

Arbitration and Unanimity Agreements in the Close Corporation

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From the preceding discussion, it can be seen that this is not always so. Nevertheless, in a field so charged with political and economic implications, there is little hope that these Recommendations will soon become law. It is submitted, however, that they should.



ARBITRATION AND UNANIMITY AGREEMENTS IN THE CLOSE CORPORATION

The statutorily expressed public policy of New York favors majority rule in corporations and the unhindered discretion of directors.¹ Varied and repeated attempts have been made to circumvent this policy through the use of stockholder agreements. In *Manson v. Curtis*,² for example, the plaintiff permitted the defendant to become the majority shareholder on condition that the plaintiff continue to manage the corporation, with the directors as mere figure-heads. This agreement was held invalid as violative of public policy inasmuch as it created a sterile board of directors. However, the unanimity agreement,³ a more moderate deviation from the statutory norm, ultimately received legislative sanction.⁴ Some of the difficulties

¹ "The business of a corporation shall be managed by its board of directors. . . . [A] majority of the board . . . shall be necessary to constitute a quorum . . . and the act of a majority . . . shall be the act of the board." N.Y. GEN. CORP. LAW § 27. See *Benintendi v. Kenton Hotel, Inc.*, 294 N.Y. 112, 117, 60 N.E.2d 829, 830 (1945).

² 223 N.Y. 313, 119 N.E. 559 (1918). Later cases relaxed the rigid attitude of the court in the *Manson* decision. In *McQuade v. Stoneham*, 263 N.Y. 323, 189 N.E. 234 (1934), the plaintiff, a dismissed director, sought specific performance of an agreement whereby the defendants were obligated to use their best efforts to continue him as director and officer of the corporation. The court held the agreement to be invalid because it destroyed the discretion of the directors. Indicative of a liberal trend, however, was the concurring opinion of Judge Lehman, maintaining that agreements to vote for one another were valid even then. Two years later, in *Clark v. Dodge*, 269 N.Y. 410, 199 N.E. 641 (1936), an agreement to vote for the plaintiff as director and general manager was upheld since there was no rigid public policy involved. In *Matter of Buckley*, 183 Misc. 189, 50 N.Y.S.2d 54 (Sup. Ct. 1944), a by-law that prohibited removal of the chairman of the board or president without cause was upheld for the same reason. The court so held despite the fact that the corporation was large and all the stockholders had never assented. See 45 COLUM. L. REV. 960, 963 n.15 (1945). Prior to this case it was thought that unanimity was essential for any deviation from the statutory norm.

³ By a requirement of unanimous concurrence for all actions of the corporation, minority stockholders retain a veto power over the acts of the majority. See *Benintendi v. Kenton Hotel, Inc.*, *supra* note 1; 1948 LEG. DOC. NO. 65(K), REPORT, N.Y. LAW REVISION COMMISSION 5 (1948).

⁴ N.Y. STOCK CORP. LAW § 9. See also 1948 LEG. DOC. NO. 65(K), *op. cit. supra* note 3, at 5-9.

raised by such agreements will be treated in this Note, with particular emphasis on the problems presented by the interplay of unanimity and arbitration agreements.

Historical Background

The unanimity agreement was first passed upon in *Ripin v. United States Woven Label Co.*⁵ In that case the court upheld a requirement in the certificate of incorporation that the shareholders must unanimously consent to any change in the number of directors. This arrangement was sanctioned though it constituted a slight infringement on the statute which provided that the number of directors could be increased or reduced "when the stockholders owning a majority of the stock of the corporation shall so determine."⁶ Nine years later, however, a unanimity agreement was voided in *Matter of Boulevard Theatre and Realty Co.*⁷ It was there held that a clause in the certificate of incorporation requiring unanimous consent of the stockholders to elect directors contravened Section 25 of the New York Stock Corporation Law, which provides for directors to be chosen by a plurality of the votes. In *Benintendi v. Kenton Hotel, Inc.*,⁸ the by-laws of the defendant corporation required unanimous consent for: (1) all shareholders' resolutions; (2) all elections of directors; (3) all directors' resolutions; and (4) all amendments of the by-laws by the shareholders. A divided Court of Appeals struck down the first three by-laws as violative of majority rule which was felt to be "an essential part of the State policy."⁹ In addition, it was stated that unanimity agreements were unworkable because they tend to create deadlocks.

