The New York Business Corporation Law

Robert A. Kessler
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ROBERT A. KESSLER †

ON April 24, 1961, L. 1961, ch. 855 was approved by the Governor of New York. The statute is entitled "An Act in relation to business corporations, constituting chapter four of the consolidated laws."¹ It represents the culmination of over four years of study by a joint legislative committee and its advisory groups² "directed toward one end—the ultimate preparation of corporate laws for legislative action that will give our State the best possible statutes under which all who carry on activity in the corporate form may conduct that activity . . . to their maximum

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* This article is the first of two articles on the newly enacted New York Business Corporation Law. The second article, which will follow in the May issue, will present a critique of the procedural aspects of the new law from the viewpoint of the Honorable Abraham N. Davis, Executive Deputy Secretary of State.

† Associate Professor of Law, Fordham University School of Law; Member, Research Advisory Subcommittee to the Joint Legislative Committee to Study Revision of New York Corporation Laws. The opinions expressed in this article are those of the author and do not necessarily reflect the opinions of the Subcommittee or the Joint Legislative Committee.

¹ The bill which thus became law was S. Int. 522, Pr. 4061, and A. Int. 885, Pr. 5310 (1961). The original versions of these bills were S. Int. 522, Pr. 522, A. Int. 885, Pr. 885 (1961).

² The Committee was set up by Joint Resolution No. 27 of the New York Senate and Assembly on March 22, 1956. 1957 N.Y. Leg. Doc. No. 17, at 9, JOINT LEGISLATIVE COMMITTEE TO STUDY REVISION OF CORPORATE LAWS —INTERIM REPORT TO 1957 SESSION OF NEW YORK STATE LEGISLATURE [hereinafter cited as 1957 N.Y. LEG. DOC. NO. 17].
benefit consistent with fairness to others with whom they deal and the public interest.”

The new enactment is a comprehensive revision of the New York law with regard to business corporations, and the first such undertaken in over thirty years. On its effective date, April 1, 1963, it will replace, for such corporations, the unique “trunk” system of present New York law under which a lawyer must consult a General Corporation Law designed to apply to every type of corporation and at least one special statute applicable to his particular kind of corporation (e.g., religious, cooperative, banking, railroad, transportation, municipal, etc.). In the case of ordinary business corporations, this special statute is, of course, the “Stock Corporation Law.”

The new statute is designed, therefore, to supersede both the General and the Stock Corporation Laws as they apply to business corporations, substituting in their stead a single “Business Corporation Law,” applicable to all ordinary business corporations. Obviously the new statute is

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6 See note 4 supra.
8 Section 101 of the new act designates this as its title. The scope of applicability is set out in § 103. The purposes of the new legislation are set forth in § 201 and the definition of “corporation” within the meaning of the statute is given in § 102(4).
9 The obvious design of the new statute is to apply to business corporations, but only to those in that category for which no other special statute (e.g., N.Y. Banking Law, N.Y. Ins. Law) makes exclusive provision. See 1960 N.Y. Leg. Doc. No. 15, at 13; Revised Comment to §§ 103, 201, 1961 N.Y. Leg. Doc. No. 12, at 11, 14, Joint Legislative Committee to Study Revision of Corporation Laws—Revised Supplement to Fifth Interim Report to 1961 Session of the New York State Legislature [hereinafter cited as 1961 N.Y. Leg. Doc. No. 12 (Rev. Supp.)].
10 The Revised Comment to § 103 of 1961 N.Y. Leg. Doc. No. 12, at 11, states: “Upon its effective date, this chapter will automatically apply to all existing business corporations and to those formed thereafter with the exception of corporations formed under other statutes such as the Banking Law, the Railroad Law, the Insurance Law, the Transportation Corporations Law and the Cooperative Corporations Law. The latter and any other corporation will be affected by this chapter only to the extent, if any, as
designed to be both a simplification and modernization of present law.\textsuperscript{10}

The Committee made a thorough study of the present law through consultants who used as their research framework the sections of the A.B.A. Model Business Corporation Act and compared The Model Act and current New York provisions with those of ten other selected jurisdictions. On the basis of his research and analysis, each consultant made recommendations with regard to the particular topic, e. g., "reserved name," which was the subject of his research report.\textsuperscript{11}

The complete research reports, or, at least, summaries of the researcher's recommendations, were widely distributed for comment by the Department of State, the State and New York City Bar Associations, and a number of Advisory Subcommittees. After criticisms by these groups, final research recommendations were framed, "Working Drafts" of statute sections were prepared, further comment solicited in writing and at meetings between the Joint Legislative Committee and the Bar Associations, and "Tentative Staff

may be specified in any law governing such corporation. The effective date of this chapter is April 1, 1963 (§1401).

"This chapter applies to interstate and foreign commerce and to federally-formed corporations only to the extent permitted by the United States Constitution and federal laws.

"Business corporations will no longer be governed by the Stk. Corp. L. or the Gen. Corp. L. After the effective date of this chapter no corporation may be formed under the Stk. Corp. L. unless a New York Statute other than the Stk. Corp. L. permits its formation under the Stk. Corp. L., thus barring the formation of business corporations under the Stk. Corp. L."

Technically, however, the statute only applies to corporations formed for profit. (N.Y. BUS. CORP. LAW §103 must be read in conjunction with N.Y. BUS. CORP. LAW §102 (a) (4) and (7), which define "corporation" as "a corporation for profit").

In any event, it is clear that the new statute will apply to all ordinary business corporations, domestic or foreign, licensed to do business in New York on its effective date, and to all such corporations which seek the right to do business in New York thereafter.

\textsuperscript{10} See note 4 supra.

\textsuperscript{11} See 1958 N.Y. LEG. DOC. No. 23, PART III, JOINT LEGISLATIVE COMMITTEE TO STUDY REVISIONS OF CORPORATION LAWS—SECOND INTERIM REPORT TO 1958 SESSION OF NEW YORK STATE LEGISLATURE [hereinafter cited as 1958 N.Y. LEG. DOC. No. 23]; 1959 N.Y. LEG. DOC. No. 39, PART II, JOINT LEGISLATIVE COMMITTEE TO STUDY REVISION OF CORPORATION LAWS—THIRD INTERIM REPORT TO 1959 SESSION OF NEW YORK STATE LEGISLATURE [hereinafter cited as 1959 N.Y. LEG. DOC. No. 39].
Drafts" or revised forms of these statute sections were prepared. These were the subject of Committee hearings. Finally a Study Bill was drafted and filed, and public hearings held in various places in the state. The Study Bill was accompanied by a Supplement, containing the "Revisers' Notes and Comments." After these hearings the Study Bill itself was revised, and a bill introduced for affirmative legislative action. It too, was accompanied by a Supplement, containing revised "Revisers' Notes and Comments."

As a result of additional recommendations by the practicing bar a further revised version of this bill was introduced, and this is the one which became law. New Revisers' Notes and Comments have recently been published for the statute as finally enacted.

The project was an elaborate one, well organized, and obviously demonstrates a painstaking effort on the part of all concerned. It truly involved a great deal of study—the initial research reports alone total over 1750 pages—and a genuine attempt to produce a truly adequate statute for the second most important corporation state in the country.

17 The bill which thus became law was S. Int. 522, Pr. 4061, and A. Int. 885, Pr. 5310 (1961).
18 1961 N.Y. Leg. Doc. No. 12 (Rev. Supp.). This is a revised version of the Fifth Interim Report to the 1961 Session of the New York Legislature, containing a Revised Supplement (also printed separately), composed of Reviser's Notes and Comments on the Business Corporation Law. Undoubtedly, the Revisers' Notes and Comments to the new statute will be of great utility in interpreting the new law. The language of these Comments is almost as significant as the wording of the statute itself. Therefore, these Comments will be discussed extensively in this article.
20 New York is second only to Delaware in the asset value of its corporations. 1957 N.Y. Leg. Doc. No. '17, at 18.
Despite the fact that a great deal more work has gone into the preparation of the bill than was employed by most states which have adopted revisions of their corporation laws recently, if for no other reason than the imperfection of man, the new law is, like every past law in every jurisdiction, bound to contain some defects.

Although in a sense the "die has been cast" by enactment of the bill as finally submitted, the delayed effective date\(^{21}\) means that amendments are still possible prior to the time the statute actually becomes operative.\(^{22}\)

Since change is therefore still possible it is not too late, and not inappropriate, to make whatever criticisms the new law may inspire, and, as is only right, also to bestow whatever kudos is merited.

Clearly, much more than a single law review article would be required to discuss the entire act adequately. Undoubtedly, more than one book will ultimately be necessary to do that. This discussion can therefore only touch upon the highspots, or, more accurately, those aspects of the new law which appear to this author to be the most important.

The heart of any corporation law is its financial section, that is, the article in the law which tells us how the corporation is to get its assets, and what it may do with them after it has gotten them, or in the more traditional language of corporation law, the problems of stock, dividends and repurchase of its own shares by the corporation. Not even the most cursory discussion of any corporation law would be complete without including some comments on its financial provisions, even though this is certainly the most difficult, and perhaps the dullest, part of any statute.

What other aspects of a corporation law are most important? Opinions may differ. Here, however, it would seem appropriate to take a functional approach. Although it is as difficult to stereotype corporations as it is individuals,

\(^{21}\) "This act shall take effect April first, nineteen hundred sixty-three." N.Y. Bus. Corp. Law § 1401.

\(^{22}\) This point is made in the Governor's Memorandum of Approval of the new law.
legal writers do recognize two polar types of corporation. The one, the "close" corporation, is characterized by an identity of ownership and management, and is typically small, the partnership which has attempted to wrap itself in the cloak of limited liability, and unfortunately, has, under many corporation laws, found that cloak to be in reality a shroud. At the other pole is the "public-issue" corporation. A picture of some industrial behemoth, like U.S. Steel or General Motors, immediately comes to mind.

The new law, like every other corporation law in the nation, contemplates only one statute applicable to both polar types, and to every possible corporate variant between. Most practitioners will want to know how this new act deals with the problems of "close corporations": what the proposed statute does, and does not do, to ameliorate the condition of such corporations, which represent the overwhelming majority of corporations in the nation. This will, therefore, be the second major topic of this paper.

The principal legal problem with regard to public-issue corporations today is probably in the field of fiduciary duties of the management personnel, and in shareholder remedies for enforcing good conduct by the people who, in theory, are merely their representatives to run the corporation, but over whose appointment and tenure they have, in reality, very little to say because of management's control of the proxy solicitation machinery, and the wide dispersal of share ownership. In most public issue corporations the shareholders get the same choice as the citizens of a communist country at election time: they may either vote for the party or simply render an ineffectual protest by refusing to do so. Under such circumstances, there is no possibility of "turning the rascals out." The stockholders' derivative suit is the only effective means for enforcing fiduciary duties. The third topic which seems important enough for this survey of the new law, therefore, is the

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23 Israels & Gorman, Corporate Practice 17 (7th ed. 1957). This is probably the most satisfactory definition.
public issue corporation—fiduciary duties and shareholders’ suits. I shall call this section Public Issue Corporations and Shareholders’ Rights.

Before getting to these three main topics it is, however, probably a good idea to take a bird’s-eye view of the act as a whole.

First, however, it is obvious that a law may be criticized from two different approaches: the purpose, or end sought to be accomplished by the provision in question, in other words, its philosophy, or, on the other hand, the criticism may be of its adequacy to achieve the ends which it has avowedly set for itself by the verbiage used. The latter, textual criticism, is, of course, simply an observation on the quality of the draftsmanship.

Both a good end and good means are equally important. Manifestly, even a statute with the ridiculous purpose of making “litter-bugging” a capital offense, should at least say so clearly. It is the opinion of this author that, by and large, the draftsmanship of the new law is an improvement over the turgidity of the present law. There were, of course, exceptions in the initial stages of the drafting process. To take just one example, the provision with regard to consideration for shares of stock in the Study Bill ran:

Consideration for the issue of shares shall consist, in whole or in part, of money or other property, tangible or intangible, or labor or services actually performed for the corporation or for its benefit or in its organization or reorganization. . . .

The provision (despite the fact that the reviser makes no reference to the fact) apparently changes the present

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25 S. Int. 3124, Pr. 3316, § 5.04(a) (1960).
26 Neither the Comments to the Study Bill (1960 N.Y. LEG. Doc. No. 15, at 24-25 (Supp.), Comments to §§ 5.04, 5.07) nor to the bill as originally introduced (1961 N.Y. LEG. Doc. No. 12, at 26, 28 (Supp.), Comments to §§ 5.04, 5.07) nor to the statute as enacted (1961 N.Y. LEG. Doc. No. 12, at 26, 28 (Rev. Supp.), Comments to §§ 504, 507), make any direct reference to the possibility of such compensation for services, although the latter concedes that the provisions of N.Y. STOCK CORP. LAW § 69 “have been expanded to cover the expenses of formation and reorganization.” (emphasis added).
law to allow issuance of stock for promotional services.\(^{27}\) Although at least one author\(^ {28}\) and numerous cases\(^ {29}\) have disapproved the practice, and it is presently outlawed in New York,\(^ {30}\) the change, if properly circumscribed, would seem to be a sensible one. It still seems that "the labourer is worthy of his hire,"\(^ {31}\) and thus that even promoters should be paid the reasonable value of their services to the corporation they have helped to form. Stock is perhaps the least obnoxious way of doing this, provided that the amount is reasonable.\(^ {32}\)

Whatever the merits of the new policy, the section as originally drawn was obviously inadequate on the simple ground of poor draftsmanship, since by use of the phrase "in whole or in part," it implied that stock might be issued as fully paid even though the value of the money, property and services received were less than the par or stated value of the stock issued in exchange. Such an authorization for issuance of "watered stock" was undoubtedly not intended.\(^ {33}\) The section was simply a case of poor draftsmanship.

\(^{27}\) Taken together with S. Int. 3124, Pr. 3316, [hereinafter cited as Study Bill], § 5.07 (1960), which permitted such services to be allowed as a "discount" on the consideration for its shares. This ambiguous provision might well have allowed the full consideration to be made up of such services. The corresponding section of the bill as finally enacted is hardly less ambiguous on this score. N.Y. Bus. Corp. Law § 507 provides: "The reasonable charges and expenses of formation or reorganization of a corporation, and the reasonable expenses of and compensation for the sale or underwriting of its shares may be paid or allowed by the corporation out of the consideration received by it in payment for its shares without thereby impairing the fully paid and nonassessable status of such shares."

See also note 177, infra.

\(^{28}\) BALLANTINE, CORPORATIONS 792-93 (rev. ed. 1946).

\(^{29}\) See cases cited, BALLANTINE, op. cit. supra note 28, at 792 n.52.


\(^{31}\) Luke 10:7 (Douay Rheims ed.).


\(^{33}\) In view of the New York attitude, which even prohibits issuance of no-par stock gratuitously, clearer language would undoubtedly have been used if this result were really intended. See Stone v. Young, 210 App. Div. 303, 206 N.Y. Supp. 95 (4th Dep't 1924).
Fortunately, the ambiguity was corrected in the final bill. Section 504(a) of the Business Corporation Law provides:

Consideration for the issue of shares shall consist of money or other property, tangible or intangible, actually received or labor or services actually performed for the corporation or for its benefit or in its formation or reorganization, or a combination thereof. In the absence of fraud in the transaction, the judgment of the board or shareholders, as the case may be, as to the value of the consideration received for shares shall be conclusive.

The philosophy is unchanged, and it will be observed there is no qualification as to reasonableness of the stock compensation for promotional services.34 Thus the provision may well be regarded as dangerous. It is not, however, as ambiguous.

Although the author will attempt to point out important ambiguities, the primary concentration will be on the philosophy of the new law as revealed by its provisions, rather than on a narrow textual criticism of its language, and this for two reasons. The first is that most of the obvious textual ambiguities of the earlier forms of the statute have been corrected in the bill as finally enacted.35

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34 Section 69 of the Stock Corporation Law, therefore, seems better. It also made clearer the corporation's right to grant stock options as a reward for past services, by authorizing their issuance for "such consideration, value or benefit . . . as may be fixed by the board . . ." (emphasis added), and by making their determination of the value or benefit (as well as the "consideration" received) conclusive in the absence of fraud. The new law is more like Del. Code Ann. tit. 8, § 157 (1953), and thus may not avoid the decision in Kerbs v. California E. Airways, 33 Del. Ch. 69, 90 A.2d 652 (Sup. Ct. 1952). See Frankel v. Donovan, 35 Del. Ch. 433, 120 A.2d 311 (Sup. Ct. 1956).

35 See, e.g., the errors in S. Int. 3124, Pr. 3316 (1960), Study Bill § 5.19(a), where the word "or" is inadvertently omitted before the second and third numbered subdivisions (corrected by N.Y. Bus. Corp. Law § 515(a)); the overly cumbersome language used in Study Bill § 5.19(c) (corrected by N.Y. Bus. Corp. Law § 515(e)). Compare, however, Study Bill § 5.09, which, following the Model Business Corporation Act, seemed to allow a corporation to issue all of its shares fractionally and thus circumvent the limitations on share repurchases (S. Int. 3124, Pr. 3316, §§ 5.13, 5.14 (1960)), and which the bill as originally introduced for affirmative action attempted to correct (S. Int. 522, Pr. 522, § 5.09(a) (1960)), but which in the bill as passed reverts to the earlier ambiguity. (N.Y. Bus. Corp. Law § 509(a)).
The second reason is the simple fact that the philosophy, i.e., what the statute intends to do, must first be determined, before the means adequate to achieve it can be found. To take the earlier example, there is not much use in criticizing the wording of a provision making "litter-bugging" a capital offense where the critic disagrees with the whole idea of such a severe punishment for the mere discarding of an old candy-wrapper.

The primary concentration, therefore, in the bird's-eye view and the three principal topics, will be on the wisdom of the ends sought to be achieved rather than on the defects in the language used to express that intent.

**Bird's-Eye View of the New Law**

The first striking feature of the new law is its retention of a large portion of previous law, albeit in a rearranged and somewhat simplified form. This is in sharp contrast with the revisions of many other states whose enactments have been almost completely a repudiation of previous law, and an uncritical swallowing of the overenthusiastic claims of its drafters in favor of the so-called "Model Business Corporation Act." 36

Of the fourteen American jurisdictions which have revised their statutes since 1950, 37 ten have wholly, or almost completely, succumbed to the seductions of that overly-touted statutory paradigm. 38

The Model Act has, with good justification, been criticized as unfair to the public, and to the shareholders of the corporation. 39 Fortunately, New York has not been

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37 See Kessler, *supra* note 36, at 639 n.6.
beguiled by the passion to "modernize" into completely casting aside the many worthwhile features of present New York law, and "buying" the Model Act in its entirety.

A notable example of the retention of a desirable feature of present New York law is the continuance of the liberal appraisal rights given to shareholders who dissent from proposed corporate actions. New York presently accords a shareholder the right to demand payment for his shares in six situations,\textsuperscript{40} while the Model Act allows it in only three of these; merger, consolidation and sale of assets not in the usual course of business.\textsuperscript{41} Although the new law yields the right in the case of dissenters from employee stock option plans,\textsuperscript{42} it does retain the appraisal right not only in the three Model Act (and old New York)\textsuperscript{43} situations but also in the case of a dissent from a dissolution sale and in the very important area of amendments to the certificate of incorporation which adversely affect the rights of shareholders.\textsuperscript{44} One of the most unfair features of the Model Act is the ease with which the par value of shares may be cut,\textsuperscript{45} and even the preferred shareholder's right to cumulative dividends already accrued be taken

\textsuperscript{40}N.Y. Stock Corp. Law § 14 (Issue of stock to employees); N.Y. Stock Corp. Law § 20 (Voluntary sale of franchise and property and rights of objecting stockholders); N.Y. Stock Corp. Law § 38(11) (Amendments affecting certain shareholder rights); N.Y. Stock Corp. Law § 85 (Merger); N.Y. Stock Corp. Law §§ 86, 87, 91 (Consolidations); N.Y. Stock Corp. Law § 105(9) (Dissolution sale).

\textsuperscript{41}Model Business Corporation Act Ann. §§ 73-74 (1960).

\textsuperscript{42}N.Y. Leg. Doc. No. 12, at 27 (Rev. Supp.), Comment to § 505.

\textsuperscript{43}Appraisal is not available: (1) to shareholders of the parent corporation merging with its 95% owned subsidiary; nor (2) to a stockholder of any surviving corporation in a merger, unless the terms of the merger alter or abolish a preferential right of his shares, change their redemption rights, alter or abolish their pre-emptive rights, or exclude or limit their voting rights; nor (3) on a shareholder-approved sale or other disposition of assets wholly for cash, where the plan calls for distribution of the proceeds of the transaction within a year and dissolution of the corporation. N.Y. Bus. Corp. Law § 910. The only innovation is with regard to the cash sale. See N.Y. Stock Corp. Law §§ 85(7), 87, 91(7) already imposing the limitations found in (1) and (2) above. With regard to the cash sale the Business Corporation Law follows Model Business Corporation Act Ann. § 73(b) (1960).

\textsuperscript{44}N.Y. Bus. Corp. Law §§ 623, 806(b)(6), 910.

\textsuperscript{45}Model Business Corporation Act Ann. §§ 53(e), 54(c) (1960).
away from him through a two-thirds vote of the shareholders.\textsuperscript{46} Since the new New York statute even outdoes the Model Act by allowing these changes by mere majority vote,\textsuperscript{47} the least that the affected shareholders deserve is the right to be bought out if they so choose. Fortunately, the new New York statute continues this right, while the slavish followers of the Model Act give the minority shareholder no choice but to submit to whatever depredations his fellow shareholders decide to inflict upon him. Thus in a very important area, protection of shareholder appraisal rights, the new statute has by and large retained the advantages of present New York law, already the most liberal in the country in this regard.\textsuperscript{48}

On the other hand, the revision has incorporated a number of the worthwhile innovations of the Model Act, and a few others that are improvements over both that act and previous New York law.

One of these pleasant innovations borrowed from the Model Act is the provision for reservation of a name prior to incorporation.\textsuperscript{49} Every practitioner has probably experienced the unpleasant discovery that the name chosen by his clients has already been preempted by some other corporation. Many others have had to face the even more frustrating experience of being informed that a name which was originally permissible has, in the interim between receiving the letter from the Secretary of State and the actual drafting and mailing of the certificate, been snatched


\textsuperscript{47} \textit{N.Y. Bus. Corp. Law} §§ 801(b)(12), 803(a).

\textsuperscript{48} An unfortunate innovation in which the new Business Corporation Law is more radical than the Model Act without the consequently necessary appraisal right is in the field of reduction of the stated capital of no-par shares. Under \textit{N.Y. Bus. Corp. Law} § 516(a) such reduction may be accomplished by mere directorial approval. Both \textit{Model Business Corporation Act Ann.} § 63 (1960) and the Study Bill, S. Int. 3124, Pr. 3316, § 5.20(a) (1960), required the greater shareholder safeguard of majority shareholder approval.

\textsuperscript{49} \textit{Model Business Corporation Act Ann.} § 8 (1960); \textit{N.Y. Bus. Corp. Law} § 303.
by some other lawyer for his corporation which has managed to file first. The Reserved Name provision is simply designed to assure that a name once available will remain available for the incorporators until the necessary papers can be drafted and submitted. Certainly no one can disagree with the philosophy of this section. It is an obvious improvement over present law.\textsuperscript{50}

Another worthwhile provision borrowed from the Model Act is the new section on the defense of ultra vires.\textsuperscript{51} In general, it removes the availability of the defense in all contract actions except where the contract is still at least partly executory, and, even then, only where the court deems it equitable to allow it and under such conditions as are equitable. The statute, properly, on the other hand, allows the use of ultra vires as a sword where the action is brought by the Attorney General to dissolve a corporation for acting beyond its proper purposes, and in actions brought against directors and officers for loss or damage done to the corporation through their improper acts. This is largely a codification of present New York case law. However, it should avoid the further proliferation of that already extensive case law.\textsuperscript{52} The statute should finally lay to rest the ill-conceived doctrine which has been used (fortunately in recent years, unsuccessfully) primarily by persons seeking to avoid their just obligations under otherwise legal contracts.

The Model Act makes a "registered agent" for the service of process mandatory for both domestic and foreign corporations licensed to do business in the state, and allows service on the Secretary of State only where service cannot be made on the designated agent.\textsuperscript{53} This probably

\textsuperscript{50} The statutory language might, however, be better. The section conditions renewability of the reservation on "good cause shown by affidavit." N.Y. Bus. Corp. Law § 303(c). It might be wiser to allow free renewability, and to credit the cost of reservation on the filing fee for the certificate.

\textsuperscript{51} Model Business Corporation Act Ann. § 6 (1960); N.Y. Bus. Corp. Law § 203.

\textsuperscript{52} See the extensive annotation in McKinney's N.Y. Gen. Corp. Law § 13.

\textsuperscript{53} Model Business Corporation Act Ann. §§ 11, 13 (as to domestic corporations), §§ 106, 108 (as to foreign corporations) (1960).
represents the majority rule in the country. Although New York has retained its requirement that the Secretary of State be designated as an agent for service of process for all corporations qualified to do business in the state, and allows the plaintiff to make effective service upon him whether or not another agent is available, it has, in the new law, allowed a corporation to designate an alternate agent, if it so chooses, who will be empowered to receive process if the plaintiff chooses to serve him instead of the Secretary. Such a provision is, although a departure from present law, ironically, a return to the older New York practice, in addition to being a partial recognition of the Model-Act's theory of the importance of the availability of a local agent.

