 (1984) (court issued an order declaring that a provision in a shareholders' agreement in a closely held corporation executed by all three shareholders, specifying that all corporate operations, including changes in corporate structure, would require the unanimous consent of the shareholders was valid); Shubin v. Surchin, 27 A.D.2d 452, 280 N.Y.S.2d 55 (1st Dep't 1967); Weber v. Sidney, 19 A.D.2d 494, 244 N.Y.S.2d 228 (1st Dep't 1963), order aff'd, 14 N.Y.2d 929, 252 N.Y.S.2d 327, 200 N.E.2d 867 (1964) (injunction to prevent violation of a shareholders' agreement); Kaminsky v. Kahn, 13 A.D.2d 143, 213 N.Y.S.2d 786 (1st Dep't 1961) (seller entitled to injunction to prevent buyer from disposing of shares in violation of agreement); Storer v. Ripley, 1 Misc. 2d 235, 125 N.Y.S.2d 831 (Sup 1953), judgment aff'd, 282 A.D. 950, 125 N.Y.S.2d 339 (2d Dep't 1953); Samuelson v. Starr, 28 Misc. 2d 479, 481, 213 N.Y.S.2d 889, 891 (Sup 1961) ("Such agreement by all of the stockholders of a corporation to vote for certain persons as directors and to continue a director as manager is not unlawful on its face and may be specifically enforced if there is no interference with the rights of creditors or minority stockholders."); Heller v. Clark Merchandisers, Inc., 9 Misc. 2d 106, 154 N.Y.S.2d 150 (Sup 1955) (proceeding in the nature of an action for mandamus to achieve objectives of shareholders' agreement dismissed because the shareholder had other remedies available—"a suit for specific performance and damages for violation of his contractual rights"); R. H. Sanders Corp. v. Haves, 541 S.W.2d 262 (Tex. Civ. App. Dallas 1976) (temporary injunction was proper to enforce compliance with the agreement). See also British Murac Syndicate, Ltd. v. Alperton Rubber Co., [1915], 2 Ch. 186 (restraining a company by injunction from breaching its agreement not to alter its articles of association).

But see Roach v. Bynum, 403 So. 2d 187 (Ala. 1981), noted 71 Ky. L.J. 282 (1982) (court held that president of a corporation was not entitled to specific performance of a clause of a shareholders' agreement compelling the other shareholders to sell their stock to the corporation, where the president was indebted to the corporation, as were the other shareholders).

[567] A few decisions indicate that voting agreements will be specifically enforced only if there is consideration other than the mutual promises of the parties. Johnson v. Spartanburg County Fair Ass'n, 210 S.C. 56, 41 S.E.2d 599 (1947); Roberts v. Whitson, 188 S.W.2d 875 (Tex. Civ. App. Dallas 1945), writ refused w.o.m., (Oct. 3, 1945). Further, it has been said that equity "will not compel specific performance unless the making of a contract relied on has been clearly established by the proof." Aldridge v. Franco Wyoming Oil Co., 24 Del. Ch. 126, 7 A.2d 753 (1939), determination sustained, 24 Del. Ch. 349, 14 A.2d 380 (1940).

[568] Zion v. Kurtz, 50 N.Y.2d 92, 428 N.Y.S.2d 199, 405 N.E.2d 681, 15 A.L.R.4th 1061 (1980), noted 33 Syracuse L. Rev 15 to 17 (1982) (court issued an injunction declaring valid a shareholders' agreement providing that no business or activities of a closely held corporation could be conducted without the consent of the minority shareholder; certain corporate actions taken without the consent of the minority shareholder were void); Davidow v. Donow, 33 Misc. 2d 406, 216 N.Y.S.2d 257 (Sup 1961), judgment aff'd, 16 A.D.2d 681, 227 N.Y.S.2d 893 (2d Dep't 1962) (election of director contrary to shareholders' agreement declared void).

[569] In re Farm Industries, Inc., 41 Del. Ch. 379, 196 A.2d 582 (1963) (court reformed a voting trust agreement to include voting rights inadvertently omitted by an attorney, and ordering specific enforcement of the agreement as reformed if that would not harm anyone not a party).