As a result of the *Benintendi* decision and its predecessors, Section 9 of the Stock Corporation Law was passed.¹⁰ This statute represents an ingenious effort to grant statutory sanction to the "incorporated partnership," without arbitrarily defining it in terms of capitalization or number of stockholders.¹¹ As amended, Section 9

⁵ 205 N.Y. 442, 98 N.E. 855 (1912).

⁶ At the time of the *Ripin* decision, Section 21 of the Stock Corporation Law provided as follows: "The number of directors of any stock corporation may be increased or reduced, but not above the maximum nor below the minimum number prescribed by law, when the stockholders owning a majority of the stock of the corporation shall so determine, at a meeting. . . ." *Ripin v. United States Woven Label Co.*, 205 N.Y. 442, 445, 98 N.E. 855, 856 (1912).

⁷ 195 App. Div. 518, 186 N.Y. Supp. 430 (1st Dep't), *aff'd mem.*, 231 N.Y. 615, 132 N.E. 910 (1921).

⁸ 294 N.Y. 112, 60 N.E.2d 829 (1945).

⁹ *Id.* at 117, 60 N.E.2d at 830 (emphasis added). *Accord*, *Kaplan v. Block*, 183 Va. 327, 31 S.E.2d 893 (1944). *But see* *Kantzler v. Benzinger*, 214 Ill. 589, 73 N.E. 874 (1905).

¹⁰ 1948 LEG. DOC. NO. 65(K), REPORT, N.Y. LAW REVISION COMMISSION 15 (1948); Recent Statute, 62 HARV. L. REV. 526, 527 (1949).

¹¹ 1948 LEG. DOC. NO. 65(K), *op. cit. supra* note 10, at 6. See Israëls, *The Close Corporation and the Law*, 33 CORNELL L.Q. 488, 491 (1948).

authorizes the insertion in a corporate charter of provisions requiring more than a majority or plurality for a quorum, vote, or consent of directors or shareholders. To limit its application to close corporations, however, the statute requires so great a majority for the adoption of these provisions that it is practically impossible for any but a close corporation to utilize them. Thus the protection of majority rule in large corporations is retained, while the "incorporated partnership" is sanctioned. Since unanimity agreements have received this statutory approval, there seems to have been an increase in the number of disputes and deadlocks¹² warned against in the *Benintendi* case. Arbitration clauses have furnished a partial answer to the problem, but since arbitration has only recently come into its own, its full effect is unknown.

Development of Arbitration

At common law it was held that executory arbitration agreements could be revoked.¹³ Lord Coke declared this to be the rule in *Vynior's Case*,¹⁴ in an effort to guard against encroachments on the jurisdiction of the courts. Only after an award had been made would equity specifically enforce such agreements.¹⁵ Furthermore, a party to an agreement to arbitrate future disputes could resort to the courts despite the agreement, and that breach of contract could not be raised as a defense.¹⁶ New York, in 1920, became the first state to pass an arbitration statute broad enough to encompass "future disputes."¹⁷ This legislation authorizes direct enforcement of arbitration agreements by a court order compelling arbitration, and indirect enforcement by staying any action commenced in violation of an arbitration clause. Although this statute removes the most formidable obstacle to the enforcement of arbitration agreements, strict statutory construction of the new act, at first, frustrated the legislature's intent to liberalize arbitration.¹⁸

¹² See 1951 LEG. DOC. NO. 65(H), REPORT, N.Y. LAW REVISION COMMISSION 12, 41-42 (1951); O'Neal, *Resolving Disputes In Closely Held Corporations: Intra-Institutional Arbitration*, 67 HARV. L. REV. 786, 787, 793 n.21 (1954).

¹³ See O'Neal, *supra* note 12, at 794; Note, 24 ST. JOHN'S L. REV. 254, 255 (1950). For a comprehensive coverage of the law of arbitration, see PRASHKER, *NEW YORK PRACTICE* §§ 538A-538I (3d ed. 1954).

¹⁴ ". . . [I]f I submit myself to an arbitrament . . . yet I may revoke it, for my act or my words cannot alter the judgement of the law to make that irrevocable, which is of its own nature revocable." *Vynior's Case*, 8 Co. 81b-82a, 77 Eng. Rep. 597, 599-600 (K.B. 1609).

