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The Close Corporation Under the New South Carolina Corporation Law

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THE CLOSE CORPORATION UNDER THE NEW SOUTH CAROLINA CORPORATION LAW*

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PART I

In recent years the close corporation has become the prevalent business form in America. As a result of its popularity most general practitioners have come into contact with it, and, indeed, most lawyers are seldom concerned with the public corporation except in relation to tort litigation. The significance of the close corporation to American business life is further evidenced by a growing body of literature.[1]

One writer suggests that the close corporation defies definition.[2] It is characterized by restricted and limited ownership, identity of management and ownership, and a tendency of the participants to consider themselves partners *inter sese.* The South Carolina Code (hereafter referred to as Code) defines the close corporation as a corporation the shares of which "are not traded on any national securities exchange or regularly traded in any over-the-counter market maintained by one or more brokers or dealers in securities."[3]

The choice of the corporate form of business organization may be desirable for a number of reasons. For example, the business may involve serious risks which would be mitigated by corporate limited liability; expansion and financing are usually more readily achieved through the corporate form;[4] tax advantages and control can often be achieved.[5] However, in a small enterprise each participant desires some voice and perhaps a

*This Article is in two parts. Part two will appear in a subsequent issue.

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1. See, *e.g.,* O'NEAL, CLOSE CORPORATIONS: LAW AND PRACTICE (2 vols. 1958); *Symposium—The Close Corporation,* 24 LAW & CONTEMP. PROB. 1 (1959); Scott, *Close Corporation in Contemporary Business,* 13 BUS. LAW. 741 (1958); Hornstein, *Judicial Tolerance of the Incorporated Partnership;* 18 LAW & CONTEMP. PROB. 435 (1953); *Close Corporations: A Symposium,* 52 NW.U.L.REV. 345 (1951); Powers, *Cross Fire on the Close Corporation: Norms Versus Needs,* 11 U.FLA.L.REV. 433 (1958).

2. Israels, *The Close Corporation and the Law,* 33 CORNELL L. Q. 488, 491 (1948).

3. S. C. CODE ANN. §§ 12-16.22(c); 12-22.14(b) (1962). This definition accords with Professor O'Neal's view. See 1 O'NEAL, *op. cit. supra* note 1, at 2-5, 13-16.

4. For an excellent discussion of factors to be considered in the choice of business form see DUKE UNIV., CHOOSING A FORM OF BUSINESS ORGANIZATION (1963).

5. For discussions of the tax considerations involved in the close corporation see *Tax Problems of Close Corporations—A Survey,* 10 W. RES. L. REV. 9 (1959); Lowndes, *Taxing the Income of the Close Corporation,* 18 LAW & CONTEMP. PROB. 558 (1953).

veto in management decisions. He wants protection for his position. The partnership form affords a maximum of protection while the corporation places greater importance on adaptability and majority rule. This can lead to unfortunate awakenings in a close corporation since the participants often believe that special fiduciary relationships exist.

One of the recurring themes throughout this article is the extent to which the new Code provides a better balance between protection and adaptability. Certainly flexibility in corporate drafting was a major goal of the Code. The Reporter, Professor Folk, stated that one of the principal guidelines was the desire to permit the shareholders in a close corporation to act almost as freely as if they were in partnership with respect to the internal affairs of the corporation.[6] Accordingly, the Code explicitly recognizes that many small corporations are no more than incorporated partnerships.[7]

A cursory examination of the articles of incorporation filed since the new Code went into effect reveals that the new corporate planning techniques have not been utilized. The lawyer must accept a role with regard to the form of business organization that is far more complex than the mere drafting of instruments. As in estate planning, it is a role for which the lawyer is specially suited. His ability to determine the important issues in the various fields of law, such as property, corporations and taxation, will play an important part in the overall planning. The lawyer must seek out the facts and raise the problems with his client to be certain they receive the proper understanding and consideration. This, then, is the obligation, even where the client insists that he needs no help other than the attorney's signature on the form.

Some lawyers fear that the client is unwilling to pay for the "full treatment." Most clients are initially unaware of the problems that might be solved or avoided by careful planning. If the lawyer is able to make known to the client the complexities of the situation and their importance, fee difficulties should be resolved.

This article is intended to be in the nature of a survey of some of the important changes in small corporations planning wrought by the new Code. Certain features which have been discussed

6. Folk, *The Model Act and the South Carolina Corporation Law,* 15 S.C.L.Rev. 275, 281 (1963).

7. See S. C. Code Ann. § 12-16.22 (1962).

previously[7a] in relation to general corporation law are reconsidered in the perspective of their effect upon the close corporation.

The One-Man Corporation

The attitudes underlying the new Code are clearly reflected in the treatment of the one-man corporation. The ownership of all of the shares of a corporation by a single person has received general judicial approval.[8] Yet more than one incorporator is still required in approximately forty states.[9] The common method of avoiding this requirement is using dummy incorporators to perfect incorporation and then turning the business over to the real parties in interest.[10] The requirement serves no useful purpose and survives as "a relic from the concept that a corporation is the product of a number of persons associating for some common object."[11]

The new Code clearly recognizes the legal validity of the one-man corporation. Section 12-14.2[12] permits "one or more persons" to organize a corporation. Section 12-18.3(a)[13] requires three directors "except that if all shares of a corporation are owned beneficially and of record by fewer than three shareholders, the number of directors may be less than three but not less than the number of shareholders." Thus, the new Code establishes a policy of modern simplicity in regard to the one-man corporation, by providing that the single individual can incorporate and directly control the incorporated enterprise.

7a. See *Symposium, on the South Carolina Corporation Law,* 15 S.C.L.R. 275 (1963).

8. See Fuller, *The Incorporated Individual: A Study of the One-Man Company,* 51 HARV. L. REV. 1373, 1378 (1938). This view had been accepted in South Carolina. See Gordon v. Hollywood-Beaufort Package Corp., 213 S.C. 438, 49 S.E.2d 718 (1948). The danger of lack of clarity is evidenced by a North Carolina case which intimated that sole ownership destroyed the corporate entity. Park Terrace, Inc. v. Phoenix Indem. Co., 241 N.C. 473, 85 S.E.2d 677 (1955), *aff'd on rehearing,* 243 N.C. 595, 91 S.E.2d 584 (1956), overruled by N. C. GEN. STAT. § 55-31 (1960).

9. See 1 HORNSTEIN, CORPORATION LAW AND PRACTICE § 135 (Supp. 1964).

10. See 1 O'NEAL, *op. cit. supra* note 1, at 7.

11. HORNSTEIN, *op. cit. supra* note 9, at 163.

12. S. C. CODE ANN. § 12-14.2 (1962).

13. S. C. CODE ANN. § 12-18.3(9) (1962). Note that several attempts to validate a single incorporator has suffered due to a lack of consistency in other sections of the Corporation code. See Ham, *Close Corporations under Kentucky Law,* 50 KY. L. J. 125, 127-34 (1961). The new South Carolina Code eliminates such ambiguities. For example, Section 12-11.4(b)(1) requires execution of the articles of incorporation "by the incorporator or incorporators." S. C. CODE ANN. § 12-11.4(b)(1) (1962).