Corporate law provisions regarding agents for service of process must have two aims: likelihood of prompt notice of suit to the corporation, and convenience in securing jurisdiction to the plaintiff who has a meritorious claim. Since the likelihood of speedy notice is great where the agent's continued employment depends on the efficiency of his service, there can be no objection to having such an alternate agent from the corporation's point of view. Since it is also obviously to the plaintiff's advantage to have as many ascertainable agents capable of receiving service as possible, the provision represents a clear improvement over present law, where as a practical matter the plaintiff can ordinarily make service only on the Secretary of State in Albany.

54 N.Y. Bus. Corp. Law §§ 304, 306(b).
55 N.Y. Bus. Corp. Law § 305.
57 The new statute might be improved, however, by allowing service on the Secretary of State by certified mail or at one of his (presently her) local offices. See N.Y. VEHICLE & TRAFFIC LAW § 253 (This even allows service by mail on the Secretary of State as "attorney" for the non-resident driver.) There are, of course, other persons upon whom service is permitted. See N.Y. Civ. Prac. Act § 228(8) as to domestic, and N.Y. Civ. Prac. Act § 229(1) as to foreign corporations. However, because New York does not require "Annual Reports" of its officers and directors (Compare MODEL BUSINESS CORPORATION ACT ANN. § 118 (1960)), the names and whereabouts of these potential recipients of process are ordinarily not known to the plaintiff. The new law will aid plaintiffs in this regard, too. N.Y. Bus. Corp. Law § 718 provides:
Also, following the Model Act, the new statute omits all requirements for directors except that they be over twenty-one.\(^68\) Although local law professors may thus be deprived of a few trick questions on examinations, the change seems a decided improvement over the present law, the only effect of which was to create a trap for the unwary.

A further simplification, also based on the Model Act, is the blanket permission granted to corporations to hold their shareholders' meetings wherever they choose.\(^69\) Not too long ago New York required that all domestic corporations hold these meetings within the state.\(^60\) The present permission, granted only to corporations with over five hundred shareholders, a majority of whom live out of state, to hold no more than three meetings outside New York in every five year period, seems designed for no purpose other than to discourage incorporation in New York.\(^61\) The new provision is a clear improvement.

A number of other examples could be given. However, these should be sufficient to demonstrate that the revisers have replaced a lot of the New York "dead wood" with

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"If a shareholder or creditor of a corporation, in person or by his attorney or agent, or a representative of the secretary of state, the attorney-general, or other state official makes a written demand on a corporation to inspect a current list of its directors and officers and their residence addresses, the corporation shall, within two business days after receipt of the demand and for a period of one week thereafter, make the list available for such inspection at its office during usual business hours."

The maximization of the number of responsible agents for service of process is a desideratum for plaintiffs, since, as is often the case, one of these agents will be locally available and thus less costly to serve. It is also an advantage to the corporation to have agents of its own choosing as the recipients of process in actions brought against it, since these persons will presumably be ones upon whom it can count to give prompt notice. Directors, officers and registered agents all fulfil these qualifications. Hence, the new provisions are no disadvantage to a corporation, despite the fact that they are also an advantage to the plaintiff.

\(^68\) N.Y. Bus. Corp. Law § 701. Under present law at least one of the directors must be a United States citizen residing in New York (N.Y. Gen. Corp. Law § 27), and all must be shareholders unless the certificate otherwise provides (N.Y. Stock Corp. Law § 55).

\(^69\) Model Business Corporation Act Ann. § 26 (1960); N.Y. Bus. Corp. Law § 602(a).


those provisions of the Model Act which are an indisputable improvement over present law.

The new New York statute has also in a number of instances gone beyond the Model Act in cutting out useless formality or has surpassed the Model Act in genuine modernity. Four examples should be sufficient to prove the point.

One of such improvements is with regard to service of process on the Secretary of State against unlicensed foreign corporations in suits arising out of their trans- action of business in New York.62 Certainly offended New York residents should not have to pursue these corporations throughout the country to redress wrongs done by them. Such a provision is a protection to legitimate New York business as against fly-by-night out-of-state competitors.

The Model Act, for reasons which the author has suggested elsewhere can only be magical,63 has retained the requirement of three incorporators.64 Even the freshest law school graduate realizes that incorporators are ordinarily "dummies," flunkies in the lawyer's office who merely sign the appropriate papers, people who have no interest in the corporation and are merely used to satisfy the technical requirements of outmoded corporation laws. The new statute which requires only one,65 as opposed to the previous three dummy signatures, is a distinct improvement over both the present law and the equally ridiculous Model Act provision.

Section 6 of the Uniform Partnership Act defines a partnership as "an association of two or more persons to carry on as co-owners a business for profit." Section 2 of the act defines "person" to include "individuals, partnerships, corporations, and other associations." Thus the Partnership law contemplates that a corporation may become a member of a partnership.

65 N.Y. Bus. Corp. Law §401. The outmoded citizenship and residence requirements of N.Y. Stock Corp. Law §5(10) are also removed.
Yet New York\textsuperscript{66} and many other states\textsuperscript{67} have nonetheless held that in the absence of an authorization in the corporation law for it to do so, a corporation may not enter into a partnership. The new statute corrects this defect: it expressly empowers a corporation to become a partner.\textsuperscript{68}

Such a privilege may be especially important in American investment in underdeveloped areas to the benefit of those countries and our own. For example, \textit{Abercrombie v. Davies},\textsuperscript{69} a decision from the highest court of Delaware, a state noted for its sympathetic treatment of corporations, involved a syndicate composed of nine oil companies and two individuals formed to develop an oil concession in the Kuwait-Saudi Arabian neutral zone. The corporate form was chosen,\textsuperscript{70} probably because of fear that Delaware like most other states would not allow a partnership composed of corporations,\textsuperscript{71} although a good number of the stockholders (six) preferred the advantages of partnership operation, and attempted to secure a reasonable facsimile of one by their "Agents' Agreement." Their eight "agents," who were also the majority directors were given voting control of the shares, and were each to vote as seven of the eight determined, or, in certain cases, as an arbitrator would decide, both as shareholders and as directors. The agreement was held void by the Supreme Court of Delaware.

The result is to discourage cooperative enterprises entered into by a group of corporations no one of which would be willing alone to undertake the risk involved in a large scale international project. Each corporation will probably want a veto power. If only the corporate form

\textsuperscript{66} People v. North River Sugar Refining Co., 121 N.Y. 582, 24 N.E. 834 (1890); Frieda Popkor Corp. v. Stack, 195 Misc. 826, 103 N.Y.S.2d 507 (Sup. Ct. 1950).

\textsuperscript{67} Central R.R. v. Collins, 40 Ga. 582 (1869); Whittenton Mills v. Upton, 10 Gray 582 (Mass. 1858); Mallory v. Hanour Oil-Works, 86 Tenn. 598, 8 S.W. 396 (1888); 13 Am. Jur. Corporations § 823 (1938); 60 A.L.R.2d 917 (1958).

\textsuperscript{68} N.Y. Bus. Corp. Law § 202(15).

\textsuperscript{69} 130 A.2d 338 (Del. Sup. Ct. 1957).

\textsuperscript{70} The name of the combine was: "American Independent Oil Company."

\textsuperscript{71} See note 67 \textit{supra}. There is apparently no Delaware case squarely in point. But the rule that a corporation may not be a partner represents the majority view. 60 A.L.R.2d 917 (1958).
is possible it can only secure this by representation on the joint venture corporation's board of directors by obedient "agents," subservient to the wills of the members of the corporate combine which has set up the new entity. However, even under the laws of the state which has the best reputation for realizing the needs of business and acceding to them, the desired result is impossible. The new provision will correct this defect. It is a third advance over the Model Act in real modernization, meeting the genuine needs of business while at the same time protecting the interests of all other parties involved.\(^7^2\)

The fourth example of superiority of the new law over the Model Act is the provision regarding interested director contracts.\(^7^3\) The Model Act has no provision whatsoever on the subject despite the fact that it is a perennial one in corporation law. The new New York section validates a corporation's contracts with one of its own directors, or another corporation having interlocking directors, under any one of three circumstances: (1) where there is disclosure and a disinterested majority approval by the directors or an executive committee, or, (2) where there is disclosure and majority shareholder approval, or, (3) even in the absence of the first two conditions, if the contract is "fair and reasonable." In effect, therefore, the new provision enacts the so-called "liberal" rule\(^7^4\) not only with regard to interlocking directors' contracts (present New York law),\(^7^5\) but also with regard to contracts between one of their own directors and the corporation (not presently New York law).\(^7^6\) The general rule which makes all interested directors' contracts voidable merely because the director participates in their approval, seems, like the ultra vires doctrine, to

\(^7^3\) N.Y. Bus. Corp. Law § 713.
\(^7^4\) Ballantine, Corporations 173-75 (rev. ed. 1946).
\(^7^5\) Everett v. Phillips, 288 N.Y. 227, 43 N.E.2d 18 (1942).
\(^7^6\) Munson v. Syracuse G. & C. R.R., 163 N.Y. 59, 8 N.E. 355 (1886). See also Globe Woolen Co. v. Utica Gas & Elec. Co., 224 N.Y. 483, 121 N.E. 378 (1918). The interested directors provision does, however, have some defects which will be discussed below under the section entitled Public Issue Corporations and Shareholders' Rights.
be merely a way to escape just liability when changed circumstances have rendered a contract no longer as profitable as was anticipated. Where there is no possibility of imposition, i.e., where there is corporate consent based on full disclosure, or where the contract is objectively fair despite the factor of self-dealing, there would seem to be no justification for giving the corporation a right which no other contractant enjoys when the bargain is a fair one, a right to escape liability completely whenever it chooses to do so. Although, as will be indicated below, the new section has certain objectionable features, it does clarify the law, and this at least is an improvement over both present law and the Model Act.  

77 Other examples of changes which are probably improvements over the present statute are N.Y. Bus. Corp. Law § 621, the Voting Trust Provision which deletes the requirement of present N.Y. Stock Corp. Law § 50 that all shareholders must be allowed to join if they wish, an obstacle to the utilization of the voting trust device in this state; N.Y. Bus. Corp. Law §§ 706, 716, which spell out and clarify existing case law on the removal of directors and officers; N.Y. Bus. Corp. Law § 712, which expressly authorizes executive committees and limits their powers.

Another provision which is a compromise between present law which provides no method for determining who the current officers and directors of a corporation are and where they live, and the Model Act, which assures that such information is available at least yearly, by its requirement for annual reports (Model Business Corporation Act Ann. § 118), is N.Y. Bus. Corp. Law § 718. See note 57 supra.

Local officers and directors are often more convenient to serve than the Secretary of State in Albany (and, it will be recalled, even under the new law a registered agent is not mandatory (N.Y. Bus. Corp. Law § 305(a)), and hence often the choice of agents for service of process will still be the same as under present law) and, thus, who these local recipients for process are and where they may be found is important to creditors desiring to sue the corporation as well as to shareholders desiring to sue the directors themselves. The addition is a good one. Presumably, a court may enforce the demand, but why does the statute not say so, or penalize the derelict directors and officers? (N.Y. Bus. Corp. Law § 719 fails to impose personal or corporate liability.)

Another feature of interest is the omission of the requirement that the initial directors be named in the certificate, and that the amount of stock subscribed for by the incorporators be specified. N.Y. Bus. Corp. Law § 402. Since the initial directors and incorporators were almost invariably dummies, who had no intention of actually investing in the corporation or of acting in its management, the only effect of the old requirement (N.Y. Stock Corp. Law § 5) was to cause unnecessary paperwork to transfer their rights to the real participants. However, since the new statute, like present law, and unlike the laws of many other jurisdictions (see, e.g., Model Business Corporation Act Ann. § 51, adopted in a number of jurisdictions) requires no minimum starting capital, and the new bill does not require any stock subscriptions, it would seem possible under
All is not bright, however, even in our bird's-eye view of the new statute. For example, there is a serious question as to whether the shareholders' right to examine corporate books and records has not been seriously limited by the new statutory provisions. Such a restriction would, to say the least, be improvident. With the exception of their right to examine the stock book, or record of shareholders and their addresses, which is statutory under present law, the shareholders' right to examine corporate books and records is regulated by the common law. Under this rule, shareholders acting in good faith for the purpose of advancing the interest of the corporation and protecting their rights as owners have a right to examine the corporate books and records at reasonable times. Such a right is essential to shareholders. As the real owners of the corporation they are entitled to know how their "stewards," the directors, are managing its affairs. If the directors are doing a good job they should be rewarded by re-election. If not, they should be voted out, or if their derelictions are serious, forced to account in a shareholders' suit. In either event the new statute to have a completely "paper" corporation, i.e., one with no assets at all.

Undoubtedly, in most instances stock subscriptions will be taken. The new section (N.Y. Bus. Corp. Law § 503) requiring written subscriptions and making preincorporation subscriptions irrevocable for three months is a good one.

The change from N.Y. Gen. Corp. Law § 12(1) which made the filing of the certificate only presumptive evidence of due incorporation into a conclusive presumption, except in actions by the attorney general, is a significant improvement based on section 50 of the Model Act, and should lay to rest the problems of de facto corporations. N.Y. Bus. Corp. Law § 403.

N.Y. Bus. Corp. Law § 624(b) provides: "Any person who shall have been a shareholder of record of a corporation for at least six months immediately preceding his demand, or any person holding, or thereunto authorized in writing by the holders of, at least five percent of all its outstanding shares, upon at least five days' written demand shall have the right to examine in person or by agent or attorney, during usual business hours, the minutes of the proceedings of its shareholders and record of shareholders and to make extracts therefrom. Holders of voting trust certificates representing shares of the corporation shall be regarded as shareholders for the purpose of this section. . . ." (Emphasis added.)

N.Y. Stock Corp. Law § 10.

See Ballantine, op. cit. supra note 74, at 376-79; Lattin, op. cit. supra note 72, at 286-87; Stevens, op. cit. supra note 72, at 487-88, and cases cited therein.
the stockholder has a right to know, and he cannot unless he has access to the corporate books. On the other hand, he should not have access to those books where his purpose is an improper one, e.g., where his reason is to get information to give to a competitor for use against the corporation.\textsuperscript{81} Legislatures have long wrestled with the problem of drafting a statute which will adequately protect the legitimate interests of shareholders while at the same time preventing a shareholder from taking advantage of his one share ownership to destroy the corporation from which he claims information in behalf of another in which his real interests lie.

Originally, impelled by a concern to insure adequate shareholder knowledge, laws were passed purporting to grant every shareholder an absolute right to examine all corporate records, regardless of motive.\textsuperscript{82} Such statutes, of course, could not be applied according to their terms. Courts had to engraft common law principles in order to prevent corporate espionage. Thus, in the leading case of \textit{Slay v. Polonia Publishing Co.},\textsuperscript{83} the Supreme Court of Michigan held that a holder of a single share of stock in the defendant corporation would not be entitled to see the corporate records, despite the fact that the statute provided:

\begin{quote}
The books of every corporation containing its accounts shall be kept, and shall at all reasonable times be open . . . for inspection by any of the stockholders of said corporation. . . .\textsuperscript{84}
\end{quote}

where it was established that the plaintiff was in the employ of a competitor and sought the information merely to help the competitor employer.\textsuperscript{85}

\textsuperscript{81} This was the situation in \textit{Slay v. Polonia Publishing Co.}, 249 Mich. 609, 229 N.W. 434 (1930), discussed below.
\textsuperscript{82} See, e.g., in addition to Mich. Pub. Acts 1921, No. 84, Part II, ch. 1, § 11, which the court used in the \textit{Slay} case, Wis. Stat. § 182.10 (1939), which was subsequently amended to qualify the right. See also \textit{Lattin, op. cit. supra} note 72, at 289.
\textsuperscript{83} 249 Mich. 609, 229 N.W. 434 (1930).
\textsuperscript{84} \textit{Id.} at 611, 229 N.W. at 435.
\textsuperscript{85} The statute has been changed now to limit the right to inspection. \textit{Mich. Comp. Laws} § 450.45 (1948).
The new New York statute guarantees a shareholder of a corporation the right to see the "minutes of the proceedings of its shareholders" and the "record of shareholders" where the shareholder meets one of two alternative standards: he may be a shareholder for six months, or authorized by five percent of the shareholders.86

Any shareholder also has the right, upon written request, to receive the "most recent balance sheet and profit and loss statement which have been distributed to its shareholders or otherwise made available to the public." 87

The statute is significantly different from the Model Act provision on which it was patterned 88 in omitting all reference to "books and records of account" when referring to shareholders' rights of inspection, although such records are expressly required to be kept, under the first paragraph of the section, following present law.89

The danger is that, although under present law there is such an obvious omission with regard to inspection of all other corporate records than the stock book that the courts can easily conclude that the legislature did not intend to say anything with regard to such matters, i.e., leave the subject to the common law,90 under the new statute, the greater specificity may be held impliedly to exclude a shareholder's rights to any other information than that actually provided for. The section is probably not intended to do this, but its difference from present law might lead courts to deny a shareholder the right to see the corporate "books and records of account" even where a proper purpose was shown for such examination.91

86 N.Y. Bus. Corp. Law § 624(b).
87 N.Y. Bus. Corp. Law § 624(e). There is, however, no enforcement provision. Furthermore, there is nothing to compel the corporation to distribute the balance sheet and income statement, initially, and it is only if it has done so that the shareholder is entitled to receive a copy. In effect, then, the section merely gives a shareholder the right to secure a second copy free if he happens to misplace the "annual report" originally sent to him.
90 Application of Schnepf, 84 N.Y.S.2d 416 (Sup. Ct. 1948).
91 The court would be aided in this conclusion by the maxim of statutory construction: *Expressum facti cessare tacitum*. Fortunately, however,
Another defect in the new statute is the carry-over of the provisions of older law with regard to the mode of service of process upon the Secretary of State.\textsuperscript{92} Clearly, the Secretary of State should be preserved as an alternate corporate “agent” for service of process, and the plaintiff, not the corporation, should be allowed to make the election as to whom he will serve. But there would seem to be no good reason why the service must be made in Albany, when the Secretary has local offices in other parts of the State which are considered adequate to receive personal service of process in motor vehicle actions.\textsuperscript{93} There would also seem no good reason to require the additional cost to litigants of requiring the Secretary to mail the copy of such process to the corporation by registered mail\textsuperscript{94} when certified mail, return receipt requested, was instituted by

\textsuperscript{92}N.Y. BUS. CORP. LAW § 306(b).

\textsuperscript{93}N.Y. VEHICLE & TRAFFIC LAW § 253.

\textsuperscript{94}N.Y. BUS. CORP. LAW § 306(b). See N.Y. BUS. CORP. LAW § 307(b)(2) with regard to service on unlicensed foreign corporations, and N.Y. BUS. CORP. LAW § 623(g) requiring the offer to dissenting shareholders to pay what the corporation considers the fair value of their shares to be sent by registered mail.
the Post Office Department for just such types of mail, and is, therefore, quite adequate and cheaper.

On bird's-eye view the most significant change, however, and one which, to those interested in shareholder rights, will undoubtedly seem one of the principal defects in the new law, is the reduction from two-thirds to a bare majority of shareholders in the requirement for authorization of certain significant corporate changes.

Thus, under the new statute although such important corporate actions as mergers, consolilations and sale of corporate assets still require the old two-thirds shareholder approval, in the vital area of certificate amendments which includes not only the right to change the corporate purpose, to authorize new stock, and to change the rights of already outstanding shares, for example, to pre-emptive rights, but also to reduce the par value of such stock and even to deprive preferred shareholders of their right to already accrued cumulative dividends, the vote necessary for approval has been reduced to a mere majority.

Of course, a good argument can be made that a minority should not be allowed to hold up a "quasi-reorganization"

95 N.Y. Bus. Corp. Law § 903(a)(2).
96 Ibid.
97 N.Y. Bus. Corp. Law § 909(a)(3) provides: "The shareholders shall authorize such sale, lease, exchange or other disposition and may fix, or may authorize the board to fix, any of the terms and conditions thereof and the consideration to be received by the corporation therefor, which may consist in whole or in part of cash or other property, real or personal, including shares, bonds or other securities of any other domestic or foreign corporation or corporations, by vote at a meeting of shareholders of the holders of two-thirds of all outstanding shares entitled to vote thereon."
N.Y. Stock Corp. Law § 20 also required shareholder approval for a sale (not in the regular course of business) of "an integral part" of the corporation's property "essential to the conduct of the business of the corporation." The new statute's deletion of this provision seems unwise. On the other hand, the characterization of a sale as including transfers for securities of another corporation seems to guarantee shareholder appraisal rights under N.Y. Bus. Corp. Law § 910 in a "de facto merger" (see Farris v. Glen Alden Corp., 393 Pa. 440, 143 A.2d 25 (1958)), and hence constitutes a desirable change.
98 N.Y. Bus. Corp. Law § 803(a). There would, of course, seem to be no objection to mere directorial approval, as the new statute also allows, for such amendments as change of corporate office, addresses to which copies of process will be mailed by the Secretary of State, and designation or change of registered agent or his address. N.Y. Bus. Corp. Law § 803(b).
which may be essential to breathe new life into a corporation which has managed to survive the storms of financial adversity, but cannot attract new funds necessary for growth because of its inability to pay dividends on new common investment as a result of an impossibly large burden of accumulated preferred stock dividend arrearages. The only question is how big the approving majority must be before it can be fairly said that the people to be directly harmed have consented to the deprivation of present rights in the hope of future gain. The more appropriate analogy, if, as is often the case in such matters, a comparison is made between corporate and political affairs, would seem to be that of the vote necessary to override a presidential veto, or to propose a constitutional amendment by Congress. Significant legislation in our country requires a two-thirds approval. There would seem no good reason why a significant corporate amendment should require less.

An even more radical departure from present law, and one which seems even less justified is the change with regard to corporate mortgages. The old requirement of two-thirds shareholder approval is not merely dropped to a majority. It is, unless the certificate of incorporation provides otherwise, reduced to none. The powers section provides:

Each corporation, subject to any limitations provided in this chapter or any other statute of this state or its certificate of incorporation, shall have power in furtherance of its corporate purposes:

...
(5) To sell, convey, lease, exchange, transfer or otherwise dispose of, or mortgage or pledge, all or any of its property, or any interest therein, wherever situated.\textsuperscript{101}

The new law, unlike the bill as introduced, goes on to make it clear that no shareholder consent will be required no matter what type of mortgage\textsuperscript{102} and no matter what assets are thus pledged, unless the incorporators are wise enough to put a contrary provision in the certificate. Section 911 of the Business Corporation Law provides:

The board may authorize any mortgage or pledge of all or any part of the assets of a corporation. Unless the certificate of incorporation provides otherwise, no vote or consent of shareholders shall be required to authorize such action by the board.

Every layman knows that if he fails to abide by the conditions of his mortgage the mortgagor can take away his property. As far as practical effect on the corporation and its shareholders is concerned, therefore, the effect of a mortgage may be quite as significant as an outright sale of the property: the corporation may well lose its only productive asset. The safeguards should, therefore, be the same: a percentage of shareholders significant enough in numbers to evidence the real will of the corporation should be required. A reduction in this percentage to a bare majority is perhaps arguable, a reduction to none is indefensible.\textsuperscript{103}

So much for our bird's-eye view. Although there are many other features of the new statute, both good and bad, that might be commented upon, the three major aspects of any corporation statute must now be dealt with. The first of these is, of course, its financial provisions.

\textsuperscript{101} N.Y. Bus. Corp. Law §202(a)(5).
\textsuperscript{102} Present law distinguishes between purchase money and other mortgages, requiring two-thirds stockholder consent for the latter. N.Y. Stock Corp. Law §16.
\textsuperscript{103} Undoubtedly, also, no appraisal rights are intended to attach, since there can be no dissenting shareholders where no shareholder vote is required. It is ironic that a mere lease of all or substantially all of the corporate assets requires two-thirds shareholder approval (N.Y. Bus. Corp. Law §909), and gives appraisal rights (N.Y Bus. Corp. Law §910(a)(2)), while a mortgage does not.
THE FINANCIAL PROVISIONS OF THE NEW LAW

Although the financial provisions of the act are set forth in Article 5, the terms used in those sections are defined in Article 1. Any understanding of Article 5 therefore requires an understanding of its new terminology from the Definitions Article.

Article 1 brings a number of new concepts into New York law. Although there are some modifications which apparently were felt necessary for greater clarity, this article is basically an introduction into New York law of the concepts of the A.B.A. Model Act. These concepts, as they bear on corporate finance, are an attempt to engraft accepted accounting principles on corporation law, and although they have been criticized, are still a definite improvement over present New York law.

The terms "capital," "legal capital," and "capital stock" have long proved ambiguous terms in the corporation laws

108 Hackney, The Financial Provisions of the Model Business Corporation Act, 70 Harv. L. Rev. 1357, 1393-99 (1957). Hackney considers the Model Act Financial Provisions in certain respects overly restrictive. For reasons expressed elsewhere, the author disagrees (Kessler, Share Repurchases Under Modern Corporation Laws, 25 Fordham L. Rev. 637, 651-60 (1960)). If, as Hackney claims (70 Harv. L. Rev. at 1398) the Model Act is ambiguous with regard to whether the corporation must first exhaust its surplus before utilizing capital for the "extraordinary" share repurchases permitted under that act (Model Business Corporation Act Ann. § 5 (1960)) and now under the New York statute (N.Y. Bus. Corp. Law § 513), at least the New York law seems to make it clear that the exhaustion of corporate surplus is not required before resort is had to capital (N.Y. Bus. Corp. Law § 513(b)). Even so the statute could be clearer, as was the bill as originally introduced (S. Int. 522, Pr. 522, § 5.14(a) (1961)), and the rule sounder, i.e., that earned surplus would have to be exhausted first, as was also the case under the bill as introduced.
109 These concepts are even more of an improvement over such inherently ambiguous provisions as those found in New Jersey. See, e.g., N.J. Stat. Ann. § 14:5-19 (1939); Goodnow v. American Writing Paper Co., 73 N.J. Eq. 692, 69 Atl. 1014 (1908); Ballantine, Corporations 582-84 (rev. ed. 1946).
of the country. The present New York provision is fortunately one of the clearer ones in the nation. Even so, the Model Act definition of "stated capital" seems an improvement if for no other reason than that it thereby distinguishes the legal term "capital" from its financial counterpart.