¹⁵ See note 13 *supra*. See also Simpson, *Specific Enforcement Of Arbitration Contracts*, 83 U. PA. L. REV. 160 (1934).

¹⁶ See note 13 *supra*.

¹⁷ N.Y. CIV. PRAC. ACT §§ 1448-69. See Hornstein, *Arbitration Provisions in Stockholders' Agreements*, 10 ARB. J. (n.s.) 67, 68 (1955).

¹⁸ See *Matter of Stern*, 285 N.Y. 239, 33 N.E.2d 689 (1941); *Matter of Fletcher*, 237 N.Y. 440, 143 N.E. 248 (1924); *Matter of Benedict*, 265 App. Div. 518, 39 N.Y.S.2d 852 (1st Dep't 1943) (per curiam); Hornstein.

Arbitration clauses concerning corporate activities have had a particularly turbulent history. In *Matter of Allied Fruit & Extract Co.*,¹⁹ decided in 1934, the directors of a close corporation removed one of their number for cause but did not first submit the question to the agreed arbitration. The court ruled that the arbitration agreement was invalid because it encroached upon the discretion of the corporation's directors. In more recent years a favorable attitude was adopted, but hostility was still reflected in some of the cases. In *Matter of Hess*,²⁰ where the board of directors was evenly divided, the corporation was ordered dissolved even though the stockholders had agreed to arbitrate differences. As late as 1948, the Appellate Division affirmed a lower court holding that a shareholder could maintain a derivative suit against a shareholder-director for an accounting, despite the existence of a stockholders' agreement for the arbitration of disputes.²¹ It was stated that even if the issues had been arbitrable, the agreement would have been against public policy and thus unenforceable.

The first decision favoring the arbitration of corporate disagreements was *Matter of DeCaro*.²² There the Second Department of the Appellate Division affirmed an arbitration award that "related to the management of the business of a corporation," as the only feasible solution to a dispute that threatened to ruin the business. The following year the same court enforced a pre-incorporation shareholders' agreement to arbitrate controversies concerning management.²³ Although both of these cases judicially approved arbitration agreements, neither went as far as *Martocci v. Martocci*.²⁴ In that case, three brothers agreed to perpetuate one another as directors and officers of a close corporation on the condition of good and faithful performance. All disputes were to be arbitrated by the American Arbitration Association. The court held that the removed director was entitled to arbitration. It was reasoned that retention in office was based upon bona fide performance, thus discretion was left in the board of di-

Stockholders' Agreements In The Closely Held Corporation, 59 YALE L.J. 1040, 1051-52 (1950).

¹⁹ 243 App. Div. 52, 276 N.Y. Supp. 153 (1st Dep't 1934), *motion for leave to appeal denied*, 266 N. Y. l.v. (1935).

²⁰ 108 N.Y.L.J. 555, col. 5 (Sup. Ct. Sept. 11, 1942).

²¹ Application of Diamond, 80 N.Y.S.2d 465 (Sup. Ct.), *aff'd*, 274 App. Div. 762, 79 N.Y.S.2d 924 (1st Dep't 1948). The lower court held: (1) the issues involved in the derivative suit were not referable to arbitration under the agreement; (2) the agreement covered the relationships of the stockholders *inter se* and not as officers and directors; and (3) the corporation was not a party to the agreement.

²² 261 App. Div. 975, 25 N.Y.S.2d 849 (2d Dep't 1941) (mem. opinion).

²³ *Matter of Carl*, 263 App. Div. 887, 32 N.Y.S.2d 410 (2d Dep't 1942) (mem. opinion).

²⁴ 42 N.Y.S.2d 222 (Sup. Ct.), *aff'd*, 266 App. Div. 840, 43 N.Y.S.2d 516 (1st Dep't 1943). See also *In re Keilsohn Offset Co.*, 120 N.Y.L.J. 1348, col. 5 (Sup. Ct. Dec. 1, 1948).

rectors. This decision is generally accepted as having overruled the *Allied Fruit* case. In *Matter of Landersman*,²⁵ the court indicated that *Allied Fruit* must "be read in the light of the affirmance in this court . . . [of] *Martocci v. Martocci*. . . ." ²⁶ Therefore, it was held that the discharge of a director for impropriety should be arbitrated according to a pre-incorporation agreement.²⁷ Although the New York Court of Appeals did not render any of these decisions, an indication of its attitude is found in *Matter of Myers*.²⁸ There the validity of an arbitration agreement was presumed and properly brought dissolution proceedings were stayed.