Shareholders' Voting Agreements

A common arrangement among participants in a close corporation is to agree in advance to vote their stock a certain way. For example, such an agreement could be entered into by a group of minority shareholders in order to secure representation on the board of directors or to assure control of the board. The agreement could provide that the shareholders would vote as a unit in accordance with decisions of the majority, or to vote for designated persons who may be parties to the agreement. In other words, the membership of the board of directors could be frozen for the life of the agreement. This would tend to protect against the possible squeezeout of someone who is depending on his position in the corporation for his livelihood. Such agreements may cover other matters subject to shareholder vote. They are an integral part of corporate planning and usually used in conjunction with other control techniques for best results.

Many early courts invalidated such agreements, but the modern tendency is to approve them provided a proper purpose can be established.[14] The principal objection was the contemplated separation of voting power from the ownership of stock.[15] In South Carolina, prior to the new Code, the legality of voting agreements was explored in *Johnson v. Spartanburg County Fair Ass'n.*[16] It was contended that purported irrevocable proxies given by several shareholders could not be revoked because this constituted an implied shareholder contract. The only supportive evidence of a contract was a statement in the proxy form that because other shareholders were signing a like proxy the proxy was irrevocable. The court correctly held no agreement existed and the proxy revocable. Then the court stated:

> If we assume that these proxies constituted an agreement between such stockholders to vote their stock in a specified manner or for a specified purpose, the proxies would be revocable as the agreement would not be supported by any other consideration other than the mutual agreements of the stockholders to vote as stated in the proxies.[17]

It was recognized that mutual promises are sufficient consideration for each other, but ". . . such a consideration alone has

14. 1 O'NEAL, *op. cit. supra* note 1, at 226-31.
15. *Ibid.*
16. 210 S.C. 56, 41 S.E.2d 599 (1947).
17. *Id.* at 72, 41 S.E.2d at 606.

never been deemed sufficient to make binding an agreement between stockholders to vote in a specified manner . . . ."[18] No reason is given for this exception to the general principles of contract law other than public policy. "Probably this idea evolved from an erroneous extension of the rule that a proxy to vote shares (being merely an agency) is revocable (though designated as irrevocable by the creator of the agency) unless coupled with an interest in the agent or supported by some consideration running from the agent to the creator of the agency other than the agent's undertaking to perform the agency."[19] In any event, the court's view has enjoyed only limited acceptance[20] and has been repudiated by the new Code.[21]

The purposes or effects of the agreement play an important role in determining its validity. This issue is particularly acute where the agreement is among less than all the shareholders. An agreement to combine in order to oppress minority shareholders is obviously illegal.[22] Yet analysis of what constitutes oppression has been undergoing a metamorphosis. "The trend of the law seems clearly to be toward more rigidity (and clarity) in the requirements as to form and at the same time toward more flexibility (and practicability) in regard to permissible purposes."[23] One writer helpfully suggests that any arrangement between shareholders should include a specific and detailed statement of its purposes and a full explanation of the business situation which gave rise to it.[24]

Section 12-16.15[25] validates shareholder pooling agreements that meet certain requirements. Primarily the agreement must

18. *Id.* at 73, 41 S.E.2d at 606.
19. 1 O'NEAL, *op. cit. supra* note 1, at 247-48.
20. See Annot., 45 A.L.R.2d 799 (1956).
21. See S. C. CODE ANN. § 12-16.15 (1962).
22. See, *e.g.*, Scripps v. Sweeney, 160 Mich. 148, 125 N.W. 72 (1910); Morel v. Hoge, 130 Ga. 625, 61 S.E. 487 (1908); Gage v. Fisher, 5 N.D. 297, 65 N.W. 809 (1895).
23. Sturdy, *The Significance of "Form" and "Purpose" in Determining the Effectiveness of Agreements among Shareholders to Control Corporate Management,* 13 BUS. LAW. 283 (1957-58).
24. O'Neal, *Protecting Shareholders' Control Agreements Against Attack,* 14 BUS. LAW 184, 194-95 (1958-59).
25. "Agreements by shareholders respecting voting of shares.—An agreement between two or more shareholders, if in writing and signed by the parties thereto, may provide that in exercising any voting rights of shares held by the parties, including any vote with respect to directors, such shares shall be voted as provided by the agreement, or as the parties may agree, or as determined in accordance with a procedure agreed upon by the parties. Such agreement shall be valid and enforceable as between the parties thereto, for a period not to exceed ten years from the date of its execution. Such agreement may be extended or renewed in like manner as a voting trust may be extended or renewed as provided by § 12-16.16." S. C. CODE ANN. § 12-16.15 (1962).

be written and signed by the contracting parties. The contracting parties need not include all shareholders, but an agreement of less than all shareholders increases the possibility of its being overturned because of improper purposes. The parties can agree in advance on how the votes are to be cast or provide as they direct. The decision may be by unanimous or less than unanimous vote. Voting decisions or shareholder deadlocks may be relegated to a procedure agreed upon by the parties. Common procedures include arbitration and the irrevocable proxy.

Some difficulty might arise over the duration of the agreement. The length of time the contract is to remain in effect has been considered a factor in determining validity.[26] Section 12-16.15 fixes the duration of the agreement at a period not to exceed ten years. The agreement may be extended for an additional period, not to exceed ten years, in the same manner as the voting trust.[27] Section 12-16.15 was ". . . intended to place the voting trust and pooling agreement on a parity and therefore, both are limited to a ten year period, after which both may be renewed or extended."[28] A question may arise whether an arrangement extending beyond the statutory maximum duration is valid.[29] Section 12-16.16 resolves this issue in favor of validity in respect to voting trusts.[30] Unfortunately, Section 12-16.15 is silent. Obviously Section 12-16.16 reflects a legislative policy that excessive duration should not affect validity, and the courts will probably so hold. However, since the issue is not expressly resolved, special care should be taken in drafting the duration features of the Section 12-16.15 agreement.

The difficulties of providing for effective enforcement of shareholder voting agreements was suggested by the famed *Ringling v. Ringling Bros.–Barnum & Bailey Combined Shows, Inc.* case.[31] There, two of three shareholders agreed to act together in voting their stock, and to submit any disagreements to an arbitrator. "The agreement (did) not describe the undertaking of each party with respect to a decision of the arbitrator

26. 1 O'NEAL, *op. cit. supra* note 1, at 245.
27. See S. C. CODE ANN. § 12-16.16(e) (1962).
28. Folk, *supra* note 6, at 321-22.
29. See Perry v. Missouri-Kansas Pipe Line Co., 22 Del.Ch. 33, 191 Atl. 823 (1937).
30. S. C. CODE ANN. § 12-16.16(f) (1962).
31. Ringling v. Ringling Bros.–Barnum & Bailey Combined Shows, Inc., 29 Del.Ch. 318, 49 A.2d 603 (1946), *modified*, 29 Del.Ch. 610, 53 A.2d 441 (1947).

other than to provide that it shall be binding upon the parties."[32] In a suit to enforce the agreement Chancellor Seitz was willing to view the arbitrator as an implied agent possessing an irrevocable proxy to vote the shares in the event of disagreement.[33] This approach substantially amounted to specific enforcement of the agreement. On appeal the Supreme Court of Delaware upheld the agreement but rejected the enforcement plan of the lower court declaring it unjustified ". . . in the absence of some indication that the parties bargained for that means."[34] The court's enforcement consisted solely of refusing to count the votes of the recalcitrant party.