"Stated capital" is defined in the new New York statute as follows:

"Stated capital" means the sum of (A) the par value of all shares with par value that have been issued, (B) the amount of the consideration received for all shares without par value that have been issued, except such part of the consideration therefor as may have been allocated to capital surplus in a manner permitted by law, and (C) such amounts not included in clauses (A) and (B) as have been transferred to stated capital, whether upon the distribution of shares or otherwise, minus all reductions from such sums as have been effected in a manner permitted by law.112

The definitions also make it clear that once this sum is subtracted from the "net assets" (total assets less liabilities),113 the result is "surplus."114

This is, of course, a codification of the present New York law for determining the availability of a dividend source, i.e., it is a clarification of New York's balance sheet test.115

Surplus is, however, broken down by the new statute into two separate types, "earned" and "capital" surplus. Generally, the "earned surplus" consists of the balance remaining from the totals of all the income statements of the

111 N.Y. STOCK CORP. LAW § 13.
112 N.Y. BUS. CORP. LAW § 102(12). The provision is almost identical to that of MODEL BUSINESS CORPORATION ACT ANN. § 2(j) (1960).
113 "Net assets" means the amount by which the total assets exceed the total liabilities. Stated capital and surplus are not liabilities." N.Y. BUS. CORP. LAW § 102(a) (9).
114 "Surplus" means the excess of net assets over stated capital." N.Y. BUS. CORP. LAW § 102(13).
115 BAKER & CARY, CASES ON CORPORATIONS 974 (3d ed. 1959); LATTIN, op. cit. supra note 110, at 469.
corporation after such deductions as dividend payments and losses have been made, from the beginning of the corporation, i.e., its accumulated and undistributed net profits.\(^{116}\) Generally, capital surplus is every other type of surplus.\(^{117}\)

The distinction is a new one to New York law, which, despite the fact that most of the corporation laws of the country,\(^{118}\) proper accounting practice,\(^{119}\) and the SEC, for corporations under its supervision,\(^{120}\) require it, has never segregated surplus into that which was the result of the profitable operations of the corporation and that which was a mere “paper” surplus created basically only by manipulation of the balance sheet.\(^{121}\) The new distinction is an important one: the existence of an earned surplus is a sign of corporate health, but a capital surplus, where there is no earned surplus,\(^{122}\) is usually a sign of corporate chicanery,

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\(^{116}\) “‘Earned surplus’ means the portion of the surplus that represents the net earnings, gains or profits, after deduction of all losses, that have not been distributed to the shareholders as dividends, or transferred to stated capital or capital surplus, or applied to other purposes permitted by law. Unrealized appreciation of assets shall not be included in earned surplus.” N.Y. Bus. Corp. Law § 102(6).

\(^{117}\) “‘Capital surplus’ means the surplus other than earned surplus.” N.Y. Bus. Corp. Law § 102(2).


\(^{119}\) See A.I.A. Accounting Research Bull. No. 39 (1949), which places such importance on the distinction that it recommends discontinuance of the term surplus altogether as tending to confuse what is really the shareholder’s contribution with corporate earnings, the only genuine surplus.

\(^{120}\) SEC Reg. S-X, 17 C.F.R. § 210.5-03 (1949).

\(^{121}\) See as to the confusion permitted and its disastrous effects, Randall v. Bailey, 23 N.Y.S.2d 173 (Sup. Ct. 1940), aff’d, 288 N.Y. 280, 43 N.E.2d 43 (1942).

\(^{122}\) Capital surplus may result from sound financial policy (such as is required by the New York Stock Exchange for listed companies, N. Y. Stock Exchange Manual at A-235) where a stock dividend is declared, and the full market value of the share issued is transferred from earned surplus. Where the market value is above the par value of the share the balance of the transfer over par becomes capital surplus, since only par need become part of stated capital. Such a capital surplus may thus be a sign of corporate prosperity. Where there is a capital surplus and no earned surplus, except perhaps in this situation (although even here it is unlikely that a corporation would ever completely exhaust its earned surplus for a stock dividend), a capital surplus is no true sign of corporate health, but rather is probably an indication of corporate manipulation to deceive unwary shareholders. The Study Bill attempted to legislate the sound ac-
an attempt to convince the public that a sick corporation is healthy. In short, where no distinction is made between the two types of surplus the result is often a simple but legal fraud on shareholders and creditors, through a misleading appearance of prosperity. Requiring a corporation to distinguish between the two types of surplus is, therefore, an advance toward full disclosure of the corporation's real financial condition.

Surplus is, of course, not only important for the impression of corporate prosperity which it creates but for the control which it exerts over corporate distribution of assets. These distributions take two principle forms: dividends and repurchases of its own shares by the corporation.

Under present law both forms of distribution may be made out of any kind of surplus. Thus, not only may corporate profits be used for dividends, but even a mere paper surplus created by a writeup of the corporation's fixed assets is available for such a purpose. Whatever may be used for dividend payments is also available for share repurchases. In addition, under present law share repurchases may be made under two circumstances even where no surplus whatsoever exists, namely to pay the appraisal rights of dissenting shareholders, and to redeem redeemable shares.

counting rule embodied in the Stock Exchange regulation by forbidding the use of the term "stock dividend" or "share dividend" to describe a stock distribution unless an amount equal to the fair value of the shares issued was transferred from earned surplus to stated capital and capital surplus. S. Int. 3124, Pr. 3316, § 5.12(a)(5) (1960). Such a requirement is necessary to prevent a corporation from giving the deceptive name of stock dividend to a distribution which is, in reality, partially a stock split because the pro rata share of assets of each share of stock is lessened. This is certainly a de facto stock split if not one in the technical sense. Cf. Joint Report of New York State Bar Association, Committee on Corporation Law, and The Association of the Bar of the City of New York, Committee on Corporate Law on Proposed New York Business Corporation Law 14 (1961). The provision was unfortunately dropped from the law as enacted.

123 See N.Y. Pen. Law § 664(1),(5), which draw no distinction between the two types of surplus. See also Randall v. Bailey, supra note 121.
124 Randall v. Bailey, supra note 121.
125 N.Y. Stock Corp. Law § 21.
126 N.Y. Stock Corp. Law § 28.
The new statute adds two other situations, in addition to those presently available, under which a corporation may purchase its own shares even where no surplus whatsoever exists. They are: to eliminate fractional shares and to compromise an indebtedness to the corporation. In this the new law follows the Model Act.

The provision with regard to retirement of fractional shares is a concomitant to the express authorization for their issuance, a complete turnabout in New York law, which in the absence of any statutory authorization had by case law determined that such fractional shares were illegal. As the author has argued elsewhere, there is really no good reason for the issuance of such fractional shares. For all legitimate purposes scrip will be an adequate substitute where fractional shares would otherwise be indicated. Furthermore, unless the statute is corrected, there is a danger that a corporation may issue all of its stock in fractional shares and thus be at liberty to repurchase all it chooses, despite the fact that no surplus, not even a paper one exists.

The provision for accepting stock in compromise of indebtedness to the corporation is not so dangerous even

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127 N.Y. Bus. Corp. Law § 513(b)(1).
128 N.Y. Bus. Corp. Law § 513(b)(2).
132 N.Y. Bus. Corp. Law § 513(b)(1) provides: "A corporation may purchase its own shares, or redeem its redeemable shares, out of stated capital except when currently the corporation is insolvent or would thereby be made insolvent, if the purchase is made for the purpose of: (1) Eliminating fractions of shares; ..." N.Y. Bus. Corp. Law § 509(a) provides: "A corporation may, but shall not be obliged to, issue certificates for fractions of shares which shall entitle the holder, in proportion to his fractional holdings, to exercise voting rights, receive dividends and participate in liquidating distributions." Thus, there seems no prohibition against a corporation's issuing all of its shares as fractional shares (e.g., instead of a certificate for 5 shares, one would be issued for 20/4 shares). The corporation could then repurchase these shares from stated capital, a disastrous result for both shareholders and creditors, and a complete circumvention of the limit on share repurchases, except in "extraordinary" situations, to surplus. The bill as introduced (S. Int. 522, Pr. 522, § 5.09) attempted to prevent this, albeit not as clearly as is desirable, by limiting issuance of fractional shares to the corporation's shareholders, i.e., persons already shareholders, thus precluding an initial issue of such fractional shares. The limitation has been deleted.
though it works a technical impairment of capital. However, the phraseology of the section may give rise to abuses.\textsuperscript{133}

In any event, the stated capital of the corporation is designed to assure that there will be financial capital\textsuperscript{134} around for the benefit of creditors and shareholders, and therefore, anything which allows corporate distributions below the level of stated capital is to be viewed with suspicion.

If the new law has shown a retrogressive attitude with regard to distributions directly from stated capital, it has on the other hand made one small advance over present law in regard to distributions from surplus. The bill does not go as far as the Model Act which restricts ordinary dividends to earned surplus.\textsuperscript{136} It permits any dividend\textsuperscript{138} and ordinary share repurchases\textsuperscript{137} to be made from any type of surplus, but it does require that where a dividend is paid from other than earned surplus written notice must be given to the shareholder of the fact.\textsuperscript{138} This change represents an improvement over present law which permits dividends to be paid to a shareholder out of what may well

\footnotesize{\textsuperscript{133} Kessler, \textit{supra} note 131, at 656-58.}
\footnotesize{\textsuperscript{134} Whence, probably, the confusion in terms.}
\footnotesize{\textsuperscript{135} MODEL BUSINESS CORPORATION ACT ANN. § 40(a) (1960). \textit{But see} MODEL BUSINESS CORPORATION ACT ANN. § 41 (1960).}
\footnotesize{\textsuperscript{136} An exception is also made for "wasting assets" corporations, expressly allowing ordinary dividends out of stated capital. N.Y. Bus. Corp. Law § 510(a) (1).}
\footnotesize{\textsuperscript{137} N.Y. Bus. Corp. Law § 513(a).}
\footnotesize{\textsuperscript{138} N.Y. Bus. Corp. Law § 510(a) (2). The statute extends the notice requirement to a number of other financial transactions in addition. Notice of the effect on stated capital and earned and capital surplus of share redistributions and reclassifications must also be given (N.Y. Bus. Corp. Law § 511(f)), of the amount of stated capital reduction on the cancellation of reacquired shares (N.Y. Bus. Corp. Law § 515(d)), of a reduction of stated capital where accomplished by board action (N.Y. Bus. Corp. Law § 516(c)—which may be done with regard to no-par stated capital, and amounts transferred from surplus to stated capital), of the elimination of an earned surplus deficit by transfer of capital surplus (N.Y. Bus. Corp. Law § 517(a) (4)—fortunately, such a creation of a spurious "earned surplus" requires shareholder approval), and of the effect of a share conversion on stated capital (N.Y. Bus. Corp. Law § 519(f)). Liability is imposed for failure of the corporation to comply in good faith with these requirements "for any damage sustained by any shareholder in consequence thereof." (N.Y. Bus. Corp. Law § 520.) This "penalty" is defective for two reasons: (1) the innocent corporation rather than the wrongdoing directors is held responsible, and (2) the shareholder will ordinarily be unable to prove any actual damages and will hence be remediless. A fixed penalty might be more likely to coerce the directors into doing their duty.}
be part of his investment contribution to the corporation, since capital surplus is ordinarily merely diverted capital, without warning him that what he thinks is profit is merely a hoaxter's trick of putting money which has been taken from one of his victim's pockets into another pocket of the same victim.

However, the statute imposes no corresponding obligation where the distribution from other than earned surplus takes the form of share repurchases. Such notice is perhaps not so important for the person being bought out (since if all of his shares are repurchased he no longer has any interest in the good financial management of the corporation). It is, however, important that the other shareholders know how their money is being spent. For simplicity of draftsmanship a notice to all shareholders should be required when any shares are repurchased, and especially if other than earned surplus is used. Even this would be insufficient to give full shareholder protection. Certainly, in view of

139 This defect is noted in the Joint Report of New York State Bar Association, Committee on Corporation Law and The Association of the Bar of the City of New York, Committee on Corporate Law on Proposed New York Business Corporation Law 16-17 (1961). The Report, however, objects to the disclosure requirements entirely. Id. at 13, 15, 17. The Bar Committees feel that: "Publicly held corporations are already adequately regulated by stock exchange and S.E.C. rules, and the supposed advantages of the disclosure requirement are largely inapplicable to small and closely held corporations." Id. at 13. This criticism seems inapposite for three reasons: (1) Although the New York Stock Exchange requires all corporations to solicit proxies, and hence bring themselves under the S.E.C. proxy rules (N. Y. Stock Exchange Manual at A-134, as amended April 3, 1959), not all public issue corporations are listed on the New York Stock Exchange; (2) Corporations which do not solicit proxies are not required to furnish an annual report under the federal law, even though they are "public issue" corporations listed on a stock exchange (Lattin, Corporations 313 (1959)), and no such annual report is required from public issue corporations even though they solicit proxies as long as they are not listed on an exchange. Thus under federal law corporations whose shares are traded on the over-the-counter markets need furnish no financial report to their shareholders even though they solicit proxies (Ballow, Corporations 416 n.71 (rev. ed. 1946)); therefore, even many public issue corporations are not required to make the advisable disclosure; (3) The real reason why the disclosure requirements are "largely inapplicable to small and closely held corporations" can only be because they are less likely to indulge in improvident dividends and share repurchases, since less apt to be familiar with the intricacies of the corporation law. Where close corporations do resort to such dividends and share repurchases from other than corporate earnings their shareholders would seem as entitled to notice of that fact as are the shareholders of any other corporation.
the grave dangers inherent in allowing a corporation to repurchase its own shares, the shareholders have a right to expect at least such disclosure.

Unfortunately, even in the situations where notice is required, the enforcement provision is so drafted as to be an invitation to non-compliance.

The bill as originally introduced also forbade share repurchases by a corporation which “would . . . reduce its net assets below the aggregate amounts payable to the holders of shares having prior or equal preferential rights upon involuntary liquidation.”

This change would have been a distinct improvement over present New York law, which, by its silence, allows a corporation to buy up junior stock even though this means that there will not be enough surplus left to discharge the liquidation preferences of superior issues. It can be argued that such a provision is not absolutely essential where the senior shares are par value shares, since their liquidation preference will rarely be much more than par, and hence the general rule against share repurchases (other than the extraordinary ones which are not covered by this section anyhow) out of stated capital will prevent purchases of junior shares which seriously impair their involuntary liquidation preferences. However, the provision would still seem advisable, since there is nothing to prevent a corporation from issuing par value shares with a significantly higher liquidation preference than par, and, in any event, some guarantee should be afforded that the full liquidation preference will be on hand for the benefit of the shareholders to whom the corporation has promised it.

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140 See generally Kessler, supra note 131.
141 See note 138 supra.
142 A. Int. 885, Pr. 885, § 5.13 (1961).
143 See, e.g., Zahn v. Transamerica Corp., 162 F.2d 36 (3d Cir. 1947), in which the par value of the preferred stock was $100, and both the voluntary and involuntary liquidation preference was $105 per share.
144 “Surplus,” it will be recalled, is “the excess of the net assets over stated capital.” N.Y. Bus. Corp. Law § 102(a)(13). “Stated capital” is the sum of the par value of all issued par shares. See N.Y. Bus. Corp. Law § 102(a)(12). Thus there can be no share repurchase out of surplus which does not leave the par value of all shares intact.
Where, on the other hand, the senior shares were no-par, the omission was a significant one under the old law, since the stated capital of such shares could have been much less than their liquidation preference. Fortunately, under the new law only that part of the consideration in excess of the liquidation preference may be allocated to surplus where the shares have a “preference in the assets of the corporation.” Oddly enough, from having almost no protection, senior no-par shares have now become favored over par preference shares, since the latter do not necessarily have their full liquidation preference protected while the former now do. In order to make a corporation keep its word when it gives a liquidation preference the new statute should have added a provision forbidding share repurchases and dividends impairing the liquidation preferences of all shares to which it grants such preferences. The act as passed, however, omits this wise safeguard of shareholder rights.

The new law with regard to surplus distributions is better than the old law. The only criticism is that it doesn’t go far enough. Although such a provision might scare off a few unscrupulous corporations from incorporating in New York, full shareholder protection would seem to demand a limitation on distributions to earned surplus alone.

This seems especially true since under the new law it is even easier to create a paper surplus than it is under present law.

Under present law and the new statute surplus may be created in a number of ways. The only real surplus, of course, is the accumulated result of the corporation’s successful operations. This “earned” surplus is the result of good business and, obviously may be created under any law.

There are, however, many other forms of surplus. For example, a “no-par surplus” may be created, where the

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145 Under N.Y. Stock Corp. Law § 12(4)(A) even preferred stock could be sold for $100, and have a liquidation preference of $105, but a capital of only $1. The new statute requires that the amount of stated capital at least equal the liquidation preference. N.Y. Bus. Corp. Law § 506(b). This is another improvement.

146 N.Y. Bus. Corp. Law § 506(b).
corporation chooses, by sale of no-par stock at a higher price than the amount allocated to "capital" for each share. Under present law, at least one dollar must become capital where the corporation seeks to take advantage of this artificial surplus builder, and its election to resort to this manner of spurious-surplus creation must be noticed in the certificate of incorporation. ¹⁴⁷ Under the new statute, however, not even a dollar of the consideration received need be allocated to capital,¹⁴⁸ and the decision of the exact amount is left to the directors.¹⁴⁹ The only restriction is that the liquidation preference of no-par preferred stock be preserved.¹⁵⁰ Thus, under the new statute, as opposed to the old law, a common stock may, e.g., sell for $100, although only 1¢ is allocated to capital, and the rest, $99.99, becomes, in the sole discretion of the directors, surplus.

Under the present law "revaluation surplus" is another form of paper surplus which is possible.¹⁵¹ Whenever the asset side of a balance sheet goes up the liability side must also go up, since perhaps unfortunately, by definition, a balance sheet must always balance. Surplus is the "accordion" factor on the liability side. Where economic inflation justifies a higher evaluation of the corporate assets an appropriate correction may be made in the dollar "value" at which these assets are carried. Although often criticized,¹⁵²

¹⁴⁸ N.Y. Bus. Corp. Law § 506(b). However, there is an exception where no-par preference shares are involved.
¹⁴⁹ Ibid. Even in England, where no-par is not permitted, Gower notes a corporation which has a par value of only 1/4d. per share, and a total capital of only 1/2d. Gower, The English Private Company, 18 Law & Contemp. Prob. 535, 545 (1953). There is nothing to prevent such grossly "thin capitalization" under the proposed no-par provision where no-par common is involved even though the shareholders' cash investment may be quite significant; thus a gross deception may be practiced on shareholders and creditors alike under the new law.
¹⁵⁰ See note 145 supra.
¹⁵² See Ballantine, Corporations 541 (rev. ed. 1946); Lattin, Corporations 477 (1959); Stevens, Corporations 451 (2d ed. 1949).
this unsound accounting practice which originated in case law is apparently still possible under the new statute.\footnote{153}

Paper surplus may also be created by the method of reacquiring shares at less than the capital allocated to them, or at least the surplus may be left unimpaired despite expenditure of corporate cash to reacquire such shares, where they are retired at no more than the capital allocated to them.\footnote{164} The new law continues this Medusa.

The final means for creating a spurious surplus is by capital reduction. The “capital” of a corporation under present law\footnote{165} is the sum of the par values of its issued par shares plus the aggregate consideration received for its no-par shares, or the product of the total number of no-par shares times an arbitrary amount (at least one dollar) for each of such no-par shares,\footnote{156} plus such amounts as the directors decide to transfer to capital.

Under present law a reduction of capital to eliminate amounts previously transferred to capital by resolution of the board of directors requires majority shareholder approval.\footnote{167} Capital reduction through reduction of the par value of par shares, or through reduction of the capital allocated to no-par shares presently requires two-thirds shareholder approval,\footnote{158} with a class vote (even though the shares whose capital is being reduced are normally non-voting) where par shares are involved.\footnote{159}

Under the new statute “capital,” or as the same thing is called in the new act, “stated capital,” may be reduced
by a mere majority vote of the shareholders in one of these situations, namely, where par stock is involved, and without any shareholder action at all in the other two situations.\(^1\) Class vote is preserved in the one situation where now allowed, i.e., reduction of the par value of par shares.\(^2\) The result of capital reduction is, of course, what is called under the new act "capital surplus."\(^3\) Because of the lowered requirements for approval under the new corporation statute it is much easier to create such a surplus. Capital surplus is, however, by and large merely a paper surplus, a "snare and delusion" to both creditors and shareholders.\(^4\) The notice requirement where distributions are made from such a paper, as opposed to real, surplus is not an adequate safeguard, especially where this paper surplus may be more readily produced.

The danger of the new provisions, despite the notice addition, is emphasized by the fact that such capital surplus may be converted into an earned surplus where the majority of shareholders and directors approve and notice of the transfer is given. As the statute provides:

Whenever under this chapter it is necessary for a corporation to determine the amount or availability of its earned surplus, the following rules shall apply:

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(4) A corporation may apply any part or all of its capital surplus to the elimination of any deficit in the earned surplus account, upon approval by vote of the shareholders. The application of capital surplus to the elimination of a deficit in the earned surplus account shall be disclosed in the next financial statement furnished by the corporation to its shareholders or in the first notice of dividend or share distribution that is furnished to shareholders between the date of such elimination of a deficit in the

\(^1\) As to reduction of stated capital behind par shares, see N.Y. Bus. Corp. Law §§ 801(b)(10), 802(a)(1), 803(a). As to reduction of stated capital by eliminating amounts transferred thereto from surplus, or by reducing the stated capital behind no-par shares, see N.Y. Bus. Corp. Law § 516(a).

\(^2\) N.Y. Bus. Corp. Law § 804(a)(2).

\(^3\) N.Y. Bus. Corp. Law §§ 102(a)(2), 517(a)(3).

\(^4\) An exception is "equalization surplus," discussed supra note 122.
earned surplus account and the next financial statement, and in any event within six months of the date of such action.\textsuperscript{164}

Once the elimination of the deficit in earned surplus has been approved, the renamed paper surplus then becomes for all purposes "earned surplus," with the deceptive significance that that new term connotes.\textsuperscript{165}

Of course, the Model Act is much worse in this regard.\textsuperscript{166} On balance, present New York law may, however, be better, if for no other reason than the possibly erroneous impression that the "earned surplus" is really an earned surplus.

There are, of course, many other changes in the financial provisions of the new law. This article would turn out to be a book if all of them were discussed at length. A few are at least worthy of passing note. For example, the new statute abrogates the authority to issue partially paid shares,\textsuperscript{167} clarifies the law with regard to subscription agreements\textsuperscript{168} and contracts by a corporation to repurchase its own shares,\textsuperscript{169} makes it clear that convertible securities must be convertible at the option of the holder and not at the option of the corporation, \textit{i.e.}, that there can be no forced conversion, and that such convertible shares may not be convertible into securities senior to them,\textsuperscript{170} and forbids repurchase of redeemable shares at more than the redemption price.\textsuperscript{171} All of these innovations are good.

An unexplained deletion of a worthwhile provision incorporated in the Study Bill also justifies comment. With regard to redemption of some but not all of its redeemable shares that earlier version of the law required that the

\textsuperscript{164}N.Y. Bus. Corp. Law § 517(a).
\textsuperscript{165}As such it is available for dividends (N.Y. Bus Corp. Law § 510) without the cautionary notice, after the first dividend. N.Y. Bus. Corp. Law § 517(a)(4). See note 166 infra.
\textsuperscript{166}Section 64 of the Model Business Corporation Act allows transfer of capital surplus to earned surplus by action of the directors alone, and without notice to the shareholders. Compare N.Y. Bus. Corp. Law § 517(a)(4).
\textsuperscript{167}N.Y. Bus. Corp. Law § 504(h).
\textsuperscript{168}N.Y. Bus. Corp. Law § 503.
\textsuperscript{169}N.Y. Bus. Corp. Law § 514.
\textsuperscript{170}N.Y. Bus. Corp. Law § 519(a); 1961 N.Y. Leg. Doc. No. 12 (Rev. Supp.), Comment to § 522(a).
\textsuperscript{171}N.Y. Bus. Corp. Law § 513(c).
redemption be either pro rata or by lot.\textsuperscript{172} Such a provision seems absolutely necessary in order to prevent favoritism towards some shareholders over others. Redemption may be a means of discriminating in favor of management's friends in a declining corporation,\textsuperscript{173} or against management's enemies in a flourishing one.\textsuperscript{174}

The New York Stock Exchange, recognizing these dangers, requires such pro rata or by lot redemption for shares traded on the Exchange.\textsuperscript{175} There would seem to be no reason for New York to impose a lesser standard of morality. On the contrary, there is every reason for the state to offer its support to the Exchange's fight for corporate morality, a movement which, because of increased investor confidence, will ultimately inure to the benefit of all American business. This omission from the proposed statute is thus a most unfortunate one.