Outside New York there are only a handful of cases involving arbitration in close corporations. Though these cases generally indicate that an unfavorable attitude exists,²⁹ *Ringling v. Ringling Bros.—Barnum & Bailey Combined Shows, Inc.*,³⁰ still stands as a landmark case embodying the liberal view. There, two sisters agreed to cast their votes for the same candidates for directors, subject to arbitration if they failed to agree. When a disagreement arose, the loser voted against the candidate designated by the arbitrator. The Delaware court enforced the agreement by setting aside those votes.

Unanimity Agreements vs. Arbitration Agreements

Two cases recently decided in New York serve to illustrate the problems which may arise when both arbitration and unanimity agreements are present. *Application of Katz*³¹ and *Matter of Burkin*³² involved development corporations in which Burkin and his son were the majority, and Katz the minority, stockholders. The certificates of incorporation provided that all directors must be present for a quorum and that unanimous consent was necessary before the stockholders or directors could undertake any action. In addition, they required that all directors and officers be elected unanimously and that no officer or director could be removed except after receipt of his resignation. As a precaution against deadlock, the certificates of incorporation contained a stipulation to arbitrate "any arbitrable con-

²⁵ 280 App. Div. 963, 116 N.Y.S.2d 495 (1st Dep't 1952) (mem. opinion).

²⁶ *Ibid.*

²⁷ For the facts in the *Landersman* case, see *Matter of Burkin*, 286 App. Div. 740, 744-45, 147 N.Y.S.2d 2, 6-7 (1st Dep't 1955); O'Neal, *Resolving Disputes In Closely Held Corporations: Intra-Institutional Arbitration*, 67 HARV. L. REV. 786, 802 (1954).

²⁸ 304 N.Y. 656, 107 N.E.2d 512 (1952) (mem. opinion).

²⁹ See, e.g., *Roberts v. Whitson*, 188 S.W.2d 875 (Tex. Civ. App. 1945). In the *Whitson* case, an arbitration clause pertaining to an arrangement similar to a voting trust agreement was held invalid.

³⁰ 29 Del. Ch. 318, 49 A.2d 603 (Ch. 1946), *modified*, 29 Del. Ch. 610, 53 A.2d 441 (Sup. Ct. 1947).

³¹ 143 N.Y.S.2d 282 (Sup. Ct.), *aff'd mem.*, 1 App. Div. 2d 657, 147 N.Y.S.2d 10 (1st Dep't 1955).

³² 286 App. Div. 740, 147 N.Y.S.2d 2 (1st Dep't 1955).

troversty that may arise among the sole stockholders by reason of the terms of the agreements or by reason of any other cause." ³³ Disputes concerning the operation of the corporations resulted in Katz being ousted as a director, despite the stockholders' agreements. In *Application of Katz*, the court reinstated him holding that his removal was illegal because of the unanimity agreement. When Katz then sought to arbitrate the question of whether Burkin and his son should be removed as directors, they moved for a stay of arbitration. In *Matter of Burkin*, the Appellate Division affirmed the decision of the Special Term that the issue was arbitrable.

In the *Burkin* case, Katz, as the minority stockholder, was unable to vote the removal of the Burkins. Even if he had controlled a majority, he would have been defeated by the unanimity clause, as were the Burkins.³⁴ Since a declaratory judgment action is not maintainable³⁵ and action by the Attorney General is, as a practical matter, unavailable,³⁶ the arbitration clause provided the sole remedy outside of dissolution. Though *Martocci v. Martocci* and *Matter of Landersman* held the removal of a director to be an arbitrable controversy, the decision in the *Burkin* case was by no means a foregone conclusion. The Court of Appeals only a short time before had narrowly construed this arbitration clause and held it inapplicable to the question of whether the assets of the corporation should be sold.³⁷ In addition, the law as to whether the subject of a stockholders' derivative action is an arbitrable controversy is unsettled.³⁸ The court, following the *Martocci* case, seemed to regard the fact that a close corporation was involved as controlling³⁹ and continued the trend of liberal construction of arbitration clauses.⁴⁰

³³ *Id.* at 741, 147 N.Y.S.2d at 4.