The contracting parties certainly expected different treatment in the *Ringling* case. The court implied a remedy when it looked to the intention of the parties; and if an irrevocable proxy scheme had been a part of the contract, it probably would have been upheld. In South Carolina, after *Johnson v. Spartanburg County Fair Ass'n*,[35] there was no assurance of what means of enforcement could be used in an otherwise valid agreement. Section 12-16.14(f)(5)[36] explicitly recognizes the legality of the use of the irrevocable proxy to enforce a voting agreement. Like the Section 12-16.15 agreement, an irrevocable proxy is limited to a period not to exceed ten years, with a right of renewal.[37]

The use of an irrevocable proxy assures that in every situation, except in the rare instance where the proxy holder refuses to vote as directed, the agreement is self-enforcing.[38] Specific performance would achieve the same result. But, as *Ringling* sug-

32. *Id.* at 617, 53 A.2d at 445-46.

33. Ringling v. Ringling Bros.–Barnum & Bailey Combined Shows, Inc., 29 Del.Ch. 318, 49 A.2d 603 (1946).

34. Ringling v. Ringling Bros.–Barnum & Bailey Combined Shows, Inc., 29 Del.Ch. 610, 53 A.2d 441 (1947). Another argument advanced for invalidity but rejected by the court is that the parties agreed to agree in the future. The agreement was to vote in accordance with the arbitrator's decision. However, one writer sees difficulty with such a provision. Hoffman, *New Horizons for the Close Corporation in New York Under its New Business Corporation Law*, 28 BROOKLYN L. REV. 1, 8-9 (1961).

35. 210 S.C. 56, 41 S.E.2d 599 (1947).

36. "A proxy which is entitled 'irrevocable proxy' and which specifically states that it is irrevocable, shall be irrevocable only when it is held by any of the following . . .

(5) a person, including an arbitrator, designated by or under a stockholders' agreement as provided by § 12-16.15." S. C. CODE ANN. § 12-16.14(f)(5).

37. S. C. CODE ANN. § 12-16.14(g). Again the section is silent about the validity of irrevocable proxies which are for longer than ten years.

38. A court would undoubtedly require a reluctant proxy holder to vote as directed.

gests, whether the courts are willing to require performance is a matter of speculation. The Section 12-16.14(f)(5) proxy is a much more satisfactory technique to provide certain and effective enforcement.

The Delaware case of *Abercrombie v. Davies*[39] suggested other pitfalls for the unwary draftsman. There six shareholders transferred their shares of stock to eight "agents" who were selected in accordance with the agreement and given the exclusive power to vote the stock. In an action questioning the validity of the agreement, Chancellor Seitz held that the agreement was valid and that the agents held irrevocable proxies.[40] The Supreme Court of Delaware reversed. It found the agreement resembled a voting trust in the following features:

> . . . (1) that the voting rights of the pooled stock have been divorced from the beneficial ownership, which is retained by the stockholders; (2) that the voting rights have been transferred to fiduciaries denominated Agents; (3) that the transfer of such rights is, through the medium of irrevocable proxies, effective for a period of ten years; (4) that all voting rights in respect of all the stock are pooled in the Agents as a group, through the device of proxies running to the agents jointly and severally, and no stockholder retains the right to vote his or its shares; and (5) that on its face, the agreement has for its principal object voting control of American.[41]

As a voting trust the agreement failed because it did not comply with the mandatory requirements that the stock be transferred on the books and that a copy of the agreement be filed at the corporation's principal office.[42]

39. 35 Del.Ch. 599, 123 A.2d 893 (1956), *reversed,* 36 Del.Ch. 371, 130 A.2d 338 (1957).

40. Abercrombie v. Davis, 35 Del.Ch. 599, 123 A.2d 893 (1956).

41. Abercrombie v. Davis, 36 Del.Ch. 371, 130 A.2d 338 (1957). The court noted that other evidence of a voting trust existed but attached special significance to the quoted factors.

42. *Ibid.* The unfortunate effect of the court's decision was to permit some of the contracting parties to disregard what had been bargained for in good faith. The court's argument that the arrangement was a "secret" voting trust is hardly persuasive where notice to third parties or others is not in issue. Compare Kantzler v. Benzinger, 214 Ill. 598, 73 N.E. 843 (1905). ("It will be time enough to consider the rights . . . (of outsiders) when they are before us complaining."). The *Abercrombie* case has left the Delaware law in confusion. See O'Neal, *supra* note 24, at 192-93. A recent lower court case, again decided by Chancellor Seitz, enforced a voting trust which expressly met the statutory requirements for a voting trust, but the parties had not completed the mandatory

The difficulties created by the *Abercrombie* case are evident. The evil of the agreement centered on the separation of the voting rights of the stock from the other attributes of ownership. Yet this occurs anytime an agreement uses an irrevocable proxy for enforcement. In light of Section 12-16.14(f)(5), the South Carolina courts should not make such an extensive prohibition of agreements failing to meet the statutory requirements for a valid voting trust. Yet the case is from an important jurisdiction and thus emphasizes the importance of adhering strictly to the form of either the Section 12-16.15 agreement or the voting trust, without vacillating between the two.

A further consideration is how to give effective notice and thus bind transferees of shares. In *Johnson v. Spartanburg County Fair Ass'n*, after discussing the invalidity of any agreement, the court stated: "The sale by Mr. Taxler of the twenty-eight shares to Mr. Johnson *ipso facto* revoked the proxy which he had previously given to vote stock."[43] This would follow because the court had held the proxies to be revocable. It is arguable that the court meant more: that any proxy is revoked on sale, whether revocable or irrevocable. The effect of the Section 12-16.15 agreements, using the Section 12-16.14(f)(5) irrevocable proxy, is clarified by Section 12-16.14(h).[44] Actual knowledge will bind the transferee. In addition, notice of the irrecovable proxy on the share certificate will suffice.[45] There is no comparable provision for binding transferees when a Section 12-16.15 agreement does not provide for an irrevocable proxy. Thus, the use of the irrevocable proxy is important in clarifying transferee's rights as well as providing for effective enforcement.

In drafting the voting features of a Section 12-16.15 agreement, any provision expressly providing for disproportionate

requirements of filing a copy of the agreement at the principal office. The court again indicated no third parties were involved. *In re* Farm Industries, Inc., 196 A.2d 582 (Del.Ch. 1963). The court's result can be wholeheartedly endorsed, but considering the evident attitude expressed in the *Abercrombie* case, it is doubtful this tenuous distinction will be upheld on appeal.