Another alteration of present law,\textsuperscript{176} which (even though no longer as ambiguous as in the Study Bill)\textsuperscript{177} may none-
theless be an unfortunate one, is the apparent authorization to the corporation to issue shares of stock to its promoters not only in reimbursement of their cash outlays in the formation of the corporation, but also for their services in its organization. 178

Certainly promoters should be reimbursed for their actual expenses in formation of the corporation. Probably, they are also entitled to receive stock in exchange for their necessary services performed for their corporation even though prior to the actual filing of the certificate. 179 “[S]ervices . . . performed . . . in its formation . . .” 180 is a very vague term, however, and the qualification that the directors’ assessment of their value may only be upset where “fraud in the transaction” 181 is present is probably not a sufficient safeguard against the danger of a newly legalized “stock watering.” 182

Clearer limitations on the power of a corporation to issue stock in exchange for pre-incorporation services are necessary to prevent imposition on shareholders and creditors. Here again the new law is inadequate.

What estimate should be made then of the financial provisions of the new act? Clearly the requirement of notice to a shareholder when he is receiving not corporate profits, but really part of his initial capital investment,
is a worthwhile innovation. The greater clarity of the Article over present law is also commendable. Weighed against the increased possibilities of capital diversion and stock watering, however, the financial provisions of the new act can hardly be said to be an improvement over present law.  

TREATMENT OF THE CLOSE CORPORATION UNDER THE NEW LAW

The "close" corporation, typified by the "incorporated hot dog stand," has a number of special problems, and hence a number of special answers which it expects an adequate corporation statute to give to them.

Unfortunately, the present law, at least as it has been interpreted by the courts, has not given too many really satisfactory answers.

A "close corporation" is really merely a chartered partnership and desires to operate as such, and, despite unfriendly laws, often attempts to do so.

Three basic needs follow from this partnership nature of the close corporation: the first, a need to mold the corporate form to make its operation as much as possible like that of a genuine partnership; the second, which follows from the first, freedom from unnecessary technicality or "paperwork"; and the third, also essential wherever the first need is satisfied, adequate provisions for breaking deadlocks, which are very likely to arise.

Unfortunately, the principal task of drafting any corporation law which will be adequate to meet these needs

183 The philosophy of the new act is generally similar to that of the federal securities laws: allow a corporation a maximum of freedom of action as long as full disclosure is made to interested parties. The wisdom of such a policy is disputable in a corporation law, especially with regard to such a popularly unknown subject as corporate finance. Increasing the freedom of action with no adequate assurance of the prescribed disclosure seems especially ill-advised.


of the New York close corporation consists in making it unequivocally clear that the legislature intends to overrule all of the leading decisions of the Court of Appeals in this area.

**The New Statute and the Close Corporation’s Need to Mold the Corporate Form to its Needs**

The close corporation desires to operate like a partnership. However, in New York, at least four apocalyptic horsemen, in the form of Court of Appeals decisions, emerged to block the way of this desired partnership operation. They ranged themselves in opposition to all small business in the corporate form.

These horsemen go by the names of the *Benintendi,*¹⁸⁶ *McQuade,*¹⁸⁷ *Manson*¹⁸⁸ and *Long Park*¹⁸⁹ cases.

*Benintendi* outlawed unanimity requirements for shareholder and director action, *McQuade* forbade majority shareholders to “control the directors” by agreeing to keep themselves as corporate officers at stated salaries. *Manson* forbade the majority shareholders to agree to “sterilize” the board by giving corporate management to one of their number. *Long Park* extended this prohibition to forbid such divestment of the board’s powers even where all of the shareholders approve.

They, and the effect of the new statute on them, will all be discussed more fully in terms of the close corporation’s specific needs for particular aspects of partnership organization.

**(a) Equal Management Participation**

Perhaps one of the most obvious aspects of a partnership (apart from its basic contractual as opposed to statutory

nature) is the equal management power normally conferred upon all the individual participants.\textsuperscript{190} Inherent in this equal management power is possession by every participant (in the absence of a contrary agreement)\textsuperscript{191} of a “veto” power over decisions of all the co-partners, unless the partners themselves (as opposed to the state for them) elect the “default law” alternative of majority rule.\textsuperscript{192}

The close corporation desires partnership operation. One desideratum for it is thus obvious. The participants in a close corporation are usually “undemocratic,” in the sense that they dislike the rule that subjects a minority to domination by a majority of the shares, or persons on the board of directors. They prefer the partnership, or U.N. Security Council arrangement, to the Congressional one in vogue in large corporations. In short, they, too, usually desire this “veto power.” High, or unanimous, vote and quorum requirements give them such an effective veto over the decisions of their associates. As a result of the restrictive Benintendi decision, New York became a pioneer in legislation designed to expressly grant to a corporation the right to set high vote and quorum requirements for shareholder and director action.\textsuperscript{193}

Section 9 of the Stock Corporation Law expressly legalized such arrangements, and, fortunately, its provisions have been carried over into the new law.\textsuperscript{194}

(b) \textit{Direct Management Participation and Freedom of Management Allocation}

In a partnership, management is conducted directly by the participants without the intermediation of any other

\textsuperscript{190} See \textsc{Uniform Partnership Act} § 18(e).

\textsuperscript{191} See \textsc{Uniform Partnership Act} § 18, which sets out the rights and duties of partners subject to any agreement between them.

\textsuperscript{192} See \textsc{Uniform Partnership Act} § 18(h).


\textsuperscript{194} N.Y. Bus. Corp. Law § 616 (as to high vote and quorum requirements for shareholder action); N.Y. Bus. Corp. Law § 709 (as to high vote and quorum requirements for directorial action).
body, or, but only if they so choose, by one or more of their number. The close corporation desires to parallel this aspect, too, of partnership operation as closely as possible. There is, however, the statutory requirement of a board of directors.

A second desideratum for the close corporation is, therefore, the ability to "sterilize the board of directors." Even under the new law a corporation will still be required to have three directors. All ordinary business decisions are confided to the board under present law, and this power will be continued under the new law. Decisions of the board are normally by a mere majority. Obviously, in a one or two man corporation the additional one or two dummy directors pose a problem. The best solution would be to allow the close corporation to do away completely with the board and operate the corporation through any other instrumentality, including if they chose, operation by unanimous action of the "shareholders," i.e., the corporate partners. Present New York law forbids the shareholders to act in supercession of the board, and, of course, does not allow the abolition of the board, although, for the close corporation, that would considerably simplify corporate organization, making it more like the partnership management structure wanted. Fortunately, the permitted unanimity requirements accomplish the desired result, albeit in a roundabout fashion, in most cases.

However, in many situations, e.g., where the financial participation is to be unequal or there is a desire to avoid the possibility of deadlock, or not all of the shareholders agree to require it, unanimity may not be chosen. For example, six shareholders having eight directors on a board

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195 Manson v. Curtis, supra note 188, is the source of the expression; Kessler, supra note 193, at 710.
196 See N.Y. Bus. Corp. Law § 702(a), which, it is submitted, is an unfortunate disadvantage; Kessler, supra note 193, at 729.
198 N.Y. Bus. Corp. Law § 701.
199 More accurately speaking, the board's decisions are usually made by a majority of a quorum, i.e., a majority of a majority. Stevens, Corporations 750-51 (2d ed. 1949).
200 See Kessler, supra note 193, at 714-29.
of fifteen may want their directors to vote as a bloc thus
controlling the board. The very object of the plan may
be to allow their dominant stock position to be reflected
in corporate decisions (which, as will be remembered, must
be made by the board) in the face of an unfriendly minority
stock interest. Or three shareholders may desire to give
a fourth (e.g., a creditor) equal control of the corporation
with them even though he only has a twenty-five percent
financial interest in the organization. In either situation,
in order to secure the desired result, there must be some
assurance that the directors will carry out the wishes of
the shareholders who have elected them. While other methods
of circumventing the usual rule of directorial autonomy
are available, the simplest method is an agreement between
the shareholders and directors involved whereby the directors
agree to vote in a way desired by their principals. Such
an agreement might well be void under present New York
law. The new statute would not seem to legalize the above
arrangements either, despite the desirability of so doing.

Section 701 of the new law provides:

Subject to any provision in the certificate of incorporation
authorized by paragraph (b) of section 620 (Agreements as to
voting; provision in certificate of incorporation as to control of
directors), the business of a corporation shall be managed by its
board of directors. . . .

Taken alone the section might seem to authorize abolition
of the board of directors, entirely. However, the section
incorporates by reference section 620, the Shareholders'
Agreements provision. That section is important enough
to set forth in full:

202 Nickolopoulos v. Sarantis, 102 N.J. Eq. 585, 141 Atl. 792 (1928).
203 Although, as indicated, the section as enacted is not free from am-
biguity, it is a distinct improvement over the bill as originally introduced.
S. Int. 522, Pr. 522, § 6.20 (1961), although generally similar to the section
as enacted, provided in lieu of the beginning of subsection (b): "A pro-
vision in the certificate of incorporation may control the discretion or powers
of the directors in their management of corporate affairs as provided in this
chapter, but only: . . . ."
(a) 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.

(b) A provision in the certificate of incorporation otherwise prohibited by law as improperly restrictive of the discretion or powers of the directors in their management of corporate affairs as provided in this chapter shall nevertheless be valid:

(1) If all the incorporators or holders of record of all outstanding shares, whether or not having voting power, have authorized such provision in the certificate of incorporation or an amendment thereof; and

(2) If, subsequent to the adoption of such provision, shares are transferred or authorized shares are issued to one who did not have knowledge thereof, and such person consents in writing to such provision.

(c) Such a provision shall be valid only so long as the shares of the corporation are not traded on a national securities exchange or regularly traded in an over-the-counter market by one or more members of a national or affiliated securities association.

(d) An amendment to strike out a provision authorized by paragraph (b) shall be authorized at a meeting of shareholders by vote of the holders of two-thirds of all outstanding shares entitled to vote thereon or by the holders of such proportion of shares as may be required by the certificate of incorporation for that purpose.

(e) The effect of any such provision authorized by paragraph (b) shall be to relieve the directors and impose upon the shareholders consenting thereto the liability for managerial acts or omissions that is imposed on directors by this chapter to the extent that and so long as the discretion or powers of the directors in

board of directors was much less certain, since "control" is a very ambiguous word. With a sympathetic court, close corporations may, under the new law, be able to emasculate the board of directors, if they desire to do so. It would have been simpler to have taken the full step, allowing a corporation to do away with the board completely where it chose to do so. If the statute had done this there would be no lingering doubt as to the permissible extent of limitations on the discretion and powers of the directors.
their management of corporate affairs is controlled by any such provision.\footnote{N.Y. Bus. Corp. Law § 620. Subdivision (b) (2) of this section seems unfortunate (or at least ambiguous). It would seem to allow destruction of a close corporation agreement for partnership management by any dissatisfied associate desiring to do so through the sale of his shares to an outsider who does not have actual notice of the arrangement. (It is obvious from the language of the statute that constructive notice from incorporation of the provisions in the certificate will not constitute such "knowledge.") Clearly, the seller cannot be expected to give notice to his vendee when it is not in his interest to do so, and the other participants may not learn of the transfer until after it is made when it is apparently too late under the statute to protect their management program. Unless the share certificates contain a comprehensive description of the special management provision, a loophole is thus created for rendering nugatory the entire close corporation plan any time one of the participants decides to ruin his co-"partners." A provision similar to that of N.Y. Bus. Corp. Law § 1105 requiring notice on each stock certificate and then binding all transferees would have been wiser. (Of course, such a notice would seem to be sufficient to give knowledge, and, hence, is advisable for any lawyer who wants to draft the papers for a close corporation adequately under the new law.) The Joint Report of the New York State Bar Association, Committee on Corporation Law, and the Association of the Bar of the City of New York, Committee on Corporate Law, on Proposed New York Business Corporation Law 22 (1961), referring to the identical predecessor of §620(d) criticizes the fact that at least a two-thirds vote is required to delete a certificate provision controlling the powers of directors. Such a requirement, unless a higher (or lower) percentage is required in the certificate, would seem necessary to prevent the carelessness of counsel’s draftsmanship from creating an additional loophole for overthrow of the management plan by a dissatisfied shareholder. In addition to the two sections set forth above, the General Powers section of the statute (N.Y. Bus. Corp. Law § 202(a)(11) bears on the subject. It provides: "Each corporation, subject to any limitations provided in this chapter or any other statute of this state or its certificate of incorporation, shall have power in furtherance of its corporate purposes: (11) To adopt, amend or repeal by-laws relating to the business of the corporation, the conduct of its affairs, its rights or powers or the rights or powers of its shareholders, directors or officers.” N.Y. Bus. Corp. Law § 601(b) is also relevant. It provides: “The by-laws may contain any provision relating to the business of the corporation, the conduct of its affairs, its rights or powers or the rights or powers of its shareholders, directors or officers, not inconsistent with this chapter or any other statute of this state or the certificate of incorporation.” The Joint Report noted at page 22 an “inconsistency” between the almost identical predecessors of these sections and the provisions of the predecessor of N.Y. Bus. Corp. Law § 620(b). It would appear, however, that no real inconsistency exists, nor do sections 202(a)(11) and 601(b) add anything to the permission granted to close corporations to mold their operations in the pattern desired, since the authority to make by-laws restricting directorial powers is in both instances expressly qualified by the requirement that such restrictions not be inconsistent with the statute. See N.Y. Bus. Corp. Law §§ 202(a), 601(b). The only significant provisions, therefore, are those discussed in the text.}
two provisions is: (a) to legalize shareholders' "pooling agreements" binding themselves to vote together as shareholders—this is merely a codification of present law; and (b) to legalize agreements binding the corporate participants in their capacities as directors, but only so long as the corporation remains close, i. e., until such time as its shares are traded on a stock exchange or regular over-the-counter market (a good criterion for separating a "public issue" corporation from all others), and only where all of the stockholders (or incorporators) agree to the arrangement, and it is incorporated in the certificate of incorporation.

The exact extent of encroachments on the functions of the board of directors permitted by these sections is, however, hardly clear. Just how far may the shareholders go in their control of the "discretion" and "powers" of the directors? Obviously, they may not abolish the board completely. May they, nonetheless strip it of all of its powers, or is this going too far? Unfortunately, perhaps only litigation will tell.

The Comment to the predecessor form of section 620 suggested that the purpose of the directorial portion (subsection (b)) was merely to codify the decision in Clark v. 206

206 Fortunately, the statute, as opposed to the bill as introduced (S. Int. 522, Pr. 522, § 6.20(b)(1) (1961)) seemingly allows the provision to be included in the certificate of incorporation as originally filed, rather than (apparently) requiring a subsequent amendment by insisting upon consent of "the holders of record of all outstanding shares", as the original bill did. It would have been still clearer to provide simply that the certificate of incorporation might contain the provisions.

208 It should be observed that the new New York provisions with regard to shareholders' pooling agreements are more liberal than the much-vaunted Delaware law on the subject. Although the New York courts have already given indication of greater liberality than Delaware on the subject of such shareholder agreements (see Storer v. Ripley, 1 Misc. 2d 235, 125 N.Y.S.2d 831 (Sup. Ct. 1953), aff'd, 282 App. Div. 950, 125 N.Y.S.2d 339 (2d Dep't 1953); and Ripley v. Storer, 309 N.Y. 506, 132 N.E.2d 87 (1956)), the new allowance of irrevocable proxies where provided for under a shareholder agreement (N.Y. BUS. CORP. LAW § 609(f)(5); compare N.Y. STOCK CORP. LAW § 47-a) insures that New York will not fall victim to the anti-close corporation Delaware decision in Ringling Bros.-Barnum & Bailey Combined Shows v. Ringling, 29 Del. Ch. 610, 53 A.2d 441 (Sup. Ct. 1947), which rejected the lower court's decision that an irrevocable proxy had been given to the party willing to abide by a shareholder's pooling agreement allowing her to vote the share of the recalcitrant signatory.
The Revised Comment to the section as enacted states:

The powers given to the shareholders by this paragraph vary the usual statutory norm of board management as expressed in § 701; accordingly that section explicitly makes exception for arrangements valid under this section. Paragraph (b) expands the ruling in Clark v. Dodge, 269 N.Y. 410, 199 N.E. 637 (1936), and, to the extent therein provided, overrules Long Park, Inc. v. Trenton-New Brunswick Theatres Co., 297 N.Y. 174, 77 N.E.2d 633 (1948), Manson v. Curtis, 223 N.Y. 313, 119 N.E. 559 (1919) and McQuade v. Stoneham, 263 N.Y. 323, 189 N.E. 234 (1934).

Thus, the statute is intended to affect all three of the remaining unvanquished four horsemen. We are, in fact, told that subsection (b) of section 620 of the new statute "overrules" all of them. Unfortunately, however, the overruling is qualified. These cases are only overruled by the new section “to the extent therein provided.” The effect of the new law on these monsters is, therefore, still equivocal.

The McQuade case invalidated an agreement by less than all of the shareholders whereby they agreed that they would not only as shareholders but as directors use their best efforts to keep one another in certain corporate offices at certain agreed salaries. The Court of Appeals struck down the agreement as contrary to public policy. There

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207 This section was § 6.13 in the 1960 Study Bill. The Comment appended (1960 N.Y. Leg. Doc. No. 15, at 36 (Supp.)) expressly stated that the provision was “intended to codify the decision in Clark v. Dodge...” The non-revised Comment to the law (1961 N.Y. Leg. Doc. No. 12, at 40 (Supp.)) omits these words but continues the same discussion of Clark v. Dodge, 269 N.Y. 410, 199 N.E. 641 (1936), thus indicating no greater liberality. (Quaere: the meaning of the revised Comment to the statute as enacted? See discussion in the text accompanying note 208-09 infra.) Compare, however, N.Y. Bus. Corp. Law § 620(e) which provides: “The effect of any such provision authorized by paragraph (b) shall be to relieve the directors and impose upon the shareholders consenting thereto the liability for managerial acts or omissions that is imposed on directors by this chapter to the extent that and so long as the discretion or powers of the directors in their management of corporate affairs is controlled by any such provision.” Unless the functions of the directors may be taken over completely by the shareholders, there would seem to be no justification for imposing directorial liability on them.


209 See text accompanying notes 187-89 supra. As to the vanquishing of Benintendi, see text accompanying notes 193-94 supra.
would seem to be no good reason why such an agreement should not be upheld. Apparently the new statute is not designed to do so, however, since on its face it requires, in the absence of a provision in the original certificate of incorporation, that all of the shareholders must agree. Such an agreement as this is very important for the close corporation, since the participants will, for tax reasons, usually want to take their share of the profits in the form of salary rather than dividends.\textsuperscript{210} Obviously, if they can be fired from their offices they are no longer entitled to the salaries appurtenant.\textsuperscript{211} Thus this decision, which held the agreement between the plaintiff and two other stockholders who together held a majority of the stock of the National Exhibition Company, owner of the old New York Giants, to all “use their best efforts” to keep the plaintiff as treasurer of the corporation at an annual salary of \$7500 (later increased to \$10,000) unenforceable, was a real blow to close corporations.

In the \textit{Manson} case the two largest stockholders agreed to give one of them, who, however, only owned a minority of the total shares outstanding, control and management of the corporation, and in order to insure this control also provided for a subservient board of directors and president. The court, although supporting the validity of ordinary shareholder agreements which merely call for pooling of their votes as \textit{shareholders}, invalidated the agreement \textit{sub judice} on the ground that it would have “sterilized the board of directors.”

Here again less than all of the shareholders were involved, and, on that score alone, the new statute would require the same result as in that case.

On the face of the statute the decision in the \textit{Long Park} case would seem to be overruled by the new section

\textsuperscript{210} Such an arrangement also enables the corporation to pay the “idea” man more than his capital contribution in shareholdings would justify without resorting to different classes of stock and complicated provisions for their respective dividend rights.

\textsuperscript{211} This is in the absence of a contract with the corporation which, despite \textit{N.Y. Bus. Corp. Law} \textsection{716}(b), must still probably be for only a reasonable time. See 19 \textit{C.J.S., Corporations} \textsection{1047}-\textsection{48} (1938).
(provided, of course, the certificate of incorporation is amended to incorporate the agreement). If section 620 is interpreted as only slightly expanding the holding in Clark v. Dodge, however, it will apparently leave unaltered the anti-close corporation decision in the Long Park case, which invalidated an agreement giving the management of the corporation's theatres to one of its shareholders, the B. F. Keith Corporation, for a nineteen year period, even though that agreement had been approved by all of its shareholders.

Where all of the shareholders agree to delegate the corporate management either to themselves or to one of their number or even to an outsider there should be no objection, and the corporation law should certainly not stand in their way. After all, it is their corporation, and not the property of the state, and they should be allowed to do as they want with it.

Similarly, any group of the shareholders should be allowed to agree to exert whatever power they possess in

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212 Sed quaere: the statute literally only allows a provision in the certificate of incorporation which is "restrictive of the discretion or powers of the directors." Does it allow a complete supercession of those powers? 213 Clark v. Dodge upheld an agreement between the two sole stockholders of two corporations whereby the defendant majority stockholder not only agreed to vote his stock in accordance with the agreement, but also agreed to vote as a director that the plaintiff (ousted minority shareholder) should (a) continue as a director, (b) continue as general manager so long as he remained "faithful, efficient and competent," (c) receive for life one-fourth of the net income of the corporations either as salary or dividends, and (d) not have his profits affected by unreasonable salaries to other officers and agents. Although manifestly portions (b), (c) and (d) of the agreement impinged on the powers of the board of directors, the agreement was held valid apparently on two grounds: there was no harm to anyone (creditors, minority shareholders or the public), and "the invasion of the powers of the directorate" was so slight as to be negligible. The Long Park case rejects the significance of the harm test, and interprets Clark v. Dodge as only permitting "a slight impingement or innocuous variance from the statutory norm. . . ." Thus, an agreement calling for "the deprivation of all the powers of the board insofar as the selection and supervision of the management of the corporation's theatres, including the manner and policy of their operation, . . ." was condemned, despite the fact that all shareholders approved and there was no showing of harm to creditors or the public. If Clark v. Dodge is interpreted to go no further than to authorize a "slight impingement" upon the powers of the directors, as the Long Park case interprets it to hold, and the new statute goes no further, then the new statute is hardly sufficient to meet the needs of close corporations.
their capacity as directors as well as shareholders without hindrance from the corporation law.

It should be noted that under the new statute, the actual result in all four of the anti-close corporation cases discussed above would be the same as in those decisions, since in none was the management arrangement placed in the certificate of incorporation. Furthermore, it is unlikely that either the Manson or McQuade agreements would be set forth in the certificate even under the new law, since, as will be recalled, unanimous shareholder consent is required for such action (or unanimous incorporator consent, which, even if only one incorporator is used, will as a practical matter mean agreement by all of the initial participants), and neither agreement included all of the shareholders. It would seem unlikely that the excluded shareholders would be anxious to give their consent to legalize agreements that were of no benefit to them.

They might, perhaps at the time of incorporation, be willing to give a kind of blanket permission to all shareholder arrangements, foreseeing the possibility of later entering into such agreements themselves. Unfortunately, however, the statute is silent on the sufficiency of such general authorizations.

Furthermore, it will be noted that, even if all the participants do originally agree to incorporate it in the certificate of incorporation, the arrangement not only terminates when the corporation transmutes from "close" to "public issue" \(^\text{214}\) (which, of course, is unexceptionable), but whenever any transferee of the stock "who did not have knowledge" of the arrangement refuses to consent in writing to be bound by it.\(^\text{215}\) Will a reference on each stock certificate to the stockholder arrangement be sufficient to constitute "knowledge" to every transferee, or can any shareholder agree to sell his stock to an outsider without actually informing him of the agreement, and, thus, at any time he

\(^{214}\) This is the effect of N.Y. Bus. Corp. Law § 620(c).

\(^{215}\) N.Y. Bus. Corp. Law § 620(b)(2).
chooses, destroy the entire close corporation arrangement? Unfortunately, again, only litigation will tell.

If the new statute is designed to go beyond a mere codification of present law, which is an unduly restrictive law, it does so in a fashion ambiguous enough to give courts imbued with a mistaken Platonic-guardian idea of the nature of the board of directors sufficient support for holding corporations to their present legal straitjacket.

The new sections dealing with permissible incursions on the power of the board of directors by shareholder agreement are thereafter condemnable on two grounds: first, they fail to go far enough in allowing the close corporation to mold itself to fit its needs, and second, the exact scope of the permission granted is so ambiguously expressed that it cannot but lead to uncertainty, and consequent litigation.

It should be added, however, that, despite its language and Comments, the new statute may, at least in the hands of a sympathetic court, and with competent draftsmanship of the necessary papers by their attorneys, go further in supporting close corporations than would at first seem. For example, the *McQuade* case, discussed above, which held that an agreement by less than all of the shareholders which had as its object the control of the board of directors in their selection of officers and the fixing of the salaries which would be paid to them was void as against public policy, may be circumvented by careful drafting provided again (unfortunately) that all of the participants concur in placing the appropriate provision in the certificate of incorporation.

Under the new law, as indicated above, an agreement, after incorporation, controlling the discretion of the directors requires unanimous shareholder consent. Thus, if as under present law, the appointment of officers is a matter confided to the board of directors, the *McQuade* case would

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216 263 N.Y. 323, 189 N.E. 234 (1934).
217 Except for new corporations where the provision may be inserted in the certificate of incorporation by the incorporator. N.Y. Bus. Corp. Law § 620(b)(1).
218 N.Y. Stock Corp. Law § 60.
still be good law, and the agreement as void under the new law as it was when that case was decided.