[570] Kronenberg v. Sullivan County Steam Laundry Co., 91 N.Y.S.2d 144 (Sup 1949), order aff'd, 277 A.D. 916, 98 N.Y.S.2d 658 (3d Dep't 1950) (reformation of the certificate of incorporation to conform to oral shareholders' agreement).

understanding; having shares transferred;[572] awarding a constructive trust over assets improperly sold;[573] ordering an accounting;[574] or providing for compensatory and punitive damages.[575]

Most of the decisions granting specific performance have involved agreements to which all shareholders were parties; but, if an agreement is valid (not being fraudulent or unfair to shareholders who are not parties to it) and an aggrieved party does not have an adequate remedy at law against the parties breaching or threatening to breach it, no reason is apparent why specific performance or an injunction should not ordinarily be available to enforce the agreement, even though some of the shareholders are not parties to it.[576] Including in a shareholders' agreement a

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[571] Weil v. Beresth, 154 Conn. 12, 220 A.2d 456 (1966) (agreement enforced by injunction which required contracting shareholders to reenact two bylaws which had originally been enacted pursuant to the agreement, to repeal all inconsistent bylaws, and to withdraw from the board of directors power to amend the two bylaws directly or indirectly); Katcher v. Ohsman, 26 N.J. Super. 28, 97 A.2d 180 (Ch. Div. 1953) (specific performance accomplished by reformation of the bylaws to make them conform to the agreement).

[572] See De Felice v. Garon, 395 So. 2d 658 (La. 1980) (court held that the respondents upon whom the owner of stock expressly conferred by contract the right to vote the shares could enforce the contract by having the shares transferred in their name on the books of the existence of the pledge); Scheurer v. Scheurer, 311 Minn. 546, 249 N.W.2d 181 (1976) (founder of corporation transferred his controlling block of shares to his sons, reserving by agreement the power to vote the shares during his lifetime; following a dispute with his sons the founder attempted to exercise his voting rights to elect new directors; the court enforced the agreement by rescinding the original share transfer transaction); Myhre v. Myhre, 170 Mont. 410, 554 P.2d 276 (1976) (stock option agreement enforceable by specific performance where stock in family corporation had no recognized market value, value of stock was dependent on performance of company in highly competitive field, and acquisition of stock would give purchaser-son operating control of company).

[573] Butler v. Attwood, 369 F.2d 811 (6th Cir. 1966) (the court, applying the equitable doctrine of constructive trust, compelled a third party with notice of an equal ownership agreement between two shareholders to sell to plaintiff shareholder one-half of the shares he had purchased from one of the contracting shareholders).

[574] For a case in which a minority shareholder in a close corporation who was a party to a shareholders' agreement brought suit against his two fellow shareholders and the corporation seeking an accounting and corporate dissolution as a result of a breach of his rights under the agreement, see Wasserman v. Rosengarden, 84 Ill. App. 3d 713, 40 Ill. Dec. 430, 406 N.E.2d 131 (1st Dist. 1980).

[575] Sankin v. 5410 Connecticut Ave. Corp., 281 F. Supp. 524 (D. D.C. 1968), judgment aff'd, 410 F.2d 1060 (D.C. Cir. 1969) (punitive and injunctive relief, as well as compensatory damages awarded against the breaching shareholder and the corporation).

[576] In Ringling Bros.-Barnum & Bailey Combined Shows v. Ringling, 29 Del. Ch. 610, 53 A.2d 441 (1947), the order of the Delaware Supreme Court had a rather unusual result and one which frustrated a principal objective of the agreement, namely, unity of action and retention of control by the two contracting shareholders who had joined together to make up a majority. The two contracting parties, Mrs. Ringling and Mrs. Haley, who between them had sufficient votes to elect five of the seven directors, agreed to act jointly in exercising their voting rights and in the event of disagreement to vote in accordance with the decision of an arbitrator. After a disagreement between the two following a famous circus fire and a decision by the arbitrator, Mrs. Haley disregarded the arbitrator's decision and voted her shares contrary to his directions and making an alliance with the third shareholder, Mr. North. The Court of Chancery ordered that a new election be held before a master and that effect be given the agreement. On appeal, the Supreme Court modified the decree of the Court of Chancery, ordering that Mrs. Haley's votes be rejected but that the other votes cast at the shareholders' meeting be counted. The result was that only six directors (instead of