³⁴ See *Application of Katz*, *supra* note 31; *Matter of Burkin*, 286 App. Div. 740, 745, 147 N.Y.S.2d 2, 7 (1st Dep't 1955) (dictum).

³⁵ *Jos. H. Carter, Inc. v. Carter*, 205 Misc. 192, 127 N.Y.S.2d 518 (Sup. Ct. 1953), *aff'd mem.*, 283 App. Div. 858, 129 N.Y.S.2d 898 (1st Dep't 1954). See *Matter of Burkin*, *supra* note 34 at 745, 147 N.Y.S.2d at 7.

³⁶ N.Y. GEN. CORP. LAW §§ 60, 61. Under these sections, no one but the Attorney General is authorized to bring a court action for removal. See *Matter of Burkin*, *supra* note 34 at 745, 147 N.Y.S.2d at 7.

³⁷ *Matter of Katz*, 308 N.Y. 789, 125 N.E.2d 433 (1955), *affirming*, 283 App. Div. 1092, 131 N.Y.S.2d 627 (2d Dep't 1954).

³⁸ See *Application of Diamond*, 80 N.Y.S.2d 465 (Sup. Ct.), *aff'd*, 274 App. Div. 762, 79 N.Y.S.2d 924 (1st Dep't 1948); *Pfeiffer v. Berke*, 121 N.Y.S.2d 774 (Sup. Ct. 1953). *But see* *Matter of Carl*, 263 App. Div. 887, 32 N.Y.S.2d 410 (2d Dep't 1942) (mem. opinion); *Lumsden v. Lumsden Bros. & Taylor, Inc.*, 242 App. Div. 852, 275 N.Y. Supp. 221, 222 (2d Dep't 1934) (mem. opinion). See also O'Neal, *Resolving Disputes In Closely Held Corporations: Intra-Institutional Arbitration*, 67 HARV. L. REV. 786, 809 (1954).

³⁹ See *Matter of Burkin*, 286 App. Div. 740, 744, 147 N.Y.S.2d 2, 6 (1st Dep't 1955).

⁴⁰ As manifestations of this trend, see *Application of Gail Kiddie Clothes, Inc.*, 56 N.Y.S.2d 117 (Sup. Ct. 1945); *cf.* *Matter of Abbey*, 274 App. Div. 389, 83 N.Y.S.2d 503 (1st Dep't 1948) (dissenting opinion), *aff'd mem.*, 299 N.Y.

The decision by no means completely resolves the dilemma fostered by a close corporation having both arbitration and unanimity clauses. Presuming that the arbitrator finds that cause exists for the removal of the Burkins and they are removed, the fact remains that they are still majority shareholders in the corporation. As such they might attempt to re-elect themselves directors, or at least insist upon the election of their own candidates. With the aid of the unanimity clause, they could throw the corporation into a deadlock if Katz did not accede to their demands. They could also harass Katz with actions for misconduct⁴¹ and stockholders' derivative actions,⁴² or, presuming such charges arbitrable, with interminable arbitrations. It would seem that one way to avoid these difficulties would be for the parties to agree in advance that a director removed by arbitration must sell his holdings to the other parties or to the corporation. Professor O'Neal suggests the use of such a prior contract as a means of preventing dissolution in corporations that have no arbitration clause;⁴³ it would seem to be equally applicable here.

Conclusion

The holding that the question of removal is arbitrable in a close corporation is a logical extension of the concept of arbitrable controversies, even in the face of the difficulties pointed out. Though the innocent party might eventually have to resort to dissolution⁴⁴ as the only escape from an impossible situation, arbitration at least defers the day of reckoning and allows time for a solution to be adopted. In the case of a prosperous corporation, where dissolution will inflict a great loss on all parties, such a cooling off period may be invaluable.

557, 85 N.E.2d 789 (1949); *Park Construction Co. v. Independent School Dist. No. 32*, 209 Minn. 182, 296 N.W. 475, 477 (1941).