However, section 715(b) of the new law states:

The certificate of incorporation may provide that all officers or that specified officers shall be elected by the shareholders instead of by the board.

Thus, New York has become like Delaware, and approximately one-quarter of the American states, in allowing a corporation, if it chooses, to remove the power to appoint corporate officers from the board of directors. If the power to appoint officers resides in the shareholders there is no forbidden interference with the board of directors, and hence the agreement should be valid, where the corporation takes advantage of the permission granted, and provides that the corporate officers may be chosen by the shareholders.

Thus, by careful drafting a close corporation should be able, under the new statute, at least to avoid two of the apocalyptic monsters arrayed against it: the MoQuade and Benintendi cases. It is regrettable, however, that the remaining demons, Manson and Long Park, with their prohibition against "sterilizing" the board of directors have not also been more definitely and forever laid to rest.

Unaccountably, however, the Committee on Corporate Laws of the Association of the Bar of the City of New York, composed of the most experienced corporate law practitioners in the country, apparently feels that the law already goes too far in its favoritism towards the close corporation in this regard.

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221 It is to be noted that, in addition, such officers are only removable by the shareholders, although they may be suspended by the directors (N.Y. Bus. Corp. Law § 716(a)), providing an additional safeguard. Such an agreement, because then only a "shareholder" agreement, seems valid even though not incorporated in the certificate of incorporation. N.Y. Bus. Corp. Law § 620(a).
222 Rohrlich, New York's Proposed Business Corporation Law, 15 Record of N.Y.C.B.A. 309, 310 (1960). Mr. Rohrlich states "our committee on corporate law has misgivings as to the wisdom of permitting such possible emasculation of the board of directors." This comment was addressed to the
Freedom from Unnecessary Technicality or "Paperwork"

One consequence of the failure of the proposed statute to go far enough in meeting the needs of the close corporation, through a frank espousal of all the means necessary to the end of partnership operation for such corporations, will be the continuance of evasion of the corporate requirements through taking advantage of technicalities. For example, those shareholders in the above example who desire to give the fourth a fifty percent control of the corporation despite his only having a twenty-five percent share interest may probably achieve their desire under the new law, or, for that matter even under present law, through setting up two classes of stock each of which will elect an equal number of directors, despite the fact that the value and dividend rights of one class will only be one third as great as that of the other. They will not, however, be able to do what they want by a simple shareholder agreement. Instead, technicalities and paperwork will have to be resorted to.

Technicalities and paperwork are, however, certainly nothing for a statute to be proud of, in general, and are anathema to the close corporation.

Even after the technicalities of corporate organization in the desired mold are overcome, the day-to-day operation of the corporation poses additional formal problems.

There is no reason why the shareholders have to behave like Congress when they all are in agreement on a proposed

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Study Bill. However, that bill was even less generous to close corporations than the law as finally enacted.

223 "Classification" of directors in the sense of having directors whose terms would expire at different times was permitted by N.Y. Stock Corp. Law § 55. "Classification" of directors in the sense of having certain directors elected by certain classes of stock would seem to have been authorized by N.Y. Stock Corp. Law § 5(4). Although N.Y. Bus. Corp. Law § 704 places greater restriction on directorial classifications in the former sense, N.Y. Bus. Corp. Law §§ 402(a)(5), 617 would seem to carry over the implied permission of previous law to classify directors according to the shares capable of electing them. An unsympathetic court might, however, hold on the basis of N.Y. Bus. Corp. Law § 704(a) that such a classification is no longer allowed.
decision. Present New York law 224 allows informal action by the shareholders; and this liberality is continued in the new enactment. 225 As the Comment to the new section, which consolidates the present dispersed permission for unanimous written shareholder consent in lieu of a duly convened meeting, aptly states:

The principle embodied in paragraph (a) is particularly appropriate to meet the exigencies and common practices of small corporations. 226

The only criticism of the present and the new law is the requirement for unanimity in the ordinary case. 227 If the shareholders by a lesser percentage acting at a meeting may consent to an action there would seem no good reason (even though the certificate does not expressly permit it) 228 why the same percentage cannot consent in writing without such a "meeting," which is often in reality, nothing more than a few extra typewritten pages.

The "exigencies and common practices" of such small corporations also demand a similar informality with regard to action by the associates in their director as well as their shareholder capacities. Case law, to a limited extent, recognizes the validity of directorial action despite the

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225 N.Y. Bus. Corp. Law § 615. The new statute appears to be more liberal in this regard than the present law, in that it seems to allow less than unanimous shareholder consent but only, however, where the certificate of incorporation so permits. The provision is somewhat ambiguous. N.Y. Bus. Corp. Law § 615(a) provides: "Whenever under this chapter shareholders are required or permitted to take any action by vote, such action may be taken without a meeting on written consent, setting forth the action so taken, signed by the holders of all outstanding shares entitled to vote thereon. This paragraph shall not be construed to alter or modify the provisions of any section or any provision in a certificate of incorporation not inconsistent with this chapter under which the written consent of the holders of less than all outstanding shares is sufficient for corporate action." The Comment to the section is not helpful on this point. 1961 N.Y. Leg. Doc. No. 12, at 37 (Rev. Supp.).
227 See notes 224-25 supra.
228 It is, of course, not perfectly clear (and for some New York courts perfect clarity is required) that even such a provision in the certificate allowing a lesser percentage for approval will be sufficient, since N.Y. Bus. Corp. Law § 615(a) requires that such a provision be "not inconsistent with this chapter." This leaves an opening for unsympathetic courts to invalidate even certificate provisions for less than unanimous consent.
fact that no formal board meeting has been held. There would seem no good reason for imposition on innocent third parties dealing with any corporation (the real effect of a requirement for formal directorial action), and this would seem especially true in the case of close corporations which habitually ignore such formalities. Unanimous written consent as a substitute for a formal meeting would seem the very minimum concession necessary. Many other states have granted this. Yet the new statute even denies this minor concession to the "exigencies and common practices" of small corporations.

While not a real substitute for express recognition of separate consent as the equivalent of a formal meeting, it should be observed that New York does under both present law and the new act permit written waiver of notice of both directors' and shareholders' meetings by the person entitled to such notice either before or after the meeting. Present law also automatically waives notice of directors' meetings where all directors are present. The Business Corporation Law makes each director's presence a waiver of notice as to him, and extends the waiver-by-attendance rule to apply to shareholders. These concessions are all to the good. They simply do not go far enough, however.

**Deadlock-Breaking Provisions**

Where, as is often the case in close corporations, unanimous consent of all of the participants is required before any action may be taken, the possibilities of stalemate on any disagreement are multiplied. One "partner" wants to do it one way. Another has a different idea. As a result nothing gets done. The corporation is paralyzed.

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220 Id. at 724-25.
231 N.Y. GEN. CORP. LAW § 31.
232 N.Y. Bus. CORP. LAW § 711(c).
233 N.Y. Bus. CORP. LAW § 606.
234 N.Y. GEN. CORP. LAW § 28.
235 N.Y. Bus. CORP. LAW § 711(c).
236 N.Y. Bus. CORP. LAW § 606.
There are two principal legal remedies for such a deadlock: arbitration and dissolution.\textsuperscript{237}

Shareholders' contracts agreeing to form close corporations often provide that disputes will be submitted to an impartial arbitrator for solution. Arbitration is, of course, a non-judicial proceeding. However, enforcement of the award must be by the courts, and where one party feels that a matter should be arbitrated under the agreement, while another does not want such arbitration, the courts must decide whether or not the matter is an arbitrable one. Accordingly the subject is regulated by law.

There is no provision in the old corporation law with regard to arbitration. The new law likewise does nothing to fill this lacuna. Whether or not a matter will be ordered submitted to arbitration under an agreement calling for this method of resolving conflict is, however, regulated by the Civil Practice Act.\textsuperscript{238} Section 1448 provides that:

\textldots{} two or more persons may submit to the arbitration of one or more arbitrators any controversy existing between them at the time of the submission, which may be the subject of an action, or they may contract to settle by arbitration a controversy thereafter arising between them. . . . \textsuperscript{239}

The provision has been interpreted to require that the controversy between the parties must be a justiciable one before it can be an arbitrable subject.\textsuperscript{240} Thus, whether a director should be removed from office,\textsuperscript{241} or whether a

\textsuperscript{237} Of course, there are at least two other alternatives: where there has been wrongdoing by one of the director-participants, a shareholder's derivative suit is possible; where the shares are not subject to transfer restrictions, the shareholder may also follow the "Wall Street rule" and sell his stock. See \textsc{Baker \& Cary, Cases on Corporations} 301 (3d ed. 1958). There is also another alternative available in two jurisdictions, the appointment of a "provisional director." \textsc{Cal. Corp. Code} § 819; \textsc{Mo. Ann. Stat.} § 351.323 (1949).

\textsuperscript{238} \textsc{N.Y. Civ. Prac. Act} §§ 1448-69.

\textsuperscript{239} \textit{Quaere}: The effect of the amendment to this section in \textsc{N.Y. Sess. Laws} 1959, ch. 232.\textsuperscript{2}

\textsuperscript{240} \textsc{In the Matter of the Arbitration of Burkin}, 1 \textsc{N.Y.2d} 570, 136 \textsc{N.E.2d} 862, 154 \textsc{N.Y.S.2d} 898 (1956).

\textsuperscript{241} \textit{Ibid.}. Even without any change in the New York Civil Practice Act allowing arbitration of non-justiciable disputes, the removal of a director for disloyalty will become arbitrable, since under \textsc{N.Y. Bus. Corp. Law} § 706(d) it will become the "subject of an action." \textsc{N.Y. Bus. Corp. Law} § 706(d).
corporation's real property should have been sold, have been held not to be arbitrable questions.

Obviously, the Civil Practice Act could be amended to allow arbitration of any dispute, including such so-called "policy" disputes.

However, arbitral awards must be enforced in order to be effective. This might result in the necessity of the court's running the corporation. This is unsatisfactory for a number of reasons, the simplest of which is that judges are not businessmen and businessmen are apt to be (properly) dissatisfied with their attempts to play that role.

Although it might be better to leave the consideration of these factors until time for enforcement of the arbitration award came up, i.e., to require arbitration, initially, of all disputes which the parties have agreed to submit to arbitral decision, the new business corporation statute cannot be too severely criticized for not so doing.

There is, however, a good substitute for arbitration of such policy deadlocks, which has been adopted in two

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provides: "An action to procure a judgment removing a director for cause may be brought by the attorney-general or by the holders of ten percent of the outstanding shares, whether or not entitled to vote. The court may bar from re-election any director so removed for a period fixed by the court."

The Comment makes clear the intent to overrule the Burkin decision. 1961 N.Y. Leg. Doc. No. 12, at 47 (Rev. Supp.) states: "The power of the attorney-general to procure a judgment ousting a derelict director, currently provided by Gen. Corp. L. §§60(4) and 136, is retained, and a new provision has been added authorizing the holders of at least ten percent of the total number of outstanding shares of the corporation to initiate judicial proceedings for the removal of a director for cause. This latter provision was included in furtherance of minority shareholder rights and in reaction to the holding in Matter of Burkin, 1 N.Y.2d 570 (1955)."

The provision is an exception to the "veto" powers afforded by N.Y. Bus. Corp. L. §§614, 709, but would seem a justifiable one.


The proposed Civil Practice Act would have overruled these cases: "A written agreement to submit any controversy thereafter arising or any existing controversy to arbitration is enforceable without regard to the justiciable character of the controversy and confers jurisdiction on the courts of the state to enforce it and to enter judgment on an award." S. Int. 26, Pr. 26, §7501 (1960). The bill was not, however, enacted.
states, and which should have been incorporated in toto in the New York Act. It is known as the "provisional director," a court-appointed, and therefore, impartial director who is to serve just to break a tie on the board.

The California Act provides:

(a) If a corporation has an even number of directors who are equally divided and cannot agree as to the management of its affairs, so that its business cannot longer be conducted to advantage or so that there is danger that its property and business will be impaired and lost, the superior court of the county where the principal office of the corporation is located may, notwithstanding any provisions of the articles or by-laws of the corporation and whether or not an action is pending for an involuntary winding up or dissolution of the corporation, appoint a provisional director pursuant to this section.

Action for such appointment may be filed by one-half of the directors or by the holders of not less than 33 1/3 per cent of the outstanding shares.

(b) The provisional director shall be an impartial person, who is neither a shareholder nor a creditor of the corporation, nor related by consanguinity or affinity within the third degree to any of the other directors of the corporation or to any judge of the court by which he is appointed. The provisional director shall have all the rights and powers of a director, and shall be entitled to notice of the meetings of the board of directors and to vote at such meetings until the deadlock in the board of directors is broken or until he is removed by order of the court or by vote or written consent of the holders of a majority of the voting shares. He shall be entitled to receive such compensation as may be agreed upon between him and the corporation, and in the absence of such agreement he shall be entitled to such compensation as shall be fixed by the court.\textsuperscript{244}

It will be observed that such a provision overcomes two objections to arbitration of policy disputes, namely the difficulty of enforcing an award calling for action, and the related objection that arbitration in effect puts the court

\textsuperscript{244} CAL. CORP. CODE § 819. The Missouri act (Mo. ANN. STAT. § 351.320 (1949) is practically identical.
in business. The provisional director should be, and probably will be, a good businessman, and his decision, like that of any other corporate director, will not be a judicial one but that of a businessman, and will therefore not involve the court in supervising the affairs of the corporation.

Although the 1960 Study Bill provided for such a provisional director, at least where a petition for dissolution had been filed, the provision has unaccountably been completely omitted from the bill as finally approved. Needless to say, this is unfortunate.

The second major method for resolving the problems of close corporation stalemate is dissolution. Present corporate law provides three methods for voluntary dissolution of a corporation. That under General Corporation Law, section 103 is the most important for close corporations. It allows a petition for dissolution by one-half of the shareholders (or where there are high vote requirements pursuant to Stock Corporation Law section 9, less than a majority, so long as there are more petitioning shares than the difference between the total number of shares entitled to vote for dissolution under the certificate and the number which would be authorized by the statute to dissolve without judicial proceedings) where the corporation has an even number of directors who are deadlocked or the stockholders are so divided that they cannot elect a board.

\[245\] S. Int. 3124, Pr. 3316, § 11.06 (1960).
\[246\] Under N.Y. Stock Corp. Law §§ 105-06, where authorized by two-thirds of the stockholders of record; under N.Y. Gen. Corp. Law §§ 101-02, where the majority of the directors, or a majority of the shareholders entitled to vote on the subject, desire to petition for such dissolution on the ground that the assets are insufficient to discharge liabilities, or the dissolution would be "beneficial to the interests of the stockholders"; and under N.Y. Gen. Corp. Law § 103, where a deadlock exists. Of course, actions for involuntary dissolution may also be brought. See N.Y. Gen. Corp. Law §§ 71, 72.

\[247\] N.Y. Gen. Corp. Law § 103 provides: "Unless otherwise provided in the certificate of incorporation, if a corporation has an even number of directors who are equally divided respecting the management of its affairs, or if the votes of its stockholders are so divided that they cannot elect a board of directors, the holders of one-half of the stock entitled to vote at an election of directors may present a verified petition for dissolution of the corporation as prescribed in this article.

"When, pursuant to section nine of the stock corporation law, as enacted by chapter eight hundred sixty-two of the laws of nineteen hundred forty-
Unfortunately, a petition for dissolution is not the same as a dissolution, and the courts have shown extreme reluctance to grant dissolution, despite the fact that the statutory requirements of deadlock are met, where the corporation has continued to operate at a profit.

The leading case on the subject is In Re Radom & Neidorff, Inc.,\textsuperscript{248} in which the petition of a fifty-percent shareholder, who was also sole manager of the business, against the respondent owner of the balance of the stock, was dismissed without even the taking of testimony, despite the fact that the corporation was unable to elect a board of directors at the previous shareholders' meeting, the petitioner had been subjected to suit by the respondent, charging that he had falsified the corporation's records and converted its assets, and the petitioner had, as a result of the respondent's unwillingness to sign his salary checks, not been paid "a penny of his salary" since the respondent became equal shareholder with him (through inheritance), and even corporate debts remained unpaid.

The majority of the Court of Appeals in upholding the
eight or as amended, a corporation has provided in its certificate of incorporation or other certificate filed pursuant to law that the number of votes of directors required for action by the board of directors, or the number of votes of stockholders required for the election of directors, shall be greater than that otherwise required by law, if the directors are divided respecting the management of the corporation's affairs in such a way that the requisite number of votes for action by the board of directors cannot be obtained, or if the votes of the stockholders are so divided that the requisite number of votes for election of directors cannot be obtained, such a petition may also be presented by the holders of such number of shares as, in accordance with the provisions of the certificate of incorporation or other certificate filed pursuant to law, represent more than the difference between the total number of outstanding shares, the holders of which are entitled to vote on the question of dissolution of the corporation without judicial proceedings and the number of such shares, the votes of the holders of which are necessary to authorize filing of a certificate of dissolution of the corporation without judicial proceedings."

The new law offers a distinct improvement in clarity over the second paragraph of N.Y. GEN. CORP. LAW § 103. N.Y. Bus. Corp. Law § 1104(b) provides: "If the certificate of incorporation provides that the proportion of votes required for action by the board, or the proportion of votes of shareholders required for election of directors, shall be greater than that otherwise required by this chapter, such a petition may be presented by the holders of more than one-third of all outstanding shares entitled to vote on dissolution under article 10 (Non-judicial dissolution)."

\textsuperscript{248} 307 N.Y. 1, 119 N.E.2d 563 (1954).
Appellate Division's dismissal of the petition, without even a hearing on the merits, stated:

Clearly, the dismissal of this petition was within the discretion of the Appellate Division. . . . There is no absolute right to dissolution under such circumstances. Even when majority stockholders file a petition because of internal corporate conflicts, the order is granted only when the competing interests "are so discordant as to prevent efficient management" and the "object of its corporate existence cannot be attained." . . . The prime inquiry is, always, as to necessity for dissolution, that is, whether judicially-imposed death "will be beneficial to the stockholders or members and not injurious to the public." . . . Taking everything in the petition as true, this was not such a case, and so there was no need for a reference, or for the taking of proof, under sections 106 and 113 of the General Corporation Law. 249

The court relied heavily on the fact that "not only have the corporation's activities not been paralyzed but that its profits have increased and its assets trebled during the pendency of this proceeding. . . ." 250

Such a fear of corporate death is morbid. When the shareholders of a corporation can no longer act together harmoniously then the corporation, just as a partnership would be, ought to be dissolved.251

Although the new statute does not guarantee dissolution, it does forbid the court from refusing to decree such a dissolution solely on the ground that the corporation has not yet started to lose money as a result of the impasse in its management.

The Business Corporation Law expressly provides, in its section on criteria for determining when dissolution should be granted:

In a special proceeding brought under section 1104 (Petition in case of deadlock among directors or shareholders) dissolution is

249 Id. at 7-8, 119 N.E.2d at 565 (citations omitted).
250 Ibid.
not to be denied merely because it is found that the corporate business has been or could be conducted at a profit.\textsuperscript{262}

It is to be hoped that this language is clear enough to overrule the Radom decision.

Another improvement over present law on the subject of corporate dissolution is the adoption of the Illinois-Wisconsin provision\textsuperscript{253} which allows a petition for dissolution by even a single shareholder,\textsuperscript{254} despite any provisions in the certificate of incorporation to the contrary, when, as the Comment to the new provision states, ". . . the hopelessness of the deadlock is indicated by the fact that two annual meetings have passed without electing directors." \textsuperscript{255}

This section of the Illinois and Wisconsin Acts has been lauded as establishing the clearest standard for deadlock or stalemate as a ground for dissolution.\textsuperscript{256} This provision is a welcome addition to New York law.

Casebooks on corporations\textsuperscript{257} like to pose the additional problem, as yet unanswered by the New York Court of Appeals,\textsuperscript{258} whether or not the court will enforce a shareholders' agreement calling for dissolution under certain specified circumstances. Present statute law, of course, makes no provision in this regard. The new law attempts to cover this problem.

Section 1105 of the new statute provides:

The original certificate of incorporation may contain, or if authorized at a meeting by vote of the holders of all outstanding shares, whether or not entitled to vote thereon, the certificate of incorporation may be amended to contain a provision that any

\textsuperscript{252} N.Y. Bus. Corp. Law § 1112(b)(3).
\textsuperscript{254} N.Y. Bus. Corp. Law § 1104(c).
\textsuperscript{255} 1961 N.Y. Leg. Doc. No. 12, at 67 (Rev. Supp.).
\textsuperscript{256} Israels, The Sacred Cow of Corporate Existence, Problems of Deadlock and Dissolution, 19 U. Chi. L. Rev. 778, 786 (1952).
\textsuperscript{258} But see Application of Hega Knitting Mills, 124 N.Y.S.2d 115 (Sup. Ct. 1953); 1961 N.Y. Leg. Doc. No. 12, at 68 (Rev. Supp.), Comment to § 1105.
shareholder, or the holders of any specified number or proportion of outstanding shares may enforce dissolution of the corporation, at will or upon the occurrence of any specified event. Each certificate for shares must bear, on the face or back thereof, a reference to such provision.

This provision represents a distinct improvement over the Study Bill which provided that, where called for by a shareholders' agreement, "a verified petition for an order dissolving the corporation" might be filed. That provision did not guarantee dissolution in accordance with the terms of the agreement, but presumably left the question of whether or not dissolution should be granted within the court's discretion.

The desired result is to carry out the will of the participants as written, leaving no discretion to the judge, who may well carry over his fear of personal death to such artificial entities as corporations, and hence refuse dissolution where the matter is discretionary, even though this is contrary to the unambiguous terms of a shareholder agreement.

The statute as enacted seems to make clear the legislative intent that such a shareholders' agreement for dissolution will be enforced according to its terms. According to the Comment to the section this probably represents present New York law.

The only objection to the provision is that it requires the agreement for dissolution to be placed in the certificate of incorporation. Thus, assuming that the Reviser is correct, the new statute is less liberal than present law. Entombing the agreement in the certificate is probably designed to protect transferees of the stock who would not otherwise have notice that their corporation may be dissolved under them. How much simpler, however, to

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259 S. Int. 3124, Pr. 3316, § 11.07(b) (1960); N.Y. Bus. Corp. Law §1112(a).
261 See TINGLE, op. cit. supra note 251, at 50.
262 "A shareholders' agreement for dissolution would probably be held valid in the absence of statutory recognition of its validity." 1961 N.Y. Leg. Doc. No. 12, at 68 (Rev. Supp.).
enforce any unanimous shareholder agreement, but make it void against an objecting transferee without notice!

Nonetheless the provision is a distinct improvement over the section as originally introduced, and the laws of many other jurisdictions.\(^{263}\)

What final assessment should be made of the close corporation provisions of the proposed statute? On balance, they undoubtedly represent a real improvement over present New York law. It can be asserted with equal confidence that they are not enough of an improvement to fully satisfy the needs of such corporations, which, after all, represent the overwhelming majority of corporations for which the new statute is being enacted, but then of course, perhaps no one can ever be perfectly satisfied in this life.

**PUBLIC ISSUE CORPORATIONS AND SHAREHOLDERS’ RIGHTS**

Most shareholders in public issue corporations are firm believers in the so-called “Wall Street law”: If you’re not satisfied with the way the corporation is being run, which generally means the adequacy of the stock’s dividend and “growth” position, sell it.

A small minority are dissenters from this defeatist rule. They possess the “reforming instinct,” and feel that public issue corporations have certain duties to their minority shareholders. Since in most such corporations every shareholder is a minority shareholder, their appeal is to the stock through reference to the certificate provisions. N.Y. Bus. Corp. Law § 1105.

\(^{263}\) See *Tingle, op. cit. supra* note 251, at 136, citing only four similar statutes. Compare the section as originally introduced in New York. S. Int. 522, Pr. 522, § 11.05 (1961) states: “If authorized at a meeting by vote of the holders of all outstanding shares, whether or not entitled to vote thereon, the certificate of incorporation may contain a provision that any shareholder, or the holders of any specified number or proportion of outstanding shares may enforce dissolution of the corporation, at will or upon the occurrence of any specified event. Each certificate for shares must bear, on the face or back thereof, a reference to such provision.” The section as originally proposed, therefore, seemed to forbid insertion of the provision in the certificate, requiring instead a later amendment of the certificate, a costly and unnecessary procedure.
entire anonymous body of people who are ultimately the owners of most of American business.\textsuperscript{264}

The activities of the partisans of minority shareholder rights in such corporations have made two principal thrusts. The first may be characterized as the "movement for corporate democracy," the second as the "movement for corporate morality."

The "movement for corporate democracy"\textsuperscript{265} is basically designed to secure greater shareholder participation in corporate management. In the public issue corporation, every shareholder is ordinarily a minority shareholder. Corporate management is usually in the hands of a board of directors composed of a professional managerial group, often dominated by the executives of the corporation, a self-perpetuating oligarchy often possessing little or no financial interest, in the sense of stock ownership, in the corporation.

The aim of the supporters of corporate democracy is to have greater representation of the corporate "owners," i.e., the minority shareholders, on the board. The principal vehicle for this shareholder representation is what, for those familiar with old New York City politics, would be called "P.R." or Proportional Representation. In corporate affairs this is known as cumulative voting.

As has been indicated elsewhere,\textsuperscript{266} a person's attitude toward "corporate democracy" is based on whether he espouses a Platonic guardian theory of corporate government, or on the other hand, feels that the "town meeting" analogy is more appropriate. This is fundamentally a political philosophy question, and is probably out of place here.