clause expressly stating that the parties agree to specific enforcement in the event of an attempted breach probably increases the chances of it being specifically enforced.[577] A court may grant specific performance of substantive terms of an agreement or it may enforce a remedy provided for in the agreement itself. In a California case, the court ordered specific performance of an agreement that provided for a buyout as the remedy for failure to abide by it.[578] A shareholders' agreement specified group voting for directors as determined by the majority of the group. Where one member of the group sided with the other group at a directors' meeting to change corporate officers, the group responded by replacing the recalcitrant member as a director. The court found the dissidents' written repudiation of the agreement to be a breach, which constituted an election to sell their shares in accordance with the buy/sell provisions.

In a federal decision, the court enforced an agreement by which the holders of 52 percent of a company's shares agreed that if they could not take resolution on how their shares would be voted, their shares would not be voted at all, with the result that shareholders' decisions would be made by the minority shareholders.[579] Agreements naming arbitrators have also been specifically enforced. A shareholders' agreement entitling a shareholder to maintain a 51% interest did not entitle shareholders to void issuance of additional shares when done by a seven person board split as designated in the agreement, but at most gave rise to a right or entitlement to receive

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seven) were elected, three by Mrs. Ringling and three by Mr. North, insuring something of a power sharing not contemplated by the original agreement, but not rewarding the party who had violated the agreement.

577 For an agreement containing such a clause, see Schmith v. Fornander, 26 Misc. 2d 339, 200 N.Y.S.2d 505 (Sup 1960), judgment aff'd, 13 A.D.2d 478, 215 N.Y.S.2d 462 (1st Dep't 1961) ("a breach or attempted breach of the covenants in this paragraph will result in irreparable damage), which damage is not measurable in money, so the parties agree to injunctive relief to compel compliance").

578 Ramos v. Estrada, 8 Cal. App. 4th 1070, 10 Cal. Rptr. 2d 833 (2d Dist. 1992), reh'g denied and opinion modified (Sept. 11, 1992) (note that the breach was not the dissident director's act to vote with the other group to change officers, but the dissidents' subsequent repudiation after the remainder of the group quickly acted to remove the plaintiff from the board and restore the balance of power contemplated by the agreement).

579 Neuman v. Pike, 591 F.2d 191 (2d Cir. 1979) (court refused to infer, however, that the parties intended as part of the agreement that neither of them would unreasonably withhold his consent to the election of the nominee of the other to the board of directors).

additional shares or the opportunity to purchase such shares in defined circumstances.[580]

[580] Superwire.Com, Inc. v. Hampton, 805 A.2d 904 (Del. Ch. 2002).

XIV. FIDUCIARY DUTIES IN THE CLOSE CORPORATION

In allowing special control devices – such as high vote requirements for shareholders and directors' action and shareholders' agreements that control actions within the traditional turf of the board of directors – both the legislators and the courts have increasingly recognized the unique needs of the close corporation (i.e., the so-called *incorporated partnership*).[581]

The wide range of techniques that may be used to squeeze out minority shareholders raises a basic question as to the nature and extent of the duties owed to minority shareholders by controlling shareholders, directors, and officers in the close corporation. A director owes a fiduciary duty to the corporation to exercise unbiased judgment in order to further the interests of the corporation.[582] Although it is firmly established that directors and officers stand in a fiduciary relationship to the corporation and its shareholders,[583] it is not clear whether there is a similar fiduciary duty owed by majority shareholders to minority shareholders in the close corporation. This problem is especially apparent when management functions are transferred