43. Johnson v. Spartanburg County Fair Ass'n, 210 S.C. 56, 73, 41 S.E.2d 599 (1947).

44. "A proxy may be revoked, notwithstanding a provision making it irrevocable, by a purchaser of shares without knowledge of the existence of such provision, unless notice of the proxy and of its irrevocability plainly appears on the face or back of the certificate representing such shares." S. C. CODE ANN. § 12-16.14(h) (1962).

45. The requirement of notice on the share certificate closely coincides with the Uniform Stock Transfer Act requirement that any stock restriction must appear on the share certificate to be binding on transferees. See S. C. CODE ANN. § 12-17.18 (1962).

voting power or varying voting strength should be avoided. An agreement to give a holder of twenty-five per cent of the shares fifty per cent of the voting power was invalidated because it conflicted with statutory norms providing for voter power.[46] The South Carolina Constitution and Code could be similarly construed.[47] In any event, such a provision should at least be included in the articles of incorporation.[48]

Shareholders' Management Agreements

The shareholder management agreement is used to turn over certain management functions, normally within the province of the directors, to the shareholders. It may be restricted to only several situations, or it may more broadly include many areas. Although similarity exists between the shareholder management agreement and the shareholder voting agreement, analytically they must be considered separately since they must meet different mandatory statutory standards. On the other hand, a shareholder voting agreement could be used to provide the decision-making apparatus of a shareholder management agreement.

The shareholder management agreement has obvious value since areas of potential trouble can be considered and resolved by pre-arrangement. It is perfectly reasonable that potential discord should be handled in advance. In the close corporation, corporate business policy is usually the intimate concern of the shareholders. Often such matters can be best handled by the shareholders under an arrangement similar to the partnership.

Section 12-16.22[49] represents a significant and important de-

46. Nickolopoulos v. Sarantis, 102 N. J. Eq. 585, 141 Atl. 792 (1928). However, an agreement whereby one shareholder agrees not to vote his stock has been upheld. Trefether v. Amazeen, 93 N.H. 110, 36 A.2d 266 (1944).

47. Compare S. C. CONST. art. 9 § 11 (1895) (". . . each shareholder shall be allowed to cast . . . as many votes as the number of shares he owns . . .") with S. C. CODE § 12-15.1 (1962) (The articles of incorporation may grant, limit or deny the voting rights of the shares . . . .").

48. S. C. CODE ANN. § 12-15.1 (1962). would be satisfied although constitutional objections may still be raised.

49. "(a) No agreement among shareholders respecting the management and affairs of their corporation or the relations of shareholders among themselves shall be deemed invalid solely because the agreement purports to treat the affairs of the corporation as if it were a partnership and the shareholders as if they were partners.

(b) No written agreement, whether contained in the articles of incorporation or bylaws or in a written side agreement, and which relates to any phase of the affairs of the corporation, shall be deemed invalid solely because the agreement limits or restricts the powers or discretion of the directors of the corporation, if the following conditions are satisfied:

parture from the general law.[50] The tone is set by Section 12-16.22(a) which rejects the contention that corporate characteristics cannot be mingled with those of the partnership. This creates a friendly atmosphere for incorporated partnership arrangements which, in turn, should encourage judicial tolerance.[51] Section 12-16.22(a) may have significance apart from its expression of an attitude. While courts can still pronounce management agreements invalid,[52] if the agreement otherwise complies with the requirements of Section 12-16.22, it is arguable that all functions of management could validly be surrendered to the shareholders.

The principal argument against restricting the management powers of directors is that in most states full management powers are entrusted to them by statute.[53] Sterilization of the board

(1) The agreement is set forth, or its existence is clearly referred to, in the articles of incorporation;
(2) The agreement has been authorized by all shareholders of the corporation, whether or not entitled to vote to elect directors;
(3) The term of the agreement does not exceed ten years from the date thereof. Any such agreement shall be renewable at any time within one year before the expiration of such ten-year period by agreement of all of the shareholders bound thereby at the date of renewal.

(c) An agreement authorized by subsection (b) shall be valid only so long as the shares of the corporation are not traded on any national securities exchange or regularly traded in any over-the-counter market maintained by one or more brokers or dealers in securities.

(c-1) The text of any agreement authorized by subsection (b) shall be set forth in full, or a clear reference shall be made to the agreement, upon the face or back of each certificate for shares issued by the corporation.

(d) A transferee of shares in a corporation whose shareholders have entered into an agreement authorized by subsection (b) shall be bound by such agreement if he takes the shares with actual notice thereof. A transferee shall be deemed to have actual notice of any such agreement if the text of the agreement, with any amendments, is set forth in the articles of incorporation.

(e) The effect of an agreement authorized by subsection (b) shall be to relieve the director or directors of, and to impose upon the shareholders consenting to the agreement, the liability for managerial acts or omission that is imposed by law upon directors 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." S. C. CODE ANN. § 12-16.22 (1962).

50. Section 12-16.22 has expanded coverage compared with other statutes. Compare N. Y. BUS. CORP. LAW § 620; N. C. GEN. STAT. § 55-73(b) (1960). The new Corporation Code recently adopted in Florida is very similar to Section 12-16.22. See FLA. LAWS 1963, Ch. 63-379, § 6.

51. See Latty, *The Close Corporation and the New North Carolina Business Corporation Act*, 34 N. C. L. REV. 432, 438 (1955-56).

52. *Id.* at 439. This might result where the agreement did not satisfy the mandatory requirements of Section 12-16.22. Such an agreement would likely counter other traditional attacks.

53. 1 O'NEAL, CLOSE CORPORATIONS: LAW AND PRACTICE 235-40 (2 vols. 1958).

of directors is contrary to the corporate norm of management. Thus many courts view a contract as "illegal and void so far as it precludes the board of directors, at the risk of incurring legal liability, from changing officers, salaries or policies or retaining individuals in office, except by consent of the contracting parties."[54] The new Code discards the corporate norm theory by providing:

> *Subject to any provisions permitted by chapters 1.1 to 1.14 of this Title to be contained in the articles of incorporation, the bylaws, or agreements among shareholders*, the business and affairs of a corporation shall be managed by a board of directors.[55] (Emphasis added.)

This precludes any suggestion that management is within the exclusive jurisdiction of the directors. It is interesting to note that this section is not limited to the close corporation. However, little harm is likely since the publicly held corporation will probably be unable practically to effect the shareholder management arrangement.

Section 12-16.22(b) sets forth specific requirements for shareholder agreements that limit or restrict the powers of directors. This provision does not provide for validity, rather, it prohibits the argument that the restriction of the directors' management power is a factor in determining invalidity. The first requirement is that the agreement be set forth or referred to in the articles of incorporation. The policy underlying this condition is not clear. While this might provide notice to those dealing with the corporation in some cases, it is doubtful that third parties will examine the articles of incorporation or should be bound by an agreement which limits the powers of the board of directors. The transferees of shares are protected by notice on the share certificate.[55a] The requirement hardly seems justified, particularly since such a provision is most likely to be taken advantage of by a contracting party who wishes to welch on bargained-for obligations.