\textsuperscript{264}Baker & Cary, op. cit. supra note 257, at 15, states: "In 1947 there were 243 non-financial corporations with assets over 100 million dollars, and 260 with more than 10,000 employees. Statistics seem to indicate that the largest 200 corporations account for one-eighth of the total civilian labor force and one-fifth of all employees of private business outside of agriculture. They held over 40 percent of all corporate assets."

A chart indicates that the 15 largest of these corporations together have almost three million shareholders. \textit{Ibid.} Any one poor shareholder must get lost in such a crowd.


\textsuperscript{266}Id. at 715-16.
Suffice it to say that present New York law makes cumulative voting discretionary: a corporation may choose to have it or not.\textsuperscript{267} Advocates of corporate democracy feel it should be mandatory.\textsuperscript{268} The Commerce and Industry Association of New York, Inc. recommended that cumulative voting should be absolutely prohibited.\textsuperscript{269} The new law continues the present option under which a corporation may choose for itself whether or not it wants cumulative voting.\textsuperscript{270}

Even where cumulative voting is required by statute or constitutional provision,\textsuperscript{271} it is possible to render the effectiveness of the provision nugatory if classification of directors is permitted. As the court in the leading case of \textit{Wolfson v. Avery},\textsuperscript{272} which invalidated the Illinois statute allowing classification of directors\textsuperscript{273} as in conflict with the constitutional provision requiring cumulative voting, pointed out, ten percent plus 1 of the shareholders of Montgomery Ward will be able to elect a member to the board if all nine of the directors are elected at one time. If the directors' terms are staggered, i.e., if there is classification of directors whereby only three are elected annually, the vote necessary to elect one director would be twenty-five percent plus 1.\textsuperscript{274}

The object of cumulative voting, minority representation on the board of directors, can be completely circumvented, therefore, by arranging the number of directors to be elected at a number just low enough so that the minority votes even though cumulated will be insufficient to elect anyone. Thus, in a New York corporation like Montgomery Ward even

\textsuperscript{267}N.Y. STOCK CORP. LAW § 49.
\textsuperscript{269}1957 N.Y. LEG. DOC. No. 17, at 39 (Suggestion 25).
\textsuperscript{270}N.Y. BUS. CORP. LAW § 618.
\textsuperscript{271}See, e.g., CAL. CORP. CODE § 2235; ILL. CONST. art. XI, § 3; PA. CONST. art. XVI, § 4.
\textsuperscript{274}Wolfson v. Avery, 6 Ill. 2d 78, 81, 126 N.E.2d 701, 704 (1955).
if the minority shareholders can muster one-quarter of the voting shares (very unlikely in a public-issue corporation unless a well-financed full-scale proxy fight is in progress), and even though cumulative voting is required, the majority (and the majority usually votes as management solicits them to) can effectively disenfranchise this significant minority by simply providing in the by-laws that three of the nine directors be elected each year, rather than all nine at the same time.\textsuperscript{275}

The present law places no limitations on the classification of directors except to require that at least one-quarter of them be elected each year and that any new directorships created be apportioned among all the classes.\textsuperscript{276} The new law, despite the fact that the Comment to the section states that its provisions "will prevent serious attenuation of cumulative voting rights through the device of classification,"\textsuperscript{277} does nothing more than limit the number of classes to four, and require that each class shall be "as nearly equal in number as possible," and that no class include less than three directors.\textsuperscript{278} Obviously neither the present nor the new law would make cumulative voting effective in the situation posed.

In fact, the new law is no more favorable to cumulative voting than the repealed requirement that at least one-quarter of the directors be elected each year; rather it is, actually, merely a more complicated way of requiring the same thing, unless a corporation is generous enough to have less than four classes of directors.

Furthermore, a mere majority of shareholders may authorize the board to create new directorships,\textsuperscript{279} and to fill the vacancies thus created, themselves.\textsuperscript{280} This should insure the ineffectiveness of cumulative voting, by guaranteeing sufficient majority-shareholder directors either originally or

\textsuperscript{275} See Kessler, \textit{supra} note 265, at 730.

\textsuperscript{276} N.Y. \textit{Stock Corp. Law} § 55.

\textsuperscript{277} 1961 \textit{N.Y. Leg. Doc.} No. 12, at 46 (Rev. Supp.), Comment to § 704.

\textsuperscript{278} N.Y. \textit{Bus. Corp. Law} § 704.

\textsuperscript{279} N.Y. \textit{Bus. Corp. Law} § 702(b).

\textsuperscript{280} N.Y. \textit{Bus. Corp. Law} § 705(a). N.Y. \textit{Bus. Corp. Law} § 704(c) would not seem to prevent this result.
by their own later creation to outvote any minority representatives put on the board by cumulative voting.281

Of course, except for corporations which desire to deceive their shareholders into thinking that they have effective cumulative voting rights, the problem is largely hypothetical, anyhow: cumulative voting is not required, and accordingly it will not be chosen by most corporations desiring to incorporate in this state. The movement for shareholder democracy has not been successful in New York.282

The second facet of shareholder attempts to protect their interest in public issue corporations is the “movement for corporate morality.” This movement takes the form of two demands: a high fiduciary standard for corporate agents, and easy access to the courts to redress wrongs done by those agents. The rationale is, of course, that if the corporation is to be run by an unimpeachable aristocracy, these people should at least behave as true aristocrats.

281 One concession to the cumulative voting advocates is, however, the guaranty that where cumulative voting prevails, the minority directors may not be ousted, even for cause, by a mere majority of the shareholders. Where such ouster is possible, cumulative voting becomes nugatory, since any minority director may always be removed when the majority decides he is interfering with their running of the corporation. Yet such removal, despite the fact that it means that although a minority may elect a director a majority vote is required to keep him on the board, has been permitted. See Campbell v. Loews, 134 A.2d 852 (Del. Ch. 1957). N.Y. Bus. CORP. LAW §706(c), on the other hand, wisely provides: “The removal of directors, with or without cause, as provided in paragraphs (a) and (b) is subject to the following: (1) In the case of a corporation having cumulative voting, no director may be removed by the shareholders when the shares voted against his removal would be sufficient to elect him if voted cumulatively at an election at which the same total number of votes were cast and the entire board were then being elected, nor may a director be removed by the board; and (2) When by the provisions of the certificate of incorporation the holders of the shares of any class are entitled to elect one or more directors, any director so elected may be removed only by the applicable vote of the holders of the shares of that class, voting as a class.”

282 The new statute’s provision (N.Y. BUS. CORP. LAW §715(b)) for election of officers directly by the shareholders, discussed above in connection with close corporations, may, if availed of by a corporation be a significant step toward shareholder democracy. However, it is unlikely that public issue corporations will avail themselves of this provision any more than they will of cumulative voting. Certain protection is afforded the minority shareholders against removal of their directors by N.Y. BUS. CORP. LAW §706(c). See note 281 supra. This is a concession to corporate democracy, but only where the corporation desires to grant it by placing the necessary provisions in the certificate of incorporation.
The fiduciary standard of directors and officers has, in turn, two facets: the "duty of care," as it has been called, or the duty not to be negligent, and the "duty of loyalty," or the duty not intentionally to harm their corporation, its stockholders and creditors.\(^{283}\)

The negligence standard is not prescribed under present statutory law. Early case law, however, established a high standard of care for corporate agents. In the case of *Hun v. Cary*\(^ {284}\) the court laid down the rule that it is the duty of directors to exercise "the same degree of care and prudence that men prompted by self-interest generally exercise in their own affairs."\(^ {285}\)

That case also held that a director gives an implied warranty of fitness for his job. The court added:

One who voluntarily takes the position of director, and invites confidence in that relation, undertakes, like a mandatary, with those whom he represents or for whom he acts, that he possesses at least ordinary knowledge and skill, and that he will bring them to bear in the discharge of his duties.\(^ {286}\)

Although a more recent case\(^ {287}\) has indicated a tendency to relax this strict standard, *Hun v. Cary* has never been overruled, and may still represent New York law.

The new statute, however, substitutes the standard of the "reasonable director" for this standard of the "reasonable man." The new section provides:

Directors and officers shall discharge the duties of their respective positions in good faith and with that degree of diligence,


\(^{285}\) Hun v. Cary, 82 N.Y. 65, 71 (1880). In the *Hun* case, the directors of a bank were held liable in a suit by a receiver for loss to the bank when a mortgage was foreclosed on a building which they had had erected at a cost of $27,000 on a lot which they had purchased at a cost of $29,250, at a time when the bank's assets were only $13,000, while its liabilities to depositors were $70,000.

\(^{286}\) Id. at 74.

care and skill which ordinarily prudent men would exercise under similar circumstances in like positions. . . .

Avowedly this is a less strict standard. As the Comment to the section states:

The prevailing rule in this state with respect to the standard of care required of directors has been stated judicially as the duty "to exercise the same degree of care and prudence that men prompted by self interest generally exercise in their own affairs" (see, Kavanaugh v. Commonwealth Trust Co., 233 N.Y. 103 (1918)). However, it has been recognized that the standard of care may vary according to the kind of corporation involved and the particular circumstances in which the director is called upon to act (see, Litwin v. Allen, 25 N.Y.S. 2d 667 (not otherwise reported)). The suggestion has been made that the standard of care should be that of an ordinary director not an ordinary man.

The adoption of the standard prescribed by this section will allow the court to envisage the director's duty of care as a relative concept, depending on the kind of corporation involved, the particular circumstances and the corporate role of the director.

Whether this semantic difference will have any practical effect upon the triers of the facts who will determine whether or not a director has been negligent is a matter of some conjecture. Certainly it should not result in any widespread relaxation of diligence on the part of corporate managers, and may in some instances prevent liability from being imposed where under the circumstances it would be morally unjust to hold the defendant. Especially considering its dubious practical effect the provision would not seem so dire as to merit condemnation, especially since it apparently represents the majority rule in the country.

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288 N.Y. Bus. Corp. Law §717. This would seem to be the standard of the "ordinarily prudent director." See Ballantine, Corporations 158-59 (rev. ed. 1946); Rohrlich, New York's Proposed Business Corporation Law, 15 Record of N.Y.C.B.A. 309, 317 (1960). Ballantine seems to treat his "just rule," substantially the same as that set forth in the new statute, as establishing the standard of an "ordinarily prudent director." Rohrlich states, however, that the bill (the law as enacted is the same as the provision upon which he commented) rejects the standard of the "ordinary director." The difference would seem merely semantic. It is at least clear that the standard of Hun v. Cary has been rejected.


290 Ibid.
The other branch of fiduciary duty is the "duty of loyalty." This duty has a number of sub-branches. It may thus be divided into the following categories: (1) interested directors' contracts; (2) contracts between corporations having interlocking directorates; (3) duties to creditors, including purchase of corporate obligations at a discount and improper distribution of corporate assets; (4) pre-emption of corporate opportunities; and (5) purchases of shares from individual stockholders without full disclosure.

There are, of course, other duties which a corporate director or officer may breach, but generally these are duties which are not restricted to directors and officers in their capacities as such, but which even shareholders have to their fellow shareholders.

With regard to (1) interested directors' contracts, and (2) contracts between corporations having interlocking directorates, New York presently has no statutory provision. As indicated above, the new statute changes this and clarifies New York law by adopting the so-called "liberal" rule with regard to interested directors' contracts, the same rule as that presently the majority rule with regard to contracts between corporations having interlocking directors, i.e., neither type of contract is automatically voidable despite the fact that the "tainted" director's presence is necessary to a quorum or even that his vote in favor of the contract is required for its approval. The only proviso is, of course, that the contract be fair and reasonable.

There is nothing wrong with such a rule, since the really important thing is that all corporate contracts be fair, and,

291 BAKER & CARY, op. cit. supra note 283, at 432.
292 A subsection of this provision would be the problem of "Executive Compensation." See BAKER & CARY, op. cit. supra note 283, at 432.
293 See BAKER & CARY, op. cit. supra note 283, at 624.
294 See BAKER & CARY, op. cit. supra note 283, at 538.
295 See, e.g., BAKER & CARY, op. cit. supra note 283, at 515 (as to duties of majority to minority shareholders), 590 (as to sale of control at a profit or to looters).
296 See textual discussion in this article under section entitled Birdseye View of the New Law.
if they are, it is immaterial whether or not an interested director participates in their adoption.

The statute also validates interested and "interlocking" contracts where there is disclosure of the interest and a majority of the shareholders ratify the transaction. This represents the majority rule and is also unexceptionable.

However, the statute goes further. It adds another means of validating such contracts, namely by disclosure coupled by approval by a directoral vote not requiring counting of the interested directors. True, the validation is not a conclusive one. All three means of upholding such contracts are qualified by the statement that no such interested or interlocking contracts shall be voidable "for this reason alone," thus implying that the contracts may be invalidated on other grounds.

According to the Comment to the omitted provision, this latter statement was:

... intended to make clear that this section does not validate a contract or transaction between an interested director and his corporation for all purposes but merely provides that such contract or transaction is not automatically void or voidable by reason alone of the director's interest.

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298 N.Y. Bus. Corp. Law §713(a)(2).
299 BALLANTINE, op. cit. supra note 297, at 176. See also 19 C.J.S. Corporations §783 (1938). Compare HENN, CORPORATIONS 376 (1961), who states: "Most of the cases, however, take the position that less-than-unanimous shareholder ratification does not bar avoidance. ..." Actually the new statute is somewhat stricter than the majority rule in that it disqualifies the interested directors from voting as shareholders to ratify their contracts. The statute, however, omits the requirement of good faith which Ballantine states is part of the majority rule.
300 N.Y. Bus. Corp. Law §713(a)(1). Although superficially similar, this is a departure from the majority rule, in that it allows the interested director to be counted for a quorum, and thus encourages his presence, and hence increases the possibility of domination.
301 A. Int. 885, Pr. 885, §7.13(c) (1961).
302 A. Int. 885, Pr. 885, §7.13(c) (1961).
303 1961 N.Y. Leg. Doc. No. 12, at 49 (Supp.).
Now, it is not so clear how conclusive the validation will be.\(^{304}\)

The only danger from the statutory provision authorizing such contracts where approved "by a vote sufficient for such purpose without counting the vote or votes of such interested director or directors" is that the interested director may be able to dominate the others and thus have an unfair contract approved. This was the situation in a well-known New York case.\(^{305}\) Probably the qualifications in the statute and its Comment will be sufficient to preserve the rule that an unfair contract will be invalidated even where adopted without the interested directors' vote. It might be advisable to make it clear that at least where domination is shown the burden of proof will be upon those seeking to uphold the contract.\(^{306}\) The new statute may well be held to place the burden of proof in every case on the party seeking to upset the contract. At least in this situation it seems unwise to do so.

The major defect from the point of view of those interested in holding corporate guardians to a standard commensurate with their perquisites, however, is in the subsection on interested directors' contracts which allows the directors to fix their own compensation,\(^{307}\) an admitted in-
novation in New York law. This provision is absolutely unqualified except for the right of the certificate or by-laws to forbid such self-dealing. The new law is therefore a significant relaxation of the fiduciary duty of corporate directors. Even where their compensation is approved by a majority of the shareholders, there are sufficient dangers to merit the requirement that that compensation be reasonable. Even if it be accepted that a man can sometimes serve two masters, himself and his corporation, satisfactorily, there is no justification for giving a carte blanche in the most dangerous area of self-dealing, the fixing of his own salary. Certainly, the very least that is necessary is to expressly subject such a power to the same conditions as other interested directors' contracts. The provision as it now stands is either a shocking example of poor draftsman-ship, or of callous disregard for the rights of corporate shareholders, out of whose pockets, it is obvious, this money will come.

A more minor relaxation in the fiduciary standard is the substitution of a prohibition of loans to directors for the present prohibition on loans to shareholders, which the Comment to the new section suggests is out-of-date. Loans to shareholders will thus be perfectly legal. Even loans to directors will be valid if approved by a

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309 See Rogers v. Hill, 289 U.S. 582 (1933), in which payments under an executive bonus arrangement became in later years so excessive that the Supreme Court ordered the district court to inquire into its reasonableness, even though the plan had initially been approved by the shareholders and not merely the recipient directors.
310 N.Y. Bus. Corp. Law § 714 provides: "A loan shall not be made by a corporation to any director unless it is authorized by vote of the shareholders. For this purpose, the shares of the director who would be the borrower shall not be shares entitled to vote. A loan made in violation of this section shall be a violation of the duty to the corporation of the directors approving it, but the obligation of the borrower with respect to the loan shall not be affected thereby."
311 N.Y. Stock Corp. Law § 59.
majority of the shareholders. Many cogent reasons can undoubtedly be given for sanctioning loans to both directors and shareholders. On the other hand, the danger to creditors through withdrawal of the assets on which they have a right to rely as security for the corporation's indebtedness presents an even more compelling reason for forbidding loans both to shareholders and to directors.\(^{313}\) In the third field or sub-branch of fiduciary duty, that of duties to creditors, this change in the law therefore hardly reflects an improvement.

This field of fiduciary duty, that of the directors' duties to creditors, is by and large the only one regulated by statute under present New York law. In addition to the loan prohibition there is the general prohibition against preferential transfers to its officers, directors or shareholders of any corporate assets when the corporation is insolvent,\(^{314}\) and the prohibition against dividends impairing capital.\(^{315}\) The new section \(^{316}\) carries over in substance the latter of these prohibitions, and adds provisions for liability for improper share repurchases\(^{317}\) and distribution of assets after corporate dissolution without adequately providing for all known liabilities.\(^{318}\) Unaccountably, however, it omits the

\(^{313}\) It should be noted that despite the intention of N.Y. PEN. LAW § 664(4), there would seem to be nothing to prevent use of this as a device to enable a shareholder to obtain a return of the consideration paid for his stock, whenever friends on the board of directors desire to allow him to do so, by lending him back the amount he has paid for his stock and then accepting his shares back in compromise of his indebtedness even though the corporation has no surplus and could therefore not repurchase those shares. See N.Y. BUS. CORP. LAW § 513(a). A clever loophole is thus created for circumvention of N.Y. BUS. CORP. LAW §§ 513, 514, restricting repurchase of shares by a corporation.\(^{314}\) N.Y. STOCK CORP. LAW §15. Although present New York law ordinarily relies on a bankruptcy insolvency test, N.Y. STOCK CORP. LAW §15 also imposes the equity insolvency restriction, which is utilized in the new statute. N.Y. BUS. CORP. LAW § 102(a)(8).\(^{315}\) N.Y. STOCK CORP. LAW § 58.\(^{316}\) N.Y. BUS. CORP. LAW § 719(a)(1) imposes joint and several liability on directors for dividends declared in violation of N.Y. BUS. CORP. LAW § 510.\(^{317}\) N.Y. PEN. LAW § 664(5) makes repurchases of shares from other than surplus a misdemeanor. However, symmetry requires that a provision for director liability be placed in the corporation law. N.Y. BUS. CORP. LAW § 719(a)(2) does so.\(^{318}\) N.Y. BUS. CORP. LAW § 719(a)(3).
prohibition against preferential transfers to insiders although forbidden in the act as originally proposed.\textsuperscript{319}

By and large, the new section mirrors the Model Act but with one significant difference. The Model Act, which has, incidentally, been criticized as being too favorable to the management group,\textsuperscript{320} exonerates a director if he relied in good faith upon the financial statements of the corporation as does the new New York statute.\textsuperscript{321}

Not content with such a specific exculpation, however, the Business Corporation Law even outdoes the Model Act in providing excuses from liability to corporate managers. It provides that if a director violates one of these provisions, he will not be liable if, "in the circumstances, he discharged his duty to the corporation." \textsuperscript{322}

This provision is very ambiguous. It might well be interpreted to exonerate any director who had grounds to believe that even the specifically interdicted distributions were not improper.\textsuperscript{323} And it will be noted these grounds

\textsuperscript{319} S. Int. 522, Pr. 522, §§7.19(a)(1), 7.19(b) (1961), respectively made directors "who vote for or concur in" a transfer of property in violation of §5.10, and officers who "participate" therein, jointly and severally liable "to the corporation for the benefit of its creditors and shareholders," to the extent of any injury suffered by them. All three provisions have now been deleted. Oddly enough, however, N.Y. Bus Corp. Law §720 allows suit "against one or more directors or officers" to compel the defendant "to account" for "the acquisition by himself, transfers to others, loss or waste of corporate assets due to any neglect of, or failure to perform, or other violation of his duties." It also allows suit "to set aside an illegal conveyance, assignment or transfer of corporate assets, where the transferee knew of its illegality," but the section only applies to director or officer transferees. See opening words of N.Y. Bus. Corp. Law §720(a), set forth infra, note 324.


\textsuperscript{321} N.Y. Bus. Corp. Law §717. MODEL BUSINESS CORPORATION ACT ANN. §43 (1960) provides: "A director shall not be liable under subparagraphs (a), (b) or (c) of this section if he relied and acted in good faith upon financial statements of the corporation represented to him to be correct by the president or the officer of such corporation having charge of its books of account, or stated in a written report by an independent public or certified public accountant or firm of such accountants fairly to reflect the financial condition of such corporation, nor shall he be so liable if in good faith in determining the amount available for any such dividend or distribution he considered the assets to be of their book value."

\textsuperscript{322} N.Y. BUS. CORP. LAW §719(e).

\textsuperscript{323} Study Bill §7.16(h) provided: "A director or officer, as the case may be, shall not be liable under any paragraph of this section if, in
are not restricted to good faith reliance on the corporation's financial statements. They might include a mere failure to investigate. Further, the corporate agent is exonerated if he performs his duty to the corporation. Is the obligation to the corporation coextensive with the obligation to shareholders and creditors for whose benefit the section is enacted, or may it not be significantly less broad? The "corporation," especially if it is already insolvent, may well not be harmed although creditors and shareholders may be pauperized.

The statute also fails to impose any specific liability on officers who participate in these few proscribed violations of duty, despite the fact that previous New York law, in three out of the four situations which the new provision replaces, and indeed the new act as originally intro-

 accordance with the standard prescribed by section 7.15 (Duty of directors and officers) of this article, he had reasonable grounds to believe and did believe that the acts or conduct imposing liability, as defined by the paragraph under which he is charged, had not occurred.

Whether the change in verbiage in the new law is designed to have any significance or is merely an attempt at greater conciseness is not clear. The Comment to the predecessor of the section as enacted is unenlightening on this score. The bill as finally enacted adds the "conclusiveness presumption" with regard to financial statements. N.Y. Bus. Corp. Law § 717 provides: "Directors and officers shall discharge the duties of their respective positions in good faith and with that degree of diligence, care and skill which ordinarily prudent men would exercise under similar circumstances in like positions. In discharging their duties, directors and officers, when acting in good faith, may rely upon financial statements of the corporation represented to them to be correct by the president or the officer of the corporation having charge of its books of accounts, or stated in a written report by an independent public or certified public accountant or firm of such accountants fairly to reflect the financial condition of such corporation."

N.Y. Stock Corp. Law §§ 15 (preferential transfers), 59 (loans to stockholders), 61 (false reports). A sympathetic court may justify the imposition of liability on the basis of N.Y. Bus. Corp. Law § 720(a) which provides: "An action may be brought against one or more directors or officers of a corporation to procure a judgment for the following relief:

"(1) To compel the defendant to account for his official conduct in the following cases:

"(A) The neglect of, or failure to perform, or other violation of his duties in the management and disposition of corporate assets committed to his charge.

"(B) The acquisition by himself, transfer to others, loss or waste of corporate assets due to any neglect of, or failure to perform, or other violation of his duties.

"(2) To set aside an illegal conveyance, assignment or transfer of corporate assets, where the transferee knew of its illegality.

"(3) To enjoin a proposed illegal conveyance, assignment or transfer..."
duced,\textsuperscript{325} and the Study Bill\textsuperscript{326} extended at least partial liability to them. Since in a large corporation the officers are more likely to "know what's going on" than many of the directors, it seems unwise not to include them under the already limited liability provisions applicable to directors.

The last concession to the demands of the opponents of corporate morality made by the new act also represents a change from the Study Bill. As indicated above,\textsuperscript{327} the new statute is an improvement over present law in requiring disclosure of the source of corporate distributions where that source is other than earned surplus. Obviously, to be effective the notice requirement must include appropriate sanctions to prevent its violation. The Study Bill provided:

Directors or officers who fail to forward to the shareholders of the corporation the written notice required by sections 5.11 (Dividends in cash or property) or 5.12 (Share distributions to shareholders) of this chapter shall be jointly and severally liable to any person who becomes or remains a creditor or shareholder of the corporation by reason of the failure to give such notice to the amount of the debt contracted which is not paid when due in the case of a creditor and to the amount of any damage sustained by reason of such failure in the case of a shareholder.\textsuperscript{328}

This subsection is deleted in the law as finally enacted. In its stead a new provision has been added to the Corporate Finance article making the corporation liable "for any damage sustained by any shareholder" in consequence of the failure to make the disclosures required in that article.\textsuperscript{329} This is a totally unsatisfactory substitute. It is rather like providing that persons who commit suicide will be punished by death.

\textsuperscript{325} S. Int. 522, Pr. 522, § 7.19(b) (1961).
\textsuperscript{326} Study Bill § 7.17(e), (f), (g).
\textsuperscript{327} See the textual discussion in this article under the section entitled The Financial Provisions of the New Law.
\textsuperscript{328} Study Bill § 7.16(g).
\textsuperscript{329} N.Y. Bus. Corp. Law § 520.
As stated above, when a corporation pays dividends or makes other distributions from capital surplus, rather than earned surplus, it is usually a sign that the corporation is not in the best of financial health. This is the reason for the notice. And it is just when the corporation is sickest, and hence will be unable to pay the "damage sustained," that the incentive to conceal this fact by failure to provide the notice will be greatest. If they are not personally liable, unscrupulous directors will not hesitate to omit the notice at the very time when it is most needed, just before insolvency. After they have salvaged their investment through distributions, they will undoubtedly have no objection to the duped shareholder's procuring his worthless judgment against the empty corporation.