The *Burkin* case is presently on appeal to the Court of Appeals. 135 N.Y.L.J. 6, col. 1 (N.Y. Ct. App. March 26, 1956). "Motion to have the appeal heard upon the record in proceeding No. 2 in this case together with available copies of the records before the Appellate Division in proceeding No. 1 and in *Matter of Katz v. Fulton-Washington Corporation* granted. Cross-motion to dismiss appeal denied without prejudice to a renewal thereof upon the argument of the appeal." *Ibid.*

⁴¹ N.Y. GEN. CORP. LAW §§ 60, 61.

⁴² See PRASHKER, *CORPORATIONS* 787-88 (2d ed. 1949). A member of a close corporation would almost never be required to post security for expenses under N.Y. GEN. CORP. LAW § 61-b. This section provides that a shareholder whose stock is worth more than \$50,000, or amounts to 5% or more of the total number of shares, does not have to post security.

⁴³ See O'Neal, *Resolving Disputes In Closely Held Corporations: Intra-Institutional Arbitration*, 67 HARV. L. REV. 786, 809 (1954).

⁴⁴ N.Y. GEN. CORP. LAW § 103. If a board of directors is so divided that it cannot take action or the stockholders are so divided that they cannot elect directors, a prescribed percentage of stockholders can petition for dissolution by virtue of this statute. See also N.Y. GEN. CORP. LAW § 101 pertaining to petition by the directors.

The *Burkin* and *Katz* cases suggest a problem which would be even more difficult to solve. A situation could arise where a director's conduct warranted his removal from the board of a close corporation that had a unanimity, but no arbitration, agreement. Although it has been held that good faith and competent performance are always implied terms, despite any provision in the agreements,⁴⁵ a unanimity clause prevents removal even where there has been a breach of these implied terms. In *Jos. H. Carter, Inc. v. Carter*,⁴⁶ where a unanimity agreement was present, a declaratory judgment that removal was warranted was denied. *Matter of Katz*, of course, was almost precisely on point in holding that even a majority does not have the right to remove in the face of a unanimity clause, whether cause exists or not. Stockholders' and directors' actions under Sections 60 and 61 of the General Corporation Law and stockholders' derivative actions are unsatisfactory because they only permit the recovery of damages.⁴⁷ A court action for removal is also of limited value because it can only be brought by the Attorney General.⁴⁸ Under present circumstances then, an action for dissolution is the only permanent remedy available. Even dissolution leaves much to be desired since it could work to the advantage of the wrongdoer.⁴⁹ Where the corporation is prosperous and the innocent party cannot afford to purchase its assets, dissolution may be more impractical than the other remedies.

It is clear that legislation which will authorize removal in such a situation is necessary. One improvement would be statutory authorization for a stockholder to bring a court action for removal if the Attorney General does not do so within a reasonable time after he has been petitioned to act. Though a director removed in this manner could still harass the corporation as easily as one who is arbitrated out of office, the mere existence of such a remedy might restrain wrongdoing.

⁴⁵ See *Fells v. Katz*, 256 N.Y. 67, 175 N.E. 516 (1931); *cf.* *Abberger v. Kulp*, 156 Misc. 210, 212, 281 N.Y. Supp. 373, 376 (Sup. Ct. 1935).

⁴⁶ 205 Misc. 192, 127 N.Y.S.2d 518 (Sup. Ct. 1953), *aff'd*, 283 App. Div. 858, 129 N.Y.S.2d 898 (1st Dep't 1954).

⁴⁷ Both these remedies can be used to recover damages for the misconduct of a director, but are not available for removal.

⁴⁸ N.Y. GEN. CORP. LAW §§ 60, 61, *Purdy v. Humphrey*, 192 Misc. 309, 82 N.Y.S.2d 92 (Sup. Ct. 1947), *aff'd*, 274 App. Div. 841, 82 N.Y.S.2d 388 (4th Dep't 1948).

⁴⁹ See *Matter of Burkin*, 286 App. Div. 740, 746-47, 147 N.Y.S.2d 2, 8-9 (1st Dep't 1955); *Matter of Zyberty*, 276 App. Div. 1070, 96 N.Y.S.2d 374 (1st Dep't) (per curiam), *aff'd mem.*, 301 N.Y. 632, 93 N.E.2d 917 (1950).