The most important requirement is that the agreement have unanimous shareholder consent. Any shareholder arrangement is

54. McQuade v. Stoneham & McGraw, 263 N.Y. 323, 189 N.E. 234 (1934). *Accord,* Long Park, Inc. v. Trenton-New Brunswick Theater Co., 297 N.Y. 174, 77 N.E.2d 633 (1948); Kaplan v. Block, 183 Va. 327, 31 S.E.2d 893 (1944). Also see Comment, *"Shareholders Agreements" and the Statutory Norm,* 43 CORNELL L. Q. 68 (1957).

55. S.C. CODE ANN. § 12-18.1 (1962).

55a. See *infra* notes 60-63, and text discussion.

greatly strengthened when it has been unanimously proved.[56] The argument that minority shareholders may be oppressed by shareholder agreements is most persuasive where the actions of directors are being restricted and supplanted by shareholder management. Absent statute there is some tendency to disregard inconsequential holdings in determining the validity of shareholder agreements.[57] The new Code has taken a firm position opposing any such laxation where shareholder management agreements are involved. The burden of this requirement should not be too overwhelming in most close corporations. In the initial stages of the business, unanimous agreement can usually be reached on management and other policy problems. Thus Section 12-16.22(b)(2) provides needed clarity of the rights of minority shareholders.

Section 12-16.22(b)(3) requires that the agreement not extend beyond ten years, with a renewable provision for an additional ten year period. Unfortunately, this provision contains the ambiguity of the Section 12-16.15 agreement in respect to agreements which by their terms extend beyond the ten-year limitation. A strong case can be made for invalidity since the provision is one of three clearly mandatory requirements. There is no good policy reason why an over-extended term in a shareholder management agreement should not be treated similarly to the voting trust, *i.e.*, to permit the agreement to be valid for a ten-year period.[58]

Section 12-16.22(b) agreements are restricted to the close corporation, defined by Section 12-16.22(c) as any corporation the shares of which are not regularly traded.[59] Absent such a requirement, it would be difficult to envision a Section 12-16.22(b) agreement in a publicly held corporation. As a practical matter unanimity could hardly be achieved. If the shareholders unanimously agree and sufficient steps are taken to notify potential transferees, perhaps a corporation actively traded should be entitled to achieve a shareholder management policy.

56. See 1 O'NEAL, *op. cit. supra* note 53, at 283-88.

57. *Id.* at 286. Note that unanimous consent is not needed for a valid Section 12-16.15 agreement. For a good discussion of the danger of less than unanimous shareholder agreements see LATTIN, CORPORATIONS 332 (1959).

58. Compare S. C. CODE ANN. § 12-16.16(f) (1962).

59. This definition corresponds with Professor O'Neal's view. See 1 O'NEAL, *op. cit. supra* note 53, at 5. The New York and North Carolina statutes do not restrict the availability of their sections to the close corporation. See N. Y. BUS. CORP. LAW § 620; N. C. GEN. STAT. § 55-73 (1960). Florida accords with the South Carolina limitation. FLA. LAWS, Ch. 63-379 § 6 (1963).

Sections 12-16.22(c-1) and 12-16.22(d) attempt to clarify the effect of a Section 12-15.22(b) agreement on transferees of shares. Section 12-16.22(c-1) states that the agreement shall be set forth or clearly referred to on each share certificate. At first glance this requirement seems to establish constructive notice to transferees similar to other shareholder arrangements,[60] but unfortunately the effect of making or omitting the required reference is not clear. The provision may be interpreted as a mandatory condition to the agreement's validity but not constituting notice to transferees. Section 12-16.22(d) deals more directly with transferees. The agreement is binding on the transferee of shares if he has actual notice of the agreement or if the agreement is fully set forth in the articles of incorporation. Since Section 12-16.22(b)(1) requires that the agreement be set forth or clearly referred to in the articles, there is no good reason why he should not be considered equally bound by a reference to the agreement. Knowledge of the reference would put the transferee on notice to investigate further. If the intention were to bind the transferee to information contained in the articles, it is redundant to have the agreement binding when in the articles, since its inclusion in the articles is a mandatory requirement of validity. A better overall approach is to key the notice to transferees solely to the share certificates. It is unlikely that the purchaser of shares will examine the articles of incorporation,[61] and, further, the use of the articles of incorporation as the means for providing notice to transferees is inconsistent with other notice provisions.[62] The draftsman should specify in the agreement to what extent it is binding on transferees and the status of the agreement if it is found not to be binding.[63]

Directors have the duty to exercise a reasonable degree of care in their management of the corporation.[64] The potential liability for negligence has been influential in invalidating restrictions on directors' management on the grounds that liability

60. Compare S. C. CODE ANN. §§ 12-16.14(h) and 12-17.18 (1962). No requirement is necessary for the voting trust since transferees would receive trust certificates. See S. C. CODE ANN. § 12-16.16 (1962).

61. See Moore, *Shareholders,* 15 S. C. L. R. 381, 393 (1963).

62. See *supra* note 60.

63. If the agreement is not binding on a transferee it may be automatically invalid since it fails to meet the unanimity requirement of Section 12-16.22 (b)(2) (1962).

64. In South Carolina the degree of care is set by Section 12-18.15. See S. C. CODE ANN. § 12-18.15 (1962) (". . . diligence, care and skill which ordinarily prudent men would exercise under similar circumstances in like positions.").

should be commensurate with responsibility.[65] This policy consideration is effectively eliminated by Section 12-16.22(e). To the extent that the agreement takes managerial powers away from the directors and gives them to the shareholders, the liability for negligent acts or omissions in respect to such powers and the corresponding duty of care is also transferred to the shareholders. This provision adds needed clarification of the effect of the management agreement on directors' responsibilities. Absent such statutory provision, the law is not clear whether the forced delegation of functions by the shareholder would relieve the directors of ultimate responsibility.

Unlike the voting agreement's irrevocable proxy provision, the shareholder management agreement has no built-in enforcement. A court action would likely be required to force reluctant parties to act in accordance with the agreement. Since the corporation will probably be a party to the proceedings and will have a role in the court's decision, enforcement difficulty may be minimized if the corporation is made one of the contracting parties.[66] The agreement could provide that the parties would vote their stock and take whatever other action is necessary to cause the corporation to become a formal party to it.

Professor O'Neal has mentioned several other drafting precautions which apply equally to shareholder voting and management agreements.[67] First, care should be taken to specify the situations or functions to which the agreement applies in a definite, unambiguous manner. The agreement should also be clear on the rights and duties of the various parties. The possible contingencies that may raise interpretation problems should be anticipated and provided for. For example, what is the effect of death or long continued illness of one of the parties to the agreement, or what would a transfer by means of gift or inheritance have on the transferee's rights. The agreement should bind the parties only in their capacity as shareholders, and not as di-

65. West v. Camden, 135 U.S. 507 (1890); Odman v. Oleson, 319 Mass. 24, 64 N.E.2d 439 (1946); Jackson v. Hooper, 76 N.J. Eq. 592, 75 Atl. 568 (1910); McQuade v. Stoneham, 263 N.Y. 323, 189 N.E. 234 (1934).