The protection offered by the new notice requirements of the act has thus been rendered completely nugatory, by failure to impose any effective sanctions.330

The Model Act has been called "an invitation to irresponsibility." 331 If such a characterization aptly applies to that moderate proposal, the only appropriate description of the fiduciary provisions of the new New York statute would seem to be a "command to irresponsibility."

It is fortunate that the other two areas of fiduciary duty, pre-emption of corporate opportunities, and purchases of shares from individual stockholders, are both, like the remaining aspect of duties to creditors, i.e., purchase of

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330 Undoubtedly the drafters of the act were concerned lest they hold directors liable for an honest mistake in the accounting computations required. This is no excuse for exonerating them from all liability. As indicated above, the new act allows a director to escape liability for improper distributions where he has done his "duty." N.Y. BUS. CORP. LAW §719(e). This, and the provision exculpating him where he can show good faith reliance on the accounts of the corporation, would seem to offer sufficient protection to honest directors, who, of course, should be protected. N.Y. BUS. CORP. LAW §717.

At the very least, wilful failure to send the appropriate notice should be added to the list of directorial misdemeanors in N.Y. PEN. LAW §664. With neither civil nor penal liability of the directors, the notice requirements of the new law are like the high-sounding guarantees of the Russian Constitution, mere words.

Corporate securities at a discount, left to case law under the new statute, as they were under the old law.

It is obvious that in those areas of fiduciary duty into which the new statute has intruded, the first demand of the movement for corporate morality, a high fiduciary standard, has not been met.

Fortunately, one significant relaxation in the fiduciary standard of directors found in the bill as originally introduced failed to become law. That bill abandoned the principle that non-dissenting directors are equally liable with those who happen to vote in favor of an illegal distribution.\(^3\) Under present law directors may only escape liability for improper dividends by such a dissent or by an affirmative showing "that they had reasonable grounds to believe, and did believe, that such dividend or distribution would not impair the capital. . . ."**\(^3\)** The Study Bill, on the other hand, had extended the presumption of assent from failure to disavow the action to all of the fiduciary duties under the new act.**\(^3\)** Unaccountably, this provision was dropped from the bill as originally proposed. Under it only directors "who vote for or concur in"**\(^3\)** the action

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\(^3\) S. Int. 522, Pr. 522, § 7.19 (1961).

\(^3\) N.Y. Stock Corp. Law § 58 provides: "No stock corporation shall declare or pay any dividend which shall impair its capital, nor while its capital is impaired, nor shall any such corporation declare or pay any dividend or make any distribution of assets to any of its stockholders, whether upon a reduction of the number or par value of its shares or of its capital, unless the value of its assets remaining after the payment of such dividend, or after such distribution of assets, as the case may be, shall be at least equal to the aggregate amount of its debts and liabilities, including capital. In case any such dividend shall be paid, or any such distribution of assets made, the directors in whose administration the same shall have been declared or made, except those (1) who may have caused their dissent therefrom to be entered upon the minutes of the meetings of directors at the time or (2) who having been absent when such action was taken may have communicated in writing their dissent to be entered on the minutes within a reasonable time after learning of such action, or (3) who affirmatively show that they had reasonable grounds to believe, and did believe, that such dividend or distribution would not impair the capital of such corporation, shall be liable jointly and severally to such corporation and to the creditors thereof to the full amount of any loss sustained by such corporation or by its creditors respectively by reason of such dividend or distribution."

\(^3\) Study Bill § 7.16(i).

\(^3\) What acts evidenced concurrence in the illegal distribution were not spelled out. The Comment was also no help. 1961 N.Y. Leg. Doc. No. 12, at 52 (Supp.).
were to be liable. A loophole for circumvention of liability by the corporate prime movers through use of naive and judgment-proof directors to make illegal distributions was thus created.\textsuperscript{336}

The bill as finally passed returns to the philosophy of the Study Bill, and thus represents a bright spot in the otherwise dim picture of management duties under the new law.\textsuperscript{337}

What of the other demand of the movement for corporate morality, easy access to the courts to redress those wrongs which, despite the lenient legal standard, are redressable offenses?

Present law is hardly generous to a shareholder desiring to bring a derivative suit. There are an almost insuperable number of obstacles to success. Assuming he can get jurisdiction over the real wrongdoers and all the beneficiary corporations, often an insurmountable barrier,\textsuperscript{338} he still has three formidable hurdles under present New York law. The first is the contemporaneous ownership requirement, or

\textsuperscript{336} Of course, if the unscrupulous absent directors were the recipients of the improper distributions the corporation (or its trustee in bankruptcy) could still have recovered them, but it was saddled with the burden of proving that the defendant knew of the illegality. S. Int. 522, Pr. 522, § 7.19(d) (2) (1961). The burden of proof should be on the absent director, as is true under present law (N.Y. STOCK CORP. LAW § 58), and, fortunately, the law as passed. N.Y. BUS. CORP. LAW § 719(b).

\textsuperscript{337} N.Y. BUS. CORP. LAW § 719(b) provides: "A director who is present at a meeting of the board, or any committee thereof, at which action specified in paragraph (a) is taken shall be presumed to have concurred in the action unless his dissent thereto shall be entered in the minutes of the meeting, or unless he shall submit his written dissent to the person acting as the secretary of the meeting before the adjournment thereof, or shall deliver or send by registered mail such dissent to the secretary of the corporation promptly after the adjournment of the meeting. Such right to dissent shall not apply to a director who voted in favor of such action. A director who is absent from a meeting of the board, or any committee thereof, at which such action is taken shall be presumed to have concurred in the action unless he shall deliver or send by registered mail his dissent thereto to the secretary of the corporation or shall cause such dissent to be filed with the minutes of the proceedings of the board or committee within a reasonable time after learning of such action."

N.Y. BUS. CORP. LAW § 719(a) forbids improper dividends, share repurchases and dissolution distributions.

the rule that he must have been a shareholder at the time of the wrongs complained of, or have inherited his shares from someone who was. 339 Secondly, he must have made a demand on the directors to bring the suit, or possess some sufficient excuse for not so doing. 340 Thirdly, and the most onerous of all, is the requirement for posting "security for expenses" of the defendants which may only be escaped under present law if the plaintiff (or combined plaintiffs) holds a total of 5% of the outstanding shares of some class of the corporation's stock, or if the value of the stock held is over $50,000. 341 An Appellate Division decision has even required that all of the plaintiffs necessary to make up this required amount meet the contemporaneous ownership requirement, i.e., that they also have been shareholders at the time of the wrongdoing complained of. 342

The conditions precedent for bringing a shareholder's derivative action are found in sections 626 and 627 of the new statute. All three of the old requirements are retained: contemporaneous ownership, 343 demand on the directors, or legitimate excuses, 344 and the security for expenses requirement. 345 With regard to the latter, however, section 627 allows the corporation to compel the security deposit "if the plaintiff or plaintiffs hold less than five percent of the outstanding shares or hold voting trust certificates or a beneficial interest in shares representing less than five percent of such shares" unless they have a value in excess of $50,000. The express acquittance of equitable owners of the requisite percentage of shares is a welcome clarification. The omission of the words "of any class" found in old New York General Corporation Law Section 61-b

339 N.Y. GEN. CORP. LAW § 61.
340 BALLANTINE, CORPORATIONS 345-46 (rev. ed. 1946); LATTIN, CORPORATIONS 352-55 (1959); STEVENS, CORPORATIONS 800-03 (2d ed. 1949).
341 N.Y. GEN. CORP. LAW § 61-b. The short statute of limitations is, of course, yet another obstacle. N.Y. CIV. PRAC. ACT § 48(8).
343 N.Y. Bus. Corp. Law § 626(b).
344 N.Y. Bus. Corp. Law § 626(c).
345 N.Y. Bus. Corp. Law § 627.
as a qualification upon the requirement of five percent share ownership, would seem, on the other hand, to mean a significant increase in the burden imposed on all shareholders in a corporation with more than one class of stock. It appears, however, that this omission was one of inadvertence, rather than design, and hence will be corrected. It is on this assumption that no additional criticism of this omission will be made. Of course, if the change is not made a terrible blow will have been dealt to the movement for corporate morality.

One bright spot of the bill as introduced was the overruling of the ill-conceived decision346 which required that all the shareholders necessary to make up the requisite 5%, or over $50,000 in value, to avoid posting security, meet the contemporaneous ownership requirement.847 The purpose of the security for expenses provision was to discourage "strike" or blackmail suits where the plaintiff brought the action merely to harass, or worse, to be bought off.348 The exception dispensing with the necessity for posting security where the plaintiff, or plaintiffs together, owned 5% of the stock, or stock worth over $50,000, was a recognition of the fact that where the stockholdings of the litigants were significant the danger of such strike suits was small. Obviously, the guarantee of reasonable cause is present where the holdings are significant, no matter when the stock was bought. Abrogating the case decision that all of the stockholders necessary to make up the required holdings must

346 Richmond v. Felmus, supra note 342.
347 A. Int. 885, Pr. 885, § 6.26(d) (1961) provided: "Shareholders or holders of voting trust certificates of the corporation or of beneficial interests in such shares may be permitted to intervene as plaintiffs in such action, whether or not they were holders thereof at the time of the transaction complained of, and the number and value of such shares or shares represented by such interests may be counted for the purposes of section 6.27 (Security for expenses in shareholders' derivative action brought in the right of the corporation to procure a judgment in its favor)."

348 See Governor's Memorandum filed with Senate Bills 1314, 1315, dated April 9, 1944.
meet the contemporaneous ownership requirement was, therefore, a good change.

Unfortunately, the statute as passed deletes the specific provision of the original bill, leaving the matter again to case law decision, or worse, perhaps indicating a legislative rejection of the wise rule that the security for expenses section does not incorporate the contemporaneous ownership requirement.

In this respect, and generally, the new statute mirrors present law, rejecting changes made in the bill as originally introduced. This is unfortunate, because taken with the

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349 See N.Y. Bus. Corp. Law §§ 626, 627.
350 Nevertheless, a sympathetic court is given some support if it chooses to interpret the statute as abrogating the Felmus rule, by the fact that N.Y. Bus. Corp. Law § 627 requires the "plaintiff or plaintiffs" to meet the ownership requirements to avoid the necessity of a security deposit, while N.Y. Bus. Corp. Law § 626(b), imposing the contemporaneous ownership requirement, merely commands that the "plaintiff" be such a holder. This is carrion comfort, however.
351 The bill as introduced made a significant change in the availability of the security deposit, to the reimbursement of the defendant corporate officers and directors for their expenses in defending the action. Present law provides for a security deposit sufficient to cover the expenses of the individual defendants, for which the corporation may become liable pursuant to the indemnification provisions of present law, and provides that the corporation shall have recourse to that deposit in satisfaction of its indemnification obligations. N.Y. Gen. Corp. Law § 61-b. The bill as introduced granted resort to the deposit only on condition that the court made "a finding that the action was brought without reasonable cause." A. Int. 885, Pr. 885, § 627 (1961). The obligation of the corporation, under its statutory duty to indemnify, may, however, be broader, since it may have to pay the accused director or officer even where he is only technically successful.

N.Y. Bus. Corp. Law § 724 grants a statutory right of indemnification "to the extent provided . . . in section 725 . . ." N.Y. Bus. Corp. Law § 725(a) provides: "... a director or officer who has been wholly successful, on the merits or otherwise, in the defense of a civil or criminal action or proceeding shall be entitled to indemnification, subject to subparagraph (g) (2)."

Subparagraph (g)(2) provides: "No indemnification shall be made under this article where it appears:

(2) That the indemnification would be inconsistent with a provision of the certificate of incorporation, a by-law, a resolution of shareholders or directors, an agreement or other proper corporate action, in effect at the time of the accrual of the alleged cause of action asserted in the threatened or pending action or proceeding in which the expenses were incurred or other amounts were paid, which prohibits or otherwise limits indemnification . . . ."

The bill as introduced had almost identical provisions. See S. Int. 522, Pr. 522, §§ 7.24, 7.25(a), 7.25(g)(2) (1961).

Such success of the real defendant presumably is not the same as a
indemnification provisions, to be discussed below, it apparently means that the plaintiff may be compelled to pay the indemnification expenses of guilty directors who are technically successful, e.g., through pleading the statute of limitations. This is unjust, in no way serves the purpose of security deposit requirements (to prevent unfounded shareholder suits), and, hence, should not be allowed under any good corporation statute.

There is, however, an innovation, in the new statute, and one to which no one really interested in shareholder rights, as distinguished from the possible blackmail value of shareholders' suits, can object. It is the provision that no derivative suit may be discontinued, compromised or "finding that the action was brought without reasonable cause." A defendant may be wholly successful, e.g., where he pleads the statute of limitations, even though he is clearly guilty, and the plaintiff would thus seem to have "reasonable cause" for bringing the action against him. Thus the liability of the corporation might have been broader than the liability of the plaintiff's security deposit, a clear favoritism to the shareholder bringing the action, but one which is ambivalent from the point of view of the advocates of the shareholder's suit as a vehicle for guaranteeing corporate morality, since after all, the money used for the balance of the required indemnification ultimately comes from the pockets of other shareholders, and is used to reimburse those who morally may have no right to such assistance. This is, however, basically a question of the adequacy of the indemnification provisions, which will be discussed below, and not of the security for expenses sections of the statute. Suffice it to say here that conditioning the loss of the plaintiff's security deposit on a finding that he has brought the action without reasonable cause would have been a significant improvement over the present law which has justified a court in forcing a plaintiff to pay the expenses of a dishonest director who was successful only because he found some legal technicality to bar an otherwise just recovery against him. The only possible objection is to the vagueness of the term "without reasonable cause." Probably a flagrant case of harassment or outright blackmail would be required before a shareholder's suit would be considered to be brought without reasonable cause. Certainly, where a defendant does not win on the merits the suit should never be considered to have been brought without reasonable cause. The courts could probably have been relied upon to give a correct interpretation to the phrase. However, the term has been completely deleted in favor of a return to the old law.

352 This was the case in Dornan v. Humphrey, 278 App. Div. 1010, 106 N.Y.S.2d 142 (4th Dep't 1951) (memorandum decision). The result seems assured in view of the language of N.Y. Bus. Corp. Law § 725(a), which grants statutory indemnification to "a director or officer who has been wholly successful on the merits or otherwise." (Emphasis added.) Thus, the legislature has given a rebuff to the judicial trend away from benefiting the guilty, which is manifested in the recent case of Diamond v. Diamond, 307 N.Y. 263, 120 N.E.2d 819 (1954).
settled without court approval and on such notice to the other shareholders as the court may direct. Under present law there is no express requirement for court approval of a settlement, and thus nothing to prevent an out-of-court settlement to the profit of the individual plaintiff, with nothing going to the rest of the shareholders, for whose benefit, theoretically, the suit has been brought. The result, in the language of the street, is merely that the "crooks" have to "kick in" part of their "take" for protection, to the stockholder who has been clever enough to catch them "with their hands in the till." True, the Court of Appeals has held that any moneys thus received by the plaintiffs may be recovered by the corporation, but this requires a second shareholder's suit, by a plaintiff who presumably must meet all the requirements for a shareholder's action.

The requirement for notice, borrowed as was the previous prohibition of out-of-court settlements from the federal rule, is also well designed to minimize collusive suits and collusive settlements. It codifies a wise custom of the lower New York courts courageously adopted despite the lack of statutory authorization under present law.

Both of the above borrowings from the federal rule are all to the good.

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353 N.Y. Bus. Corp. Law § 626(d) provides: "Such action shall not be discontinued, compromised or settled, without the approval of the court having jurisdiction of the action. If the court shall determine that the interests of the shareholders or any class or classes thereof will be substantially affected by such discontinuance, compromise, or settlement, the court, in its discretion, may direct that notice, by publication or otherwise, shall be given to the shareholders or class or classes thereof whose interests it determines will be so affected; if notice is so directed to be given the court may determine which one or more of the parties to the action shall bear the expense of giving the same, in such amount as the court shall determine and find to be reasonable in the circumstances, and the amount of such expense shall be awarded as special costs of the action and recoverable in the same manner as statutory taxable costs."


357 See BALLANTINE, CORPORATIONS 364 n.7 (rev. ed. 1946); Hornstein, New Aspects of Stockholders' Derivative Suits, 47 COLUM. L. REV. 1, 20 (1947).
Fortunately, the bill as finally passed does not borrow another provision of the federal rule although this was originally incorporated in the Study Bill. Section 6.25(c) of the Study Bill was based on Federal Rule 23(b), and, accordingly, not only required the plaintiff to set forth with particularity the efforts he had made to secure action by the directors, but also "if necessary, by the stockholders." 358

Such a provision is perfectly all right in a federal procedural rule, since the object of the federal courts since Erie v. Tompkins has been to produce conformity of result in the federal court with that in the appropriate state court. To do so it is obviously necessary to assimilate state substantive law. If a demand on the shareholders is necessary in the particular state of incorporation it would conflict with the policy of Erie v. Tompkins to dispense with such a demand merely because the action were being brought in a federal court. Such a requirement is important enough to be considered "substantive." 359 Hence, the provision, "if necessary," i.e., if necessary under the appropriate state law.

Unfortunately, when the states themselves have swallowed the federal rule whole, these words have produced a good deal of confusion. Designed as they were merely to adapt to state substantive law, they have nonetheless been held in New Jersey to change that substantive law by requiring a demand on the shareholders where one was not previously necessary.360 The Delaware Chancery Court made a similar error, which was fortunately corrected by the Delaware Supreme Court.361

It is obvious that in a large, or even medium-sized corporation, the expense and inconvenience involved in making a demand on every shareholder will be so great that the suit will never be brought where such a demand is a necessary condition precedent.

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358 Study Bill § 6.25(c).
The present New York rule is clear, and logical: no demand need be made on the shareholders where they would not have the power to ratify the transaction.\textsuperscript{362} Fraud on the part of the directors is non-ratifiable.\textsuperscript{363} Hence, no demand need be made where such fraud is alleged. There can be no good reason under such circumstances for requiring a shareholder demand, unless allowing the wrongdoers to escape liability because the plaintiff will not have enough money to proceed, is considered a good reason.\textsuperscript{364}

Yet the Delaware Chancery Court, and the Supreme Court of New Jersey decided that such a demand was necessary. Perhaps the New York courts would have been wiser. It is better, however, to omit the provision altogether, as has been done in the final draft.

There would seem no very cogent reason for a demand on the shareholders under any circumstances. The statute would seem to dispense with it completely, and thus\textsuperscript{365} assure that no new hurdle will be erected as an addition to the significant barriers already in the way of the shareholders in their struggle to enforce corporate morality.

Fortunately, too, another obstacle that was almost erected, getting as far as the Study Bill,\textsuperscript{366} has also been removed from the Business Corporation Law as finally passed. The Study Bill, perhaps attempting an uneasy compromise between present New York law and the provisions of the California statute, which only requires posting of security, regardless of the size of the plaintiff's shareholdings, where "there is no reasonable probability that the prosecution

\textsuperscript{363} Ibid.
\textsuperscript{364} The reasons advanced by the majority in the leading case to the contrary, Claman v. Robertson, 164 Ohio St. 61, 128 N.E.2d 429 (1955), do not seem persuasive. A distinguishing feature of the case is that under Ohio law, as opposed to the sounder New York rule, a disinterested majority of shareholders may ratify directors' frauds. Even so, this unwise decision was overruled by an amendment to the Ohio statute. Ohio Rev. Code Ann. § 2307.311 (Baldwin 1960).
\textsuperscript{365} See 1961 N.Y. Leغ. Doc. No. 12, at 43 (Rev. Supp.), Comment to § 626, which reads: "Paragraph (c) is new and is based on Federal Rule 23(b) but the necessity of making a demand upon the shareholders as well as the directors has been omitted."
\textsuperscript{366} Study Bill § 626(b).
of the cause of action . . . will benefit the corporation or its security holders," or the moving defendant "did not participate in the transaction complained of . . .," apparently did not make the posting of security mandatory even where the combined shareholdings of the plaintiffs were less than 5% or $50,000 in value.

No shareholder seeking to vindicate corporate rights could object to such a provision. However, this boon to stockholders' suits was coupled with a provision allowing the court to compel plaintiffs who had not been required to post security to pay the reasonable expenses of the defendants where the court found that the action was brought "without reasonable cause."

The entire section was not without ambiguity. However, even a face interpretation of it would allow assessment of the defendant's expenses not only against plaintiffs owning a small amount of stock, who nevertheless, in the discretion of the court had not been required to post the security deposit, but even against plaintiffs owning 5% of the stock, or those whose stock was worth over $50,000. The very purpose of these limitations was to allow those whose shareholdings were significant enough to guarantee that their suits would not be without foundation to bring their action without imposition of the burden designed merely to discourage strike suits. Although courts would probably be rightfully reluctant to hold that suits instituted by persons with such a considerable stake in the corporation, as $50,000 or even 5% of the shares signifies, it cannot be

367 CAL. CORP. CODE § 834.
368 Study Bill § 6.26(a) allowed only a "petition" by the corporation where the 5% or $50,000 requirements were not met. Every New York practitioner knows that a "petition" is no guarantee of a remedy. See textual discussion in this article entitled Deadlock—Breaking Provisions.
369 Study Bill § 6.26(b) provided: "In any such action hereafter instituted, where the plaintiff or plaintiffs have not been required to give security as provided in this section, the court having jurisdiction, upon final judgment and a finding that the action was brought without reasonable cause, may require the plaintiff or plaintiffs to pay the reasonable expenses, including attorney's fees, incurred by the corporation in connection with such action and by the other parties defendant in connection therewith for which the corporation may become liable pursuant to article 7 (Directors, officers and employees) of this chapter."
denied that uncertainty about the outcome might well have deterred a shareholder's suit by those least apt to use such a suit for its "strike" or blackmail value; those with the greatest honest incentive to attempt to redress wrongdoing even in cases of doubtful liability. The severely criticized provision has fortunately been deleted.

On the whole, then, although the second demand of those who desire corporate morality, easy access to the courts to redress corporate wrongs, has not been met by a lowering of the already formidable barriers to a successful shareholder's suit, the new act has at least not raised those hurdles, and has added provisions which will further insure that shareholder suits are used for the purpose for which they were intended, the vindication of corporate rights against disloyal officials for the benefit of the entire body of shareholders, and not solely for the advantage of the shareholder bringing the action.

Another important aspect of any corporation law as it

370 See Brief circulated by Milton Paulson, a New York City attorney.
371 Of course, strike suits must be discouraged, but, as Professor Hornstein has suggested (Hornstein, New Aspects of Stockholders' Derivative Suits, 47 Colum. L. Rev. 1 (1947)) the methods adopted by present New York law are already too severe. A more appropriate solution even than that finally chosen would be to abandon completely the arbitrary percentage and value test of present New York law and substitute a test of reasonable likelihood of success as the standard for determining whether or not the security deposit must be posted. Once that question has been decided in favor of the plaintiff he should be exposed to no liability for the expenses of the defendant directors or officers, merely because they have later proved that what on their face appeared to be legitimate grounds for complaint ultimately turned out to be unfounded. On the other hand, where the preliminary determination of probability of good cause is adverse to the plaintiff, the court can require a deposit which will be ample to adequately indemnify all the defendants, and which will, by the same token, discourage unfounded strike suits, no matter by how large a bloc of shareholders they are brought.

The requirement for posting the security will give advance notice of the likelihood of failure, and the extent of the "penalty" which will have to be paid if the plaintiffs are unable to establish their dubious case. Clearly, this is enough of a deterrent to unfounded suits, and the plaintiff's liability should accordingly be limited to the amount of the required deposit. Since he already has notice of probable liability it is not necessary to condition later use of the fund on a finding of lack of reasonable cause.

372 N.Y. Bus. Corp. Law § 626(d) expressly forbids out-of-court settlements. See also N.Y. Bus. Corp. Law § 626(e) which provides that the court may direct the successful plaintiff to account to the corporation for all but his reasonable expenses where anything has been received by the plaintiff even though as a result of a compromise or settlement.
impinges on public issue corporations and the rights of their shareholders, and one at least peripherally related to the movement for corporate morality, is the subject of indemnification of corporate officers and directors for expenses incurred by them as a result of litigation commenced against them for acts done in their capacities as such corporate officials.

In such situations the shareholders' interest is ambivalent: whatever is paid for the defense of these officials obviously comes "out of their pockets," in the sense that it means less corporate profits available for dividends. On the other hand, a guarantee that the corporation "will stand behind them" when they act in what they consider the corporation's best interests may well help to secure better qualified personnel, and thus, ultimately, mean greater profits available for these shareholders. The appropriate balance between these two seemingly conflicting interests is difficult to draw.

Clearly when he acts for his own benefit, as opposed to that of his corporation, a corporate official should not be reimbursed for either the judgment against him or his expenses in defending the suit. Where, on the other hand, he acts in what he honestly believes to be the best interests of that corporation, the corporation should protect him as far as possible from financial loss whether the action against him be a civil or even a criminal one. The proposed statute represents a significant departure from present law.

Under current law, New York allows a corporation voluntarily to indemnify an officer, director or employee for litigation expenses incurred where he is a defendant in a shareholder's derivative suit, unless he has been "adjudged" liable for negligence or misconduct.373 Thus, where it wants to, a corporation may indemnify such a director or officer, even though guilty, if he wins on some technicality or settles the action against him.