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[581] There is an extensive literature on the scope of fiduciary obligations in the close corporation and LLC settings. See, e.g., Matheson & Maler, A Simple Statutory Solution to Minority Oppression in the Closely Held Business, 91 Minn. L. Rev. 657 (2007); Moll, Minority Oppression & The Limited Liability Company: Learning (Or Not) From Close Corporation History, 40 Wake Forest L. Rev. 883 (2005); Siegel, Fiduciary Duty Myths in Close Corporation Law, 29 Del. J. Corp. L. 377 (2004); Moll, Shareholder Oppression & Reasonable Expectations: Of Changes, Gifts, and Inheritances in Close Corporation Disputes, 86 Minn. L. Rev. 717 (2002); Moll, Shareholder Oppression In Close Corporations: The Unanswered Question In Perspective, 53 Vand. L. Rev. 749 (2000); Van Vliet Jr. & Snider, The Evolving Fiduciary Duty Solution for Shareholders Caught in a Closely Held Corporation Trap, 18 N. Ill. U. L. Rev. 239 (1998); Thompson, The Shareholder's Cause of Action for Oppression, 48 Bus. Law 699 (1993); Thompson, Corporate Dissolution And Shareholders' Reasonable Expectations, 66 Wash. U. L. Q. 193 (1988). See also Cary, How Illinois Corporation May Enjoy Partnership Advantages: Planning for the Closely Held Firm, 48 Nw. U. L. Rev. 427 (1953); Hornstein, Judicial Tolerance of the Incorporate Partnership, Law & Contemp. Problems, 435 (1953); O'Neal & Thompson, O'Neal and Thompson's Close Corporations and LLCs: Law and Practice (rev. 3rd ed. 2009, database updated July 2013); O'Neal, Close Corporation Legislation: A Survey and an Evaluation, 1972 Duke L.J. 867; O'Neal, Control Distribution Devices, 1969 U. Ill. L.F. 48; Bivins, Jr., The New Texas Close Corporation Legislation: A Comparison with Florida and Delaware, 27 SW. L.J. 340 (1973).

[582] Henn & Alexander, Laws of Corporations, §240 (3rd ed. 1983).

[583] O'Neal, Squeeze-Outs of Minority Shareholders: Expulsion or Oppression of Business Associates, §7.13 (1975 & Supp. 1983). See, e. g., Berman v. Gerber Prod. Co., 454 F. Supp. 1310, 1319 (W.D. Mich. 1978) (corporate officers and directors owe a high fiduciary duty to shareholders); Salvadore v. Connor, 87 Mich. App. 664, 675, 276 N.W.2d 458, 463 (1979) (directors, officers and majority shareholders are fiduciaries who owe a strict duty of good faith to the corporation and the majority shareholders). See also Miller, The Fiduciary Duties of a Corporate Director, 4 U. Balt. L. Rev. 259 (1975).

from directors to shareholders.[584]

In the past, some courts have allowed majority shareholders to exercise whatever powers were granted to the controlling shareholders under the statutes and the corporation charter and bylaws.[585] Furthermore, some courts have treated the fiduciary duties of directors as requiring a duty only to the corporation, and not to the minority shareholders.[586] Nevertheless, some court decisions suggest that a fiduciary duty does exist between the majority and minority shareholders in the close corporation.[587] Further, such duties have been found to be analogous to the duties owed by partners to each other.[588] An examination of several state court decisions actually shows the development of the trend at issue.

In *Jones v. H. F. Ahmanson & Co.*,[589] the majority shareholders in a close corporation artificially created a market for their shares by forming a separate holding company and exchanging their close corporation shares for the holding company's shares. The minority shareholders, however, were not allowed to participate in the exchange. When the majority shareholders made a public offering of the holding company shares, the minority shareholders sued because their shares were now unmarketable. The California Supreme Court held that the use of a majority position to create a market for shares that was not available to minority shareholders violated the fiduciary duty owed by the controlling shareholders to the minority ones. Thus, the *Jones* decision recognizes that a fiduciary relationship exists between the minority and majority shareholders in the close corporation. The good faith standard requires that majority

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584 As provided for in some modern corporate statutes.