66. See O'Neal, *Protecting Shareholders' Control Agreements Against Attack*, 14 BUS. LAW 184, 202-03 (1958-59). An agreement between all shareholders affords a private remedy but does not bind the corporation. Batos v. United Sausage Co., 138 Conn. 18, 81 A.2d 442 (1951). A corporation will not be enjoined from violating a shareholder agreement to which it is not a party. Thresher v. Cuddy-Gardner Co., 165 Atl. 438 (R.I. 1933). These cases represent the minority view. See O'Neal, *supra* at 203.

67. For a more detailed discussion of protecting shareholder agreements from attack, see O'Neal, *supra* note 66.

rectors since directors are not permitted to enter into contracts respecting the casting of their votes or undue delegation of their duties.[68] Lastly, a severability clause should be included in the agreement if part of the agreement may be declared invalid and the parties want the remainder to be enforced.

Voting Trusts

A device to secure voting control which has many similarities to the shareholder voting agreement is the voting trust. In this arrangement the shareholders transfer legal title for a definite period to a voting trustee and in return receive trust certificates. This exchange of shares for trust certificates is the major legal distinction between the voting trust and the shareholder voting agreement.

Although voting trusts were subjected to judicial suspicion at the turn of the century, today they are recognized as valid in every jurisdiction either by statute or judicial decision, provided they are for a permissible purpose. Professor Ballentine lists the following purposes as legitimate:

> . . . (1) To aid in reorganization plans and adjustments with creditors in bankruptcy or financial difficulty; (2) to assist financing, to procure loans, and to protect bondholders and preferred shareholders; (3) to accomplish some definite plan or policy for the benefit of the company and to assure stability and continuity of management for this purpose; (4) to prevent rival concerns or competitors from gaining control; (5) to apportion representation and protect minority interests or those with balanced holdings, as in corporations to exploit a patent, by putting the selection of directors in impartial hands; (6) in connection with mergers, consolidations or purchase of a business, in order that the predecessors or constituents, though in the minority, may have representation.[69]

The voting trust is most commonly used to insure a responsible management in a reorganized corporation.[70] In this situation the voting trust satisfies the need both for a guaranteed control

68. See Odman v. Oleson, 319 Mass. 24, 64 N.E.2d 439 (1946); Miller v. Vanderlip, 285 N.Y. 116, 33 N.E.2d 51 (1941).

69. Ballantine, *Voting Trusts, Their Abuses and Regulation,* 21 TEXAS L. REV. 139, 152-53 (1942).

70. BAKER AND CARY, CASES AND MATERIALS ON CORPORATIONS, 336 (3d ed. 1959).

arrangement and for a solemn, formal arrangement reflecting the transfer of control to a new group.

In *Alderman v. Alderman*[71] the South Carolina Supreme Court explicitly recognized the validity of the voting trust. The trust was formed for the general purpose of securing a stable and continuous management. The significance of the common law trust recognized in the *Alderman* case is considerably lessened by the new corporation law. Section 12-16.16[72] creates a statutory

71. 178 S.C. 9, 101 S.E. 897 (1935).

72. "(a) Any shareholder or shareholders may create a voting trust, revocable or irrevocable, for the purpose of conferring upon a trustee or trustees the right to vote or otherwise represent their shares, for a period not exceeding ten years, by executing a written agreement specifying the terms and conditions of the voting trust, and by transferring the shares to such trustee or trustees for the purposes stated in the agreement. The certificates or shares so transferred may be

(1) surrendered by the trustee to the corporation which shall thereupon cancel the shares and issue new certificates therefor to the trustee or trustees stating that they are issued under the voting trust agreement or

(2) in lieu thereof, retained by the trustee.

In either case, the corporation shall specifically enter into its records the fact that such shares are subject to the voting trust agreement. In any case, trust certificates shall be issued by the trustees to the shareholders who transfer their shares in trust.

(b) A fully conformed copy of the voting trust agreement (including any amendments to or changes in the agreement) shall be on file both at the corporation's registered office, and with the voting trustee or trustees. Such conformed copies shall be subject at any reasonable time to examination by any shareholder of the corporation, or by any holder of a voting trust certificate, in person or by attorney or other agent.

(c) The trustee or trustees shall keep a complete and current list of the names and addresses of all persons who are holders of voting trust certificates and the number and class of shares represented by the certificates held by them and the date when they became the owners thereof. Such list shall be kept on file at the office of the trustee or trustees and at the registered office of the corporation, and shall be subject at any reasonable time to examination by any shareholder of the corporation or by any holder of a voting trust certificate, in person or by attorney or other agent.

(d) The holder of a voting trust certificate shall be considered to be a shareholder of the shares represented by his trust certificate with respect to his right to inspect corporate books and records.

(e) At any time within one year before the expiration of a voting trust agreement as originally created or as extended under this subsection, one or more holders of voting trust certificates may, by agreement in writing, extend the duration of such agreement, nominating the same or substitute trustee or trustees, for an additional period not to exceed ten years from the date of such extension. Such extension agreement shall not affect the rights or obligations of persons not parties to the agreement, and such persons shall be entitled to remove their shares from the trust and promptly to have their share certificates reissued to them. The extension agreement shall comply with all provisions of this section applicable to the original voting trust agreement.

(f) The validity of a voting trust agreement, otherwise lawful, shall not be affected during a period of ten years from the date of its creation or extension, by the fact that by its terms it will or may last beyond such ten-year period; but it shall, after the expiration of such ten-year period, be inoperative.

voting trust in South Carolina. Undoubtedly the section has occupied the field and all voting trusts must meet the statutory conditions. As noted previously,[73] drafting efforts must strictly comply with the terms of the statute and the document will not be considered a shareholder agreement if it fails as a voting trust. Voting trusts have failed where stock certificates were not turned over to the trustee,[74] or a duplicate copy of the trust was not filed at the corporation's registered office.[75]

The voting trust is usually created by shareholders of the corporation. It has been suggested that generally more than one settlor is required to establish a voting trust.[76] Thus, a trust established by a single settlor would not have to meet statutory requirements. However, Section 12-16.16(a) permits single shareholders to form a trust. The recognition of a unilateral trust as a statutory voting trust may contain serious problems where stock is in trust and the trustee holds voting power. Failure to observe the terms of Section 12-16.16 may result in invalidity.

The shareholders who are permitted to join the trust should be clearly identified.[77] Several states expressly require that all shareholders shall have the right to become parties.[78] The new Code is silent and the issue is unresolved in South Carolina. If other shareholders are allowed to join they may gain control of the trust. The trust could be open to all shareholders and control protected by establishing a group as qualified trustees.[79]

The legitimate duration of a voting trust has caused considerable difficulty. At common law the criteria was reasonableness measured by the purpose. In the *Alderman* case, the court up-

(g) The trustee or trustees under a voting trust agreement shall, unless otherwise provided by the agreement, vote upon all amendments of the charter, and upon any merger, consolidation, dissolution, sale of assets or voting trust agreement provides otherwise, whenever any provision of chapters 1.1 to 1.14 of this Title grants a shareholder the right to dissent to proposed corporate action and to be paid the fair value of his shares if such action is effected, the holder of a voting trust certificate shall, to the extent of the shares represented thereby, have such right as if he had not transferred his shares in trust." S. C. CODE ANN. § 12-16.16 (1962).