Even where the corporation does not voluntarily agree to indemnify its defendant agent, he is nonetheless entitled

373 N.Y. Gen. Corp. Law § 63.
to reimbursement (statutory indemnification) where he has been found to be "successful in whole or in part," or the action against him has been settled with court approval. Thus, again, guilty directors must be reimbursed unless they are wholly unsuccessful, or have only "won" by buying themselves release through an out-of-court settlement.374

No indemnification is due, however, where the corporation refuses to grant it, and the defendant, instead of being a defendant in a shareholder's derivative suit, is, e. g., accused of a crime as a result of activities in behalf of his corporation.375

Although the voluntary indemnification provisions of the new bill as introduced were not wholly unambiguous,376 it would seem that, even where it desired to do so, a corporation could not reimburse a defendant director or officer in a shareholder's derivative suit where he had, in fact, "breached his duty to the corporation," even though he had been technically successful, e. g., on the defense of the statute of limitations.377

Certainly this change was advisable. It accorded with the real purpose of such indemnification provisions: to stand behind the innocent, but not to protect the guilty.

The law as finally enacted, however, returned to the language of present law, allowing indemnification "except in relation to matters as to which such director or officer is adjudged to have breached his duty to the corporation under section 717. . . ." 378 This reintroduces the possibility of voluntary indemnification even for guilty directors as long as they succeed in avoiding an actual adjudication of breach of duty.

376 For example, they seemed inconsistent with the statutory indemnification provisions of S. Int. 522, Pr. 522, § 7.25(a) (1961). The law as finally passed is identical with this latter provision. N.Y. Bus. Corp. Law § 725(a).
377 S. Int. 522, Pr. 522, § 7.22(a) (1961).
378 N.Y. Bus. Corp. Law § 722(a) (emphasis added). N.Y. Gen. Corp. Law § 64 required indemnification of directors "except in relation to matters as to which it shall be adjudged in such action, suit or proceeding that such officer, director or employee is liable for negligence or misconduct in the performance of his duties."
The one slight improvement in the new over the present law is the requirement that before the expenses of a director or officer in settling a pending derivative action may be paid, a disinterested quorum of directors must resolve to make the payment "upon a finding that such director or officer has not breached his duty to the corporation . . ." 379 or, in the absence of such a disinterested quorum, there must be express shareholder approval of the indemnification,380 or, at least, an "opinion in writing of independent legal counsel that indemnification is proper in the circumstances because the applicable standard of conduct . . . has been met by such director or officer."381

In addition, no expenses may be paid "in disposing of any such pending action without court approval,"382 nor may amounts paid in settling (the "payoff") any such action be reimbursed even though the action is settled with court approval.383

Thus, neither voluntary indemnification (nor, of course, indemnification by the court) may be granted in a derivative action for (1) amounts paid in settling any such pending action, (2) expenses incurred or amounts paid in settling or defending a threatened derivative action, or, (3) expenses incurred or amounts paid in discontinuing, compromising or settling any such pending action without court approval.384

This is some improvement over present law, at least in specificity. It will still allow indemnification, at least for litigation expenses, of some guilty directors.

The new statute also expressly extends voluntary in-

379 N.Y. Bus. Corp. Law §722(a)(1). Quaere: Must the directors be generally disinterested? The statute literally only requires a quorum "consisting of directors who are not parties to such action . . ." N.Y. Bus. Corp. Law §722(a)(1). The same language is used in the sections authorizing reimbursement in non-derivative actions (N.Y. Bus. Corp. Law §723(a)(1)(A)) and advances of expenses in both types of suits (N.Y. Bus. Corp. Law §725(b)(1)).
380 N.Y. Bus. Corp. Law §722(a)(2). Oddly enough, the law would seem to permit such shareholder approval only where a disinterested quorum of directors is not possible.
381 N.Y. Bus. Corp. Law §§ 722(a)(2), 725(e).
382 N.Y. Bus. Corp. Law §725(f)(3).
384 N.Y. Bus. Corp. Law §725(f).
demnification to cover officers and directors where they are made defendants in non-derivative actions, including criminal ones, and the director or officer acted, in good faith, for a purpose which he reasonably believed to be in the best interests of the corporation and, in criminal actions or proceedings, in addition, had no reasonable cause to believe that his conduct was unlawful. . . .

The right to indemnify includes also the payment of the judgment or fine, and may be granted where the defendant has pleaded nolo contendere to a crime, or even has been convicted after trial.®  Even expenses of defending threatened non-derivative civil litigation may be reimbursed.®  And even amounts paid (the “payoff”) in settling pending or even threatened non-derivative civil actions or proceedings may be paid.®  The only condition imposed in either case (other than the general conditions imposed above) is that the reimbursement be individually authorized by a disinterested quorum of directors, or, in the absence of that, by the shareholders or the directors (even though not disinterested), as long as they secure a written opinion by independent counsel that the indemnification has met the above standard of conduct.

A doubt left unresolved in Schwarz v. General Aniline & Film Corp., is also expressly covered.®  An adverse judgment, plea of nolo, or even a criminal conviction will not create any adverse presumption against the defendant seeking reimbursement.

Expenses in any type of action may be advanced but must be repaid by him “in case the director or officer is ultimately found . . . not to be entitled to indemnification. . . .”®  The court may also order such an advance, under

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385 N.Y. Bus. Corp. Law § 723(a).
386 N.Y. Bus. Corp. Law § 723(a)(2).
387 N.Y. Bus. Corp. Law § 723(a)(1).
388 N.Y. Bus. Corp. Law § 723(a)(1).
389 N.Y. Bus. Corp. Law §§ 723(a)(1), (2), 725(e).
390 N.Y. Bus. Corp. Law § 725(d).
391 N.Y. Bus. Corp. Law § 723(a)(3).
392 N.Y. Bus. Corp. Law § 723(d).
a similar obligation to make reimbursement, where the court “shall find that the defendant has by his pleadings or during the course of the litigation raised genuine issues of fact or law.”

Where voluntary indemnification in any type of action is made, other than with court or shareholder approval, notice must be given to voting shareholders of the persons paid, the amounts paid, and the nature and final disposition of the litigation or threatened litigation. This is a wise carryover from the present law. The shareholders should have a right to know how their directors are spending their money, so that if they find the expenditure unjustifiable they may take action at the next shareholders’ meeting, at least by denying management’s usual vote of confidence. However, as with other notices required, no penalty against noncomplying directors is imposed. This, of course, is an unfortunate omission.

So far, there is nothing to criticize in any of the new provisions except their failure to rectify defects in the present law, and their possible over-generosity to defendants in non-derivative actions. In many situations, the service to the corporation may justify payment of the offending director’s or officer’s fines, (although it is difficult to conceive of any person intelligent enough to be selected as an officer or director meeting the requirement that he “had no reasonable cause to believe that his conduct was unlawful”). However, there would seem to be no better reason for a corporation’s reimbursing one of its officials for the amount of his “pay-off” to terminate a non-derivative civil action than there is for it to repay amounts in settlement of derivative ones.

This authorization might, for example, result in the anomaly of reimbursement of a disloyal director for his expenses or even the amount of the recovery against him in an action brought by the corporation itself against him.

393 N.Y. Bus. Corp. Law § 725(c). This provision also applies to derivative actions.
394 N.Y. Bus. Corp. Law § 725(h).
396 For example, the directors might decide to bring an action against a
Even stranger results may follow from the provisions for involuntary indemnification.

In addition to indemnification by voluntary action of the corporation, the defendant director or officer is also entitled to "statutory indemnification" in both derivative and non-derivative actions (civil or criminal), and even though the corporation attempts to deny it to him, "to the extent provided in [the voluntary indemnification] sections and in section 725. . . ." 397 unless (1) he is an official of a foreign corporation the law of the state of incorporation of which forbids such indemnification, (2) a shareholder agreement, certificate or by-law provision, or a shareholder or director resolution, etc., in force at the time of the alleged wrongdoing forbids or limits such indemnification, or, (3) the indemnification would violate the terms of a court-approved settlement.398

The problem arises from the quoted words, not from the exceptions which seem clear and reasonable. While the cross reference to the voluntary indemnification sections probably means that indemnification may be allowed under the circumstances there outlined, without, of course, the requirement of shareholder or director approval, the incorporation of section 725 introduces an unsettling element. As will be recalled, voluntary indemnification in derivative actions may not be granted where the corporate official "is adjudged to have breached his duty to the corporation," 399 and in non-derivative actions where he fails to meet the requirements of good faith, and reasonable belief that his acts were in the best interests of the corporation.400

disloyal director or officer. Since this is a non-derivative action, voluntary indemnification is governed by N.Y. Bus. Corp. Law § 723. There is nothing to prevent a later board or, perhaps, the majority of shareholders from granting reimbursement, therefore, even in an action brought by order of the directors. N.Y. Bus. Corp. Law § 723(a)(1). See, however, note 380 supra. The conditions for approval of voluntary indemnification in non-derivative suits are the same as those found in N.Y. Bus. Corp. Law § 722(a) for derivative actions.

397 N.Y. Bus. Corp. Law § 724(a).
398 N.Y. Bus. Corp. Law § 725(g).
399 N.Y. Bus. Corp. Law § 722(a).
However, section 725(a) provides:

Notwithstanding any contrary provision in [the sections on voluntary indemnification] a director or officer who has been wholly successful, on the merits or otherwise, in the defense of a civil or criminal action or proceeding shall be entitled to indemnification. . . . 401

This is a very different test. The words "or otherwise" seem clearly to require indemnification even where the defendant, although guilty, i.e., where he has "breached his duty to the corporation," or has acted in bad faith and consciously against the interests of his corporation, has somehow been "wholly successful." The provision thus compels the court to allow indemnification where the disloyal official has been successful because the short statute of limitations has run 402 or the plaintiff is unable to meet the security deposit requirements.403

This carry-over of present law 404 is certainly a waste

401 N.Y. BUS. CORP. LAW § 725(a). This section concludes "subject to subparagraph (g)(2)." Subparagraph (g)(2), however, merely forbids indemnification where it appears: "That the indemnification would be inconsistent with a provision of the certificate of incorporation, a by-law, a resolution of shareholders or directors, an agreement or other proper corporate action, in effect at the time of the accrual of the alleged cause of action asserted in the threatened or pending action or proceeding in which the expenses were incurred or other amounts were paid, which prohibits or otherwise limits indemnification. . . ."

402 See Dornan v. Humphrey, 278 App. Div. 1010, 106 N.Y.S.2d 142 (4th Dep't 1951) (memorandum decision) (allowing indemnification under present law where the defendant is successful on the basis of the statute of limitations (N.Y. CIV. FRAC. ACT § 48(5));

403 See Tichner v. Andrews, 193 Misc. 1050, 85 N.Y.S.2d 760 (Sup. Ct.), appeal dismissed, 275 App. Div. 749, 90 N.Y.S.2d 920 (1st Dep't 1949) (allowing indemnification under present law where the defendant is successful because of plaintiff's failure to comply with the securities-for-expenses law).

404 See notes 402 and 403, supra. The language of the section, requiring the indemnitee be "wholly successful on the merits or otherwise," seems to assure this result as much as former N.Y. GEN. CORP. LAW § 67 which required that he be "successful in whole or in part, or that the action against him has been settled with the approval of the court. . . ." However, these unfortunate decisions are not inevitable, since the statute does not directly affect the decision in Diamond v. Diamond, 307 N.Y. 263, 120 N.E.2d 819 (1954), which denied statutory indemnification to a wrongdoing director who had been successful in the derivative action (on the grounds of acquiescence and ratification by the plaintiff, the only other shareholder), even though there had been no formal adjudication of the defendant director's (admitted) guilt. It is to be hoped that the courts will not take the new statute as a rebuff to this small judicial concession to a proper policy interpretation of indemnification laws.
of the shareholders' money since it can hardly be contended that such indemnification is well-calculated to secure personnel whose loyal service will offset the out-of-pocket cost to the shareholders of defending them.

The ambiguity of the statute might even authorize a court to order a corporation to indemnify a guilty director or officer not only for his expenses but also for amounts he paid to the corporation in settlement of a suit against him brought by the corporation itself—a manifest travesty on justice.

It is difficult to believe that any of this could have been intended, and much more likely that the defect is one in draftsmanship rather than philosophy. Whichever is at fault, however, the error should be corrected.

With regard to the effect of the new statute on public issue corporations and shareholder rights, then, as with most other features of the new statute, there are some things to be commended, others to be condemned. The movement for shareholder democracy has not gained a victory, although at least an attempt is made to insure greater shareholder enlightenment, so that whatever voting power they do possess may be utilized more intelligently. The standard of corporate morality has been relaxed, but the means for enforcing it, through the shareholders' suit, have been improved somewhat. The provisions for voluntary indemnification of the defendants in such actions are im-

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405 Such an action would be non-derivative, and hence the limits of N.Y. Bus. Corp. Law §725(f)(2) and (3) would not apply. The provision of N.Y. Bus. Corp. Law §724(a), ordering the court to indemnify "to the extent provided in [§723] and in section 725," taken with the general provision of N.Y. Bus. Corp. Law §725(a) granting a right to indemnification to any successful defendant, and N.Y. Bus. Corp. Law §723(a)(1) authorizing payments of "amounts paid in settling or defending" such actions would seem to authorize, if not require, reimbursement even under such circumstances.

406 See the notification requirements of N.Y. Bus. Corp. Law §626(d) in the case of settlement of shareholders' actions and N.Y. Bus. Corp. Law §725(h) in the case of indemnification payments. See also the notice requirements where distributions or financial adjustments are being made. N.Y. Bus. Corp. Law §§510(a)(1), (2), 511(f), 515(d), 516(c), 517(a)(4), 519(f). But compare the possible adverse effect on shareholder information in N.Y. Bus. Corp. Law §624, discussed in text accompanying note 78 supra.
proved only slightly to prevent waste of the shareholders' money in the defense of disloyal directors. The general limitations on voluntary indemnification in non-derivative actions may not be sufficient to prevent such a waste in those cases, too. The provisions for judicial, or involuntary, indemnification are either designed to carry-over the excessively generous present law, or are merely poorly drafted, a significant fault in either event.

CONCLUSION

What shall we say now of the statute as a whole? Such a question is as obvious as it is impossible to answer. It is rather like asking what one thinks of life, and can only be answered in the same way. Some of it is bad, some not so bad and, even for a perfectionist, some of it at least is good enough to give us complete satisfaction.

Of course, apart from mere consideration of appropriateness of form to accomplish the ends chosen, i.e., whether or not its provisions are ambiguous, one's assessment of any statute is based on his philosophy, that is, whether or not its aims are acceptable to him, or accord with his ideas of what is right. Clearly, therefore, anyone who judges the new statute will have to judge it in terms of his own philosophy of what a corporation law should be like.

I have outlined my philosophy on a number of previous occasions. Although names have little meaning, I should like to characterize it as the "liberal" position, although I am afraid that in corporation law jargon the terms are often the reverse of their political counterparts, and hence the characterization will be disputed. A corporation,
I think, is basically no more than a legally sanctioned vehicle for the betterment of the economy. It is a recognition that the welfare of the people as a whole may best be served by encouraging people to take the risk of developing new products (or making old ones better) without having to risk everything they have on the success or failure of the venture. The interest of the state is, as is always true in a democracy, merely the interest of the people, that is, the common welfare. Obviously, once it has decided that the general welfare is best served by conferring limited liability on some individuals, the state must concern itself with the welfare of those most intimately concerned with each individual corporation: its employees, shareholders, creditors and customers. The primary interest of all, but especially of the first three, is the survival of the enterprise as a going concern. The interest of the customers is adequately provided for by tort and contract law, both case and statutory, to assure them that their dealings with the corporation are fair. The interests of the employees and shareholders conflict only on the question of their relative shares in the profits of the enterprise. This is, today, by and large, a subject for negotiation between the representatives of the two groups, regulated by labor laws. The basic concern of corporation laws today is, therefore, the shareholders and the creditors.

The welfare of these two groups, consonant with the public welfare and the welfare of the corporate employees and customers, seems therefore, to be the only interest of the state in enacting corporation laws. The state has no interest, in the sense of legitimate concern, in the form or operation of the limited liability vehicle as long as the individuals in these two groups are protected, without injury to anyone else.

Complete flexibility, where no harm is done by the corporate structure or operations desired, is therefore a desideratum. The idea of "statutory norms" of corporate organization from which no deviation, or "only a slight infringement" upon, will be permitted is therefore anathema

\[409\] See Long Park, Inc. v. Trenton-New Brunswick Theatres Co., 297 N.Y.
unless it can be shown that someone will be harmed by such experiments. Testing the close corporation provisions of the proposed law by this standard it is clear that they are an improvement over present statutory law, which except for the addition of section 9 of the Stock Corporation Law, as a reaction against narrow judicial construction, has not made clear enough its permissive scope. It is equally obvious that the proposed law does not go far enough since it still places limits on the extent to which the shareholders may mold, by their own agreement, the operational structure of their business.

Shareholders and creditors of large corporations are peculiarly unprotected in this country. Creditors have, ordinarily, no say in the operation of the corporation. Their only protection usually comes from a requirement of sound financial management of the corporation. Since they have no voice in this, the law should step in to protect their interest through prohibition of improvident corporate distributions. Under present New York law, and under the laws of most American states, it has done little to prevent such harmful distributions, until actual insolvency has taken place. This is why the financial provisions of a corporation law are so important. The financial provisions are also a potential means for protection of the shareholders who, unless they are themselves the recipients, have a like interest in preventing such improvident distributions. The new law has done little to help either group. The most significant change is the requirement that notice be given to the shareholders, when they receive such an improvident distribution, that it is from capital or capital surplus. Even granting that they understand the significance of this notice, it is not much protection to the shareholders, and certainly none to the creditors.

However, after the great permissiveness of present law

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in this regard, it is probably too much to hope for adoption of a strict rule restricting distributions, with but a minimum of exceptions, to earned surplus, and requiring creditors' consent to "quasi-reorganizations," as they are called, but which are really diversions of corporate capital into a spurious surplus category.

Partly for the same reasons one cannot have too many sanguine hopes for "corporate democracy." Even if minority representation on the boards of large corporations is desirable (and I have some misgivings about that) cumulative voting alone will not guarantee it. Even for minimal guarantees of effectiveness of that device the provisions requiring it would probably have to enter New York law as a constitutional amendment, rather than through the corporation law.\textsuperscript{411} Even there, there would be little assurance of its success in attaining its end,\textsuperscript{412} and the long-standing contrary rule in this state gives little hope that such a constitutional amendment would be enacted.

Even apart from the overrated panacea of cumulative voting, pleas for greater shareholder participation generally in corporate affairs seem rather impractical. The "town meeting" analogy of corporate government is as inappropriate to the running of a large corporation as it is to a national election. Perhaps, it would be nice to have direct national presidential primaries, perhaps also it would be a good thing to have more shareholder control of public issue corporations. I am not convinced that the results in either sphere would represent any considerable improvement. Even granted that they would, apathy and the practical difficulties involved in taking such a poll, if it is not to degenerate into the same type of thing we now have, would seem to foredoom the

\textsuperscript{411} In Illinois, the constitutional provision guaranteeing cumulative voting was held to invalidate a statute allowing classification of directors, an obvious device for circumventing the effectiveness of cumulative voting. Wolfson v. Avery, 6 Ill. 2d 78, 126 N.E.2d 701 (1955). Despite its constitutional provision, however, Pennsylvania upheld the validity of the "loophole" of director classification. Janney v. Philadelphia Transp. Co., 387 Pa. 282, 128 A.2d 76 (1956). If even a constitutional provision is not a sure guarantee of the efficacy of cumulative voting, the ineffectiveness of a mere statutory provision is obvious.

effort to failure. At any rate, the new statute does carry over the permission to have cumulative voting, should enough of the shareholders feel it desirable to force it upon the corporation, and the number of shares required to do so has been reduced to a bare majority rather than the almost unattainable two-thirds of present law. Furthermore, on the same terms, the shareholders may retain to themselves the power of electing officers. This is some concession to the movement for greater shareholder participation in corporate management.

While the shareholders of large corporations probably do not have a vital need for more shareholder democracy, they do have a legitimate right to demand proper corporate management, and means at their disposal for enforcing this demand. The state should act in this area since to abstain here in favor of permissivism means definite harm to the corporate shareholders. The standard of corporate morality set by the new statute is much lower than that of the old law. The means provided for enforcement of the standard, the shareholder's derivative suit, was already under that old law, a seriously limited policeman of that norm.

As is usual in statutory draftsmanship the matter requires a balancing of conflicting interests. The real interest of the shareholders is as much opposed to "strike" suits as it is to requirements so onerous as to prevent legitimate shareholder suits. Both mean a loss of money to them: the cost to the corporation, and, therefore, to them, in defending unfounded suits, and the loss to the corporation, and also to them, in being unable to recover on justifiable claims. Admittedly, the balance that must be struck is a delicate one: "strike" suits must be prevented, legitimate derivative actions must be encouraged. Under present law too much weight has been given to preventing "strike" suits. The legitimate interest of the shareholders in the legitimate shareholder's suit has not, in my opinion, been properly recognized. Fortunately, however, under the new law the

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413 N.Y. Bus. Corp. Law § 618.
414 N.Y. Bus. Corp. Law § 803(a).
415 N.Y. Stock Corp. Law § 37(1)(c)(2).
416 N.Y. Bus. Corp. Law § 715(b).
situation is made no worse, and the settlement provisions are somewhat of an improvement. Unfortunately, however, the indemnification provisions leave something to be desired, since they appear overly-generous to corporate wrongdoers. It must be remembered, however, in criticizing any statute like this, which represents a recension of basic law in the country's most populous, and second greatest corporation state,\textsuperscript{417} that the act is bound in many respects to involve compromises in an attempt to satisfy the competing demands of those who must live under the statute. And this is entirely proper, since any corporation act, as I have suggested above, should be designed as much as possible to satisfy the needs of those who will utilize it, consistent with the proper protection of the public.

Since corporations are more and more ambulatory, large corporations, at least, have a tendency to incorporate in those states which they feel are most sympathetic to corporate problems. Even if they do not intend to take advantage of their shareholders or the public they may still prefer incorporation in states which are not too concerned with shareholder and creditor rights, since the laws of "strict" states, such as New York is at present, are bound to be more technical and hence more burdensome to comply with, in order to accomplish their end of adequate shareholder and creditor protection, than are the laws of the states which take a more old-fashioned laissez-faire attitude to those interests.

Clearly, New York could exclude all foreign corporations if it chose, or require their reincorporation under local law as a condition to doing business.\textsuperscript{418} The loss in business

\textsuperscript{417} 1957 N.Y. LEG. Doc. No. 17, at 18.

\textsuperscript{418} Paul v. Virginia, 75 U.S. (8 Wall.) 168 (1868); Bank of Augusta v. Earle, 38 U.S. (13 Pet.) 519 (1839). Subjecting foreign corporations to the same standards as local corporations to some extent accomplishes the same results. The new statute attempts to do this in a number of areas. See N.Y. Bus. Corp. LAW §§ 1318-20.

However, in an attempt to avoid discouraging foreign corporations from doing business in New York, the bill as enacted has made a significant change in its coverage of foreign corporations with regard to directorial liability, and failure of a corporation to give the notices, discussed under the Financial Provisions portion of this article. Under the statute as enacted only "domiciled foreign corporations" are subject to these requirements. N.Y. Bus. Corp. LAW §§ 1318, 1319; cf. S. Int. 522, Pr. 522, §§ 13.17, 13.18 (1961). The object of this distinction is basically the same as that of the new
to the state which might follow such a course, however, would be a clear injury to the public interest which it is the duty of the legislature to protect. The only practical alternative is a certain amount of competition for the incorporation business. Again the balancing of interests is a difficult one: the statute must be "liberal" enough not to drive away big corporate business, while at the same time "strict" enough to give protection to the shareholders and creditors.

One thing I can say without hesitation is that the Joint Legislative Committee has earnestly attempted to balance all of these conflicting interests, reflected in divergent proposals, in a way which will adequately protect the public interest in aiding business, and at the same time afford sufficient protection for the special needs of shareholders, creditors, and organizers of close corporations.

But compromise rarely satisfies everybody, and, no matter how sincere the effort to do the best, opinions will always differ as to whether or not it has been accomplished.

Is the new law better than the old? Yes, if for no other reason than that it is simpler in many respects not affecting substantial rights, as indicated in my bird's eye view. Is it as good as it should be? That I leave to your philosophy of what a good corporation law should be like.

federal diversity statute's provision which makes foreign corporations citizens of the state in which they have their "principal place of business": to accord spurious foreign corporations the same treatment as domestic ones. N.Y. Bus. Corp. Law § 1317 provides:

"(a) As used in this chapter an authorized foreign corporation or a foreign corporation doing business in this state is a 'domiciled foreign corporation' if:

(1) At least two-thirds of all its outstanding shares, with or without voting rights, are owned, either beneficially or of record, by residents of this state, or

(2) At least two-thirds of all its outstanding shares with voting rights are owned, either beneficially or of record, by residents of this state, or

(3) At least two-thirds of its business income or its investment income is allocable to this state for franchise tax purposes under the tax law."

The New York provision is less likely to give the interpretive difficulties present under the new federal statute. See Federal Diversity Jurisdiction—"Principal Place of Business" 23 Corp. J. 83 (1961). This is fortunate, at least, although the provision means that not all foreign corporations doing business in New York will be held to the New York standard of conduct. See, as to the federal statute, Kessler, Corporations and the New Federal Diversity Statute: A Denial of Justice, 1960 Wash. U.L.Q. 239, 243, 272.