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Article 11

Corporations--Removal of Directors as Inherent Right of Stockholders (Matter of Auer v. Dressel, 306 N.Y. 427 (1954))

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In this case the extension was unquestionably justified. The basis for this decision may be best determined by the language used by the Court, when it states "[s]o unconscionable a result, so unfortunate a preference of one wrongdoer over another, should not be countenanced if there be any escape therefrom." [24] The Court, with this in mind, seized upon the word "adjudged," and, by strict construction, held that the defendant was sufficiently adjudged a wrongdoer.

The instant case points out the inadequacy of the existing statute. There is no question that the defendant-director should not have been entitled to litigation expenses, but it was only through a strained interpretation that the court could arrive at a just result. While the decision might be regarded by some as a wedge in the door of the "mandatory" rule, the statute will continue to work an injustice in a great many cases. It seems most unjust that an erring director should be entitled to expenses from the corporation which he has harmed, merely because a stockholder fails to meet the requirements of Section 61-b of the General Corporation Law, or because the statute of limitations has run.

Legislation should be enacted providing that the court be empowered to inquire into the facts, and where it is clear that such directors have been guilty of misconduct, that they be precluded from recovering counsel fees. The California statute [25] might well serve as a model for such legislation. Care should be taken, however, not to make the rule so stringent that the evils existing under the "benefit" rule would once more return.[26]

CORPORATIONS — REMOVAL OF DIRECTORS AS INHERENT RIGHT OF STOCKHOLDERS.—A proceeding under Article 78 of the New York Civil Practice Act was brought for an order in the nature of mandamus [1] to compel the defendant, president of a corporation, to call a stockholders' meeting. Among other reasons, petitioners sought the meeting to enable the shareholders to vote upon a proposal to hear charges against some of the directors and, if cause were shown,

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[24] *Id.* at 266, 120 N.E.2d at 820.

[25] CAL. CORP. CODE § 830 (Deering, 1953). This Section provides that in addition to being successful in whole or in part, the court must find that his conduct fairly and equitably merits such indemnity.

[26] See notes 9 and 10 *supra*.

[1] New York, in 1937, abolished the proceeding of mandamus. See PRASHKER, NEW YORK PRACTICE 825 (3d ed. 1954). Today, an action which would have been brought by this proceeding is governed by Article 78 of the New York Civil Practice Act.

to remove them. In affirming the lower court which granted the order, the Court of Appeals *held, inter alia,* that a provision in the certificate of incorporation, authorizing the directors to remove one of their number, did not destroy the shareholders' inherent right to remove erring directors, and that therefore this purpose was a valid ground for demanding a meeting. *Matter of Auer v. Dressel,* 306 N.Y. 427, 118 N.E.2d 590 (1954).

It is axiomatic that a corporation's activities are governed by the constitution and laws of the state which authorizes its existence, by the certificate of incorporation which is granted by such state,[2] and by its own by-laws.[3] In New York, the power to commence an action to remove a director for cause is given by statute to the attorney general.[4] This does not restrict a corporation from exercising the power in a manner which to it may seem fit.[5] In the utilization of this power, however, corporations in New York have been restricted by the courts.

It has been stated that the board of directors may not remove a fellow director either with or without cause unless the power is specifically given by the certificate of incorporation or the corporate by-laws.[6] The shareholders, however, because of their right to elect directors, may always remove a director where cause exists;[7] but

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[2] See PRASHKER, CASES AND MATERIALS ON THE LAW OF CORPORATIONS 249 (2d ed. 1949).

[3] See Note, *Limitations of Corporate By-Laws,* 19 ST. JOHN'S L. REV. 144 (1945).

[4] "An action may be brought against one or more of the directors or officers of a corporation to procure judgment for the following relief or any part thereof:

". . .

"4. To remove a defendant from office and to direct the filling of the vacancy in accordance with the charter and by-laws of the corporation, or, if they contain no provision therefor, in such manner as the court shall direct." N.Y. GEN. CORP. LAW § 60. "An action may be brought for the relief prescribed in section sixty of this chapter, by the attorney-general in behalf of the people of the state. . . ." N.Y. GEN. CORP. LAW § 61. *Cf.* People v. Ballard, 134 N.Y. 269, 32 N.E. 54 (1892).

[5] Section 136 of the General Corporation Law, which states that "[a] director or officer of a corporation shall not be suspended or removed from office by a court or judge, otherwise than by final judgment in an action brought by the attorney-general, as prescribed in section sixty of this chapter," is not to the contrary. See Matter of Auer v. Dressel, 306 N.Y. 427, 118 N.E.2d 590 (1954); People *ex rel.* Manice v. Powell, 201 N.Y. 194, 202, 94 N.E. 634, 637 (1911).

[6] See Matter of Korff, 198 App. Div. 553, 190 N.Y. Supp. 664 (1st Dep't 1921) (without cause); Raub v. Gerken, 127 App. Div. 42, 111 N.Y. Supp. 319 (2d Dep't 1908) (without cause); BALLANTINE, CORPORATIONS 436 (Rev. ed. 1946); 2 FLETCHER, CYCLOPEDIA CORPORATIONS 162-164 (Rev. vol. 1954). *But cf.* Fells v. Katz, 256 N.Y. 41, 175 N.E. 506 (1931).