585 See, e.g., Barrett v. Denver Tramway Corp., 53 F. Supp. 198, 202 (D. Del.), *aff'd* 146 F.2d 701 (3d Cir. 1944); McNulty v. W. & J. Sloane, 184 Misc. 835, 841-42, 54 N.Y.S.2d 253, 260 (Sup. Ct. 1945).

586 See, e.g., Carpenter v. Danforth, 52 Barb. 581, 584 (N.Y. Sup. Ct. 1868).

587 See Watts v. Des Moines Register & Tribune, 525 F. Supp. 1311, 1316-17 (S.D. Iowa 1981); Provident Nat. Bank v. United States, 436 F.Supp. 587, 589 (E.D. Pa. 1977).

588 See Wilkes v. Springside Nursing Home, Inc., 370 Mass. 842, 848, 353 N.E.2d 657, 661 (1976) (duty among shareholders of closely held corporation, like duty of partners, defined as 'one of utmost good faith and loyalty').

589 Jones v. H. F. Ahmanson & Co., 460 P.2d 464 (Cal. 1969), noted in 83 Harvard Law Review 1904 (1970), 1969 Ill. L. Rev. 534.

shareholders' action must benefit all shareholders, proportionately. Furthermore, the majority shareholders may not use their powers for their own personal benefit or to the detriment of the minority shareholders.

The Massachusetts Supreme Judicial Court expanded the fiduciary duty doctrine in *Donahue v. Rodd Electrotype Company of New England.*[590] Rodd Electrotype Company, a close corporation, entered into an agreement with a former officer and director to repurchase his shares. The minority shareholder, Donahue, protested and offered to sell her shares on the same terms but was refused. When the company refused to repurchase her shares, Donahue brought suit claiming the repurchase was a violation of the fiduciary duty owed to her by the majority in its capacity as controlling shareholder. Donahue argued that the corporation ought to have made an offer to repurchase her shares that was similar to the one made to the former director. The Massachusetts court, treating the case in the context of the close corporation, held that shareholders in the close corporation owe one another substantially the same fiduciary duty in the operation of the enterprise as *partners*, and thus are subject to a duty of good faith and loyalty in their dealings.[591]

The court's decision in *Donahue* is significant for two reasons: Firstly, the decision goes beyond *Jones v. H. F. Ahmanson & Co.*, in that it applies to all shareholders, not only the majority ones. Any shareholders able to manipulate corporate policy or negotiate transactions on behalf of the corporation, happens to be bound, at least in Massachusetts, to a standard of utmost good faith and loyalty; secondly, the *Donahue* decision is significant because it recognizes the differences between close and public corporations. By defining the close corporation and describing the role of its shareholders in partnership terms, the *Donahue* court clarified and set

[590] Donahue v. Rodd Electrotype Co., 328 N.E.2d 505, 511 (Mass. 1975).

[591] The court concluded that the higher standard placed upon majority shareholders was justified in the close corporation in light of the difficulty experienced by oppressed minority shareholders in obtaining relief under current fiduciary standards.

forth the extent of the rights and duties of minority shareholders in the close corporation.

While the *Donahue* case has alerted courts to the need for greater protection of minority shareholders in close corporations, the strict fiduciary duty standards have not been accepted by other states. Even Massachusetts has retreated from a broad imposition of the standard by adopting a balancing test of minority interests versus business purpose—ultimately.[592] The Massachusetts court has also concluded that minority shareholders owe a strict fiduciary duty to the majority shareholders when the minority acts out of avarice, expediency or self-interest: in *Smith v. Atlantic Properties, Inc.*,[593] four persons formed a corporation to invest in land with each investor receiving twenty-five percent of the stock in the corporation. The articles of incorporation and bylaws of the corporation required that an eighty percent affirmative vote of the corporate stock was necessary to initiate new corporate policy. This agreement in effect gave each shareholder a veto over corporate affairs. As a result of the investment, the corporation accumulated a large amount of retained earnings.[594] The court determined that the same effort and loyalty are required from all shareholders in a close corporation, and distinctions between majority and minority shareholders are not important. The court concluded that the defendant unreasonably used his veto power to the detriment of the corporation and its shareholders, and