73. See *supra* notes 39-42, and text discussion.

74. Smith v. Biggs Boiler Works, 32 Del.Ch. 147, 82 N.E.2d 372 (1951).

75. State v. Keystone Life Ins. Co., 93 So.2d 565 (La. 1957).

76. Note, *The Voting Trust*, 34 N.Y.U.L.REV. 290, 295 (1959). See *In re* Will of Pittock, 102 Ore. 159, 199 Pac. 633 (1921).

77. BAKER AND CARY, *op. cit. supra* note 70, at 348.

78. See 1 MODEL BUS. CORP. ACT ANN. § 32.

79. Compare DeMarco v. Paramount Ice Corp., 102 N.Y.S.2d 692 (1950), where such requirements were upheld although the statute required that all shareholders be allowed to join.

held a trust which was to last until the death of the survivor of two trustees.[80] Almost every statutory trust expressly provides for a maximum legal duration. Section 12-16.16(a) limits the trust to ten years. In addition, Section 12-16.16(a) permits an extension for an additional ten years for those shareholders who agree to the extension within one year before the expiration of the trust. Any person objecting to the extension is entitled to remove his shares from the trust. Several cases have held that voting trusts which exceed the maximum term set forth in the statute are invalid.[81] Section 12-16.16(f) rejects this view by providing that validity is not affected and that the trust becomes inoperative after the permissible period.

The other conditions of validity are clearly stated: the trust must be in writing and entered into the corporation's records; the participating shareholders must transfer their share certificates to the trustees and receive trust certificates; a copy of the agreement must be filed at the corporation's registered office; and a list of the holder of the trust certificates must be on file at the office of the trustees or at the registered office of the corporation.

The new Code clarifies the rights of trust certificate holders in relation to inspection of the corporate books and records. Since the shareholders transfer legal ownership to the trustees, analytically they stand to lose various beneficial rights. Traditionally the right to inspect corporate books and records is extended to shareholders, and, absent statute, this right may attach to legal ownership and pass to the trustee.[82] In such jurisdictions a minority shareholder may find he has lost an important means of protecting his interest. Section 12-16.16(d) specifically places the holder of a trust certificate on par with the shareholder in respect to inspection rights.[83] This provision

80. Alderman v. Alderman, 178 S.C. 9, 101 S.E. 897 (1935). Other states have upheld long term trusts where the purpose required was extended period. See Clark v. Foster, 98 Wash. 241, 167 Pac. 908 (1917) (twenty years); Carnegie Trust Co. v. Security Life Ins. Co., 11 Va. 1, 68 S.E. 412 (1910).

81. Christopher v. Richardson, 394 Pa. 425, 147 A.2d 375 (1959); Perry v. Missouri-Kansas Pipe Line Co., 22 Del.Ch. 33, 191 Atl. 823 (1937). Also see Kittinger v. Churchill Evangelistic Ass'n, 151 Misc. 350, 271 N.Y. Supp. 510 (1934); *aff'd mem.*, 244 App.Div. 876, 281 N.Y. Supp. 680 (1935) (trust agreement held valid for ten years but an extension for a term beyond that allowed held invalid).

82. See BALLANTINE, CORPORATIONS § 184(b) (rev. ed. 1946); State *ex rel.* Crowder v. Sperry Corp., 41 Del. 84, 15 A.2d 661 (1940); Brentmore Estates, Inc. v. Hotel Barbizon, Inc., 263 App.Div. 389, 394, 33 N.Y.S.2d 331, 336 (1942).

83. The provision accords with the Model Act. Compare MODEL BUS. CORP. ACT ANN. § 32.

could possibly be considered conditional to validity if a violation is attempted.

The trust certificate holder's rights, when he dissents to corporate action which would ordinarily entitle him to payment for his shares pursuant to Section 12-16.27,[84] are clarified by Section 12-16.16(g). The parties are permitted to provide for a satisfactory arrangement in the trust agreement. Absent an arrangement, a compromise is reached by allowing the trustees to vote upon all proposed fundamental changes, except for those shares representing dissenting certificate holders. The dissenters are allowed both to dissent and to receive payment for their shares in the event the action is approved.

Several additional precautions in drafting the trust agreement must be observed.[85] The duties of the trustees should be specifically set forth. Ambiguity may be interpreted in such a way as to create a situation that is contrary to the intention of the parties. Again the major step in good draftsmanship is to anticipate and provide for the contingencies. An obvious precaution is to provide for the orderly succession of trustees. Their voting procedures, the permissibility of proxies, and quorum requirements should also be specified.

Interest in the voting trust as a control arrangement may wane under the new Code. A major advantage of the voting trust in the past has been the legal uncertainty of the shareholder voting agreement,[86] but this advantage has been eliminated by Section 12-16.15. The usual enforcement problems of the shareholder agreement have been corrected by the recognition in Section 12-16.14(f)(6) of the use of an irrevocable proxy. The voting trust is obviously more formal and clumsy than the voting agreement. The statutory requirements for the voting trust must be strictly observed. The transfer of title to trustees may involve prohibitive tax transfer costs.[87] Since the shareholder agreement can be used to accomplish the same ends as the voting trust, and in most instances with a greater degree of flexibility, most draftsmen should prefer the simpler voting agreement.

84. See S. C. Code Ann. § 12-16.27 (1962).

85. For a more complete discussion of drafting precautions, see O'Neal, *op. cit. supra* note 53, at 307-10.

86. *Id.* at 313.

87. See Annot., 118 A.L.R. 1292 (1939); Orpheum Bldg. v. Anglim, 127 F.2d 478 (9th Cir. 1942).

Greater-Than-Normal Quorum and Voting Requirements

A favorite method of assuring protection to minority shareholders is that of requiring a high percentage or unanimous attendance to constitute a quorum or vote for corporation action. In effect, minority shareholders can acquire veto power over some or all corporate decisions. Maintenance of the *status quo* can be of great importance to participants in a close corporation. They usually expect to be directors and officers at some agreed upon rate of pay. If the shareholder participates only as an investor he may want a veto over increases in salaries or other corporate acts which may tend to jeopardize his investment. A provision requiring unanimity or a high vote for shareholder and director action may be the most effective method to protect a minority shareholder against oppression by those in control.[88]

In the absence of a statute it has been generally held that specific statutory requirements respecting the percentage of votes required could not be changed either upward or downward ". . . on the theory that the public policy was expressed in the statute."[89] The usual objections to such provisions were explored in the leading case of *Benintendi v. Kenton Hotel, Inc.*[90] In the *Benintendi* case several by-laws, requiring unanimous vote for action to be taken by shareholders or directors, were declared invalid. The court stated that voting requirements must conform to the statutes.[91]

High quorum and veto requirements may be established at the shareholder level or director level. Both levels must be considered.[92] Veto power at the shareholder level could accomplish the desired control over matters subject to shareholders' vote. However, absent a Section 12-16.22(b) agreement, protection at the shareholder level does not protect against acts by directors such as salary increases or removal of officers. Protection only at the director level has similar difficulties. The minority shareholder could be injured by an amendment to the articles or by being removed from the board of directors.