[7] See Feldman v. Pennroad Corp., 60 F. Supp. 716 (D. Del. 1945), *aff'd,* 155 F.2d 773 (3d Cir. 1946), *cert. denied,* 329 U.S. 808 (1947); BALLANTINE, CORPORATIONS 434 (Rev. ed. 1946); *cf.* Abberger v. Kulp, 156 Misc. 210, 212, 281 N.Y. Supp. 373, 376 (Sup. Ct. 1935).

they are not permitted to remove a director without cause unless they are empowered to do so by a provision in either the certificate or the by-laws.[8] This lack of power is based upon the fact that directors are not considered to be mere employees of the corporation, but rather, are fiduciaries in the nature of trustees.[9] However, directors who are in office prior to the time any such provision is adopted in the charter or by-laws may not be removed pursuant thereto.[10] The protection of directors against removal without cause has been criticized on the ground that such a restriction deprives the shareholders of managerial control which is an essential attribute of corporate ownership.[11] Nevertheless, New York has adhered to the rule that a director may not be removed without cause—subject to the conditions discussed above.

In the instant case, the certificate of incorporation gave the board of directors power to remove directors for proven cause. The shareholders had not reserved to themselves the power of removal. Thus the question before the Court was whether such delegation of power to the directors had abrogated the shareholders' right to remove. The Court held that the provision in the certificate was not ". . . an abdication by the stockholders of their own traditional, inherent power to remove their own directors." [12] The Court believed that if it held otherwise, wrongdoing directors who controlled the board would not be inclined to divest themselves of office, and that therefore the shareholders would be without a remedy. In a vigorous dissent, Judge Van Voorhis pointed out that where both the shareholders and the directorate have the capacity to remove wrongdoing directors, different results might obtain from their separate investigations.[13] In dismissing the majority's fear of the results of an opposite conclusion, he indicated that the attorney general could always be called upon to prosecute an action for removal.[14]

It would seem that the holding of the instant case is opposed to the axiom that the state's statutes and the corporation's charter and by-laws are the only sources from which the shareholders derive their rights. But the Court is merely sustaining an inherent right associated with ownership, and one which is essential to that status. Ownership, then, carries with it certain rights which need not be expressed in the charter or by-laws. As the owners of a corporation, shareholders are justified in asserting the right to remove miscreant

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[8] See BALLANTINE, CORPORATIONS 434 (Rev. ed. 1946) (cases cited therein).

[9] See People *ex rel.* Manice v. Powell, *supra* note 5 at 200-201, 94 N.E. at 637; PRASHKER, CASES AND MATERIALS ON THE LAW OF CORPORATIONS 642-643 (2d ed. 1949).

[10] Matter of Automotive Manufacturers Ass'n, Inc., 120 Misc. 405, 199 N.Y. Supp. 313 (Sup. Ct. 1923); *see* Abberger v. Kulp, *supra* note 7.

[11] See BALLANTINE, CORPORATIONS 434-435 (Rev. ed. 1946).

[12] Matter of Auer v. Dressel, 306 N.Y. 427, 433, 118 N.E.2d 590, 593 (1954).

[13] *Id.* at 438, 118 N.E.2d at 596.

[14] *Id.* at 441, 118 N.E.2d at 598. See note 4 *supra*.

managers. The principle enunciated in this case of first impression permits shareholders to exercise a greater voice in the management of their business affairs.

FEDERAL PRACTICE—SOVEREIGN IMMUNITY—SET-OFF AGAINST FOREIGN GOVERNMENT ALLOWED.—The Shanghai-Nanking Railway Administration, an official agency of the Republic of China, established a $200,000 account with the National City Bank of New York in 1948. Subsequently, the bank refused to permit withdrawal of the funds. The Republic of China thereupon brought suit in the federal district court wherein the bank raised two counterclaims for $1,634,432,[1] which it later denominated as a set-off. Both the district court and court of appeals refused to allow such a set-off, stating that it was violative of the doctrine of sovereign immunity since the set-off did not arise out of the same transaction as the sovereign's claim. By a divided court, the Supreme Court reversed, *holding* that the doctrine of sovereign immunity did not preclude the defendant from raising any set-off. The Court reasoned that by initiating the action in this country the foreign sovereign impliedly subjected itself to such set-off or counterclaims. *National City Bank v. Republic of China,* 75 Sup. Ct. 423 (1955).

The origin of the doctrine of sovereign immunity is not clear. The prevailing opinion appears to be that it originated early in English history and reached its maturity with the divine right of kings theory.[2] When the United States Constitution was drafted little was said concerning this immunity principle, and nothing applicable to it was incorporated therein.[3] In 1793 the Supreme Court, in *Chisholm v. Georgia,*[4] held that a state was subject to a suit brought by a citizen of another state. Immediately after this decision, the Constitution was amended so as to preclude such suits.[5] No mention, however,

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[1] Both counterclaims arose out of treasury notes issued by the Chinese government which had become due and payable.

[2] See Pugh, *Historical Approach to the Doctrine of Sovereign Immunity,* 13 LA. L. REV. 476, 477-480 (1953). See also Barry, *The King Can Do No Wrong,* 11 VA. L. REV. 349, 350-355 (1925); Borchard, *Governmental Responsibility In Tort, VI,* 36 YALE L.J. 1, 17-37 (1926).

[3] It has been suggested that a literal interpretation of Article III would justify a suit against the Federal Government. See Pugh, *supra* note 2, at 481. Blackstone recognized the doctrine of sovereign immunity in his writings and this played an important part in the molding of American thought concerning this question. *Id.* at 479, 481.

[4] 2 Dall. 419 (U.S. 1793).

[5] "The Judicial power of the United States shall not be construed to extend to any suit in law or equity, commenced or prosecuted against one of the United