[592] This retreat is exemplified by the case of *Wilkes v. Springside Nursing Home, Inc.*, (Wilkes v. Springside Nursing Home, Inc., 370 Mass. 842, 848, 353 N.E.2d 657, 661 (1976)) involving a minority shareholder who was terminated from employment in a close corporation. Although Wilkes, the minority shareholder, had not neglected his duties, he was informed that he was not wanted in the corporation and would no longer receive income from the company. Wilkes then brought an action against the majority shareholders for breach of the fiduciary duty owed to him in his capacity as a shareholder. The court retreated from its position in *Donahue* by stating that it would allow majority shareholders to demonstrate that a legitimate business purpose was served by the termination of minority shareholders. Therefore, when minority stockholders in a close corporation bring suit against the majority alleging a breach of the strict good faith duty owed to them by the majority, the action taken by the controlling stockholders in the individual case is under careful scrutiny. It must be asked whether the controlling group can demonstrate a legitimate business purpose for its action. The court found that action taken by the majority was unjustified and lacked any legitimate business purpose, since the evidence did not disclose any misconduct by Wilkes as a director, officer, or employee of the corporation. The majority shareholders' squeeze-out attempt, at bottom, was a breach of fiduciary duty to Wilkes.

[593] Smith v. Atlantic Properties, Inc. Mass. Ct. App., 422 N.E.2d 798 (1981).

[594] The three plaintiff/shareholders wanted dividends declared out of the retained earnings, but the defendant/minority shareholder vetoed any declaration of dividends. The three shareholders warned the defendant that continued retention of the high earnings would result in tax penalties for unreasonable accumulation of earnings. This is exactly what occurred three years later, with the penalties being paid by the corporation.

this action constituted a breach of fiduciary duty.[595]

Some commentators argue that legislatures ought to provide that the shareholders in the statutory close corporation should be held to the same strict fiduciary duties of partners.[596] A strict fiduciary duty standard would lessen self-dealing abuses in close corporations and encourage investment by persons who previously hesitated to invest capital in small private corporations. Two justifications are offered for such an argument: on the one hand, current statutes afford shareholders of close corporations little protection when a breach of fiduciary duty is alleged; on the other hand, oppression results inasmuch as many courts have not taken adequate safeguards to protect the minority and have allowed corporate decisions to be protected by the business judgment rule.[597]

As a counter argument, though, while it is certainly true that minority shareholders in close corporations are vulnerable to majority oppression, an important policy consideration is whether a broad application of the strict fiduciary duty standards – which minimizes the importance of majority interests – ends up giving too much power to the minority. Broad application of the strict fiduciary duty standards permits even greater economic loss than that caused by squeeze-outs in tying up corporate resources on the basis of complaints by a few minority shareholders. However, if the minority shareholders are also required to adhere to the strict fiduciary duty standard, the majority may be adequately protected from potential oppression

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[595] The court found the minority shareholder had breached the strict good faith standard of duty articulated in *Donahue*.

[596] Elfin, A Critique of the Proposed Statutory Close Corporation Supplement to the Model Business Corporation Act, 8 J. Corp. L. 439, 454 (1983) ('The Proposed Statutory Supplement [...] should provide that the shareholders in the Statutory Close Corporation shall be held, in their relations with one another, and with the corporation, to the same standard of strict fiduciary duty as are partners'); Johnson, Strict Fiduciary Duty in Close Corporations: A Concept in Search of Adoption, 18 Cal. W. L. Rev. 1, 26 (1982) ('The concept of a strict fiduciary duty standard should be adopted (by all courts) in order to establish specific, affirmative guidelines as to what duty majority shareholders owe to the minority').

[597] Johnson, Strict Fiduciary Duty in Close Corporations: A Concept in Search of Adoption, 18 Cal. W. L. Rev. 1, 22 (1982).

by minority shareholders.[598]

[598] Hochstetler & Svejda, Statutory Needs of Close Corporations—An Empirical Study: Special Close Corporation Legislation or Flexible General Corporation Law?, 10 J. Corp. L. 849 (1985).

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