88. O'NEAL AND DERWIN, EXPULSION OR OPPRESSION OF BUSINESS ASSOCIATES: "SQUEEZE-OUT" IN SMALL ENTERPRISES 177 (1961).

89. 2 MODEL BUS. CORP. ACT ANN. § 136 at 763; see 1 HORNSTEIN, CORPORATIONS 210 (1959).

90. 294 N.Y. 112, 60 N.E.2d 824 (1945). In New York the Benintendi decision was subsequently overruled by statute. See N. Y. STOCK CORP. LAW § 9. Compare Kaplan v. Block, 183 Va. 327, 1 S.E.2d 893 (1944).

91. *Id.* at 118, 60 N.E.2d at 831.

92. See O'NEAL AND DERWIN, *supra* note 89; Powers, *Crossfire on the Close Corporation: Norms Versus Needs*, 11 U. FLA. L. REV. 433, 441 (1958).

The new Code permits considerable flexibility in using high vote or quorum requirements. At the shareholder level, Section 12-16.8 expressly permits a provision in the articles of incorporation requiring a greater-than-normal number to constitute a quorum.[93] Undoubtedly, the section would be interpreted to permit unanimity. Attempts to vary voting and quorum requirements may appear in various instruments. The *Benintendi* case involved by-law provisions. Section 12-16.8 clearly indicates that any attempted change in such requirements at the shareholder level will not be effective unless it is in the articles of incorporation.

Section 12-16.10 provides that corporate action is authorized when it receives a majority of the shares cast "except to the extent that the vote of a greater number . . . is required . . . by the articles of incorporation as permitted by chapter 1.1 to 1.14 of this Title . . . ."[94] The section seems to limit the use of a veto provision to those situations which specifically allow a higher vote requirement. This suggestion is buttressed by the fact that several sections requiring shareholder approval specifically permit a high vote requirement.[95] This limitation is unfortunate, particularly since high vote requirements would not cover many situations that would arise under a shareholder management agreement. Although it is recognized that the better practical technique is to use a high vote requirement,[96] in South Carolina primary emphasis must be placed upon the high quorum requirement when assuring protection at the shareholder level.

Less difficulty is encountered in drafting high quorum and vote requirements at the director level. Section 12-18.10 provides for majority quorum or vote ". . . unless a greater proportion is required . . . by the articles of incorporation or by-laws."[97] Validating the use of the by-laws or articles of incorporation provides an atmosphere of maximum validity.

Still such provisions should be inserted in both the by-laws and articles of incorporation. If the requirements are in the

93. See S. C. CODE ANN. § 12-16.8 (1962).

94. S. C. CODE ANN. § 12-16.10 (1962).

95. See S. C. CODE ANN. § 12-21.3(b) (1962). It is possible that Section 12-16.10 may be interpreted to permit high shareholder vote in all situations but that it must be in the instrument indicated by other sections.

96. O'Neal, *Giving Shareholders Power to Veto Corporate Dicisions: Use of Special Charters and By-Law Provisions,* 18 LAW & CONTEMP. PROB. 451, 464 (1953). The parties at least come together when a high vote requirement is used. Under a high quorum provision, the complaining party will boycott the meeting thus prohibiting the possibility of an agreement.

97. S. C. CODE ANN § 12-18.10 (1962).

articles it indicates the parties give high priority to such provisions. Notice is given to all interested parties of the limitation. The requirements should also be set forth or referred to on the share certificate. This insures that transferees will have notice and will be bound. It is advantageous to repeat the provisions in the by-laws. "By-laws serve as a guide for directors and officers in the conduct of corporate activities; consequently, veto provisions placed there are constantly before the attention of the directors and officers."[98]

Arrangements, in which each shareholder has what is in effect the power of veto, have several serious drawbacks. The chance of corporate deadlock is increased. Further, the veto power may be used to blackmail the other parties into granting unfair advantages to the complaining shareholder. One method of overcoming much of the risk in the use of high vote or quorum provisions is to require more than one person to effect the veto. Since each of five shareholders in a corporation can elect a director on a five-man board of directors, ". . . perhaps adequate protection can be given minority interests against arbitrary action by the majority by requiring the concurrence of four directors for effective action."[99] In return, the corporation would be protected from the arbitrary actions of any one director.

Although the abuses of veto provisions may be overstated,[100] it is generally agreed that the draftsman should refrain from giving a blanket veto power. The individual situation requires careful study to determine which interests need veto protection. It might be advisable to include all veto-protected provisions in the articles of incorporation and require unanimity for any amendment. Thus situations which will be subjected to majority rule will be primarily in the by-laws, although several by-law provisions could also be veto-protected. No draftsman should neglect to protect against possible change in the high vote or quorum requirement by a mere majority vote. Such requirements are hardly effective if they can be circumvented by majority rule. The articles of incorporation should specifically require unanimity to change agreed upon veto provisions.

98. O'NEAL, *op. cit. supra* note 53, at 211.

99. *Id.* at 212-13.

100. "It might be argued that veto power or some other form of control in a minority of stockholders is subject to abuse, but the answer is that the voting powers of the majority can also be abused in a close corporation, especially if the owners have unanimously agreed to dispense with orthodox majority control." Powers, *Crossfire On the Close Corporation: Norms Versus Needs*, 11 U. FLA. L. REV., 433, 451 (1958).

Classification of Shares

Another method of protecting minority shareholders is through tailoring the share structure. A common control device is to divide the stock into two or more classes and allocate to the classes different voting rights. The draftsman could establish two classes of stock with identical rights, except that one class would have voting rights and the other would not. This would enable the shareholders to give or sell a substantial part of the equity without endangering their control. Another approach is to use several classes of stock with each class being entitled to elect one or more directors. This technique could be used to achieve equal representation where the proprietary interest is disproportionate.

The use of stock with no voting or restricted voting rights is widely accepted. However, in a few jurisdictions the state constitution requires in effect that each shareholder shall have the right to cumulative vote.[101] Several states have interpreted this provision to mean that each shareholder must have at least one vote per share.[102] Section 12-15.1 provides that the ". . . articles of incorporation may grant, limit or deny the voting rights of the shares . . . ." However, Article 9, section 11 of the South Carolina Constitution requires mandatory cumulative voting with terminology that raises serious doubt about the validity of any attempt to limit voting rights.[103] Several commentators,

101. Approximately thirteen states require by constitution the necessity of cumulative vote. See MODEL BUS. CORP. ACT ANN. § 31 at 522.

102. See, *e.g.*, ILL. CONST. art. XI § 3; People *ex rel.* Watseka Telephone Co. v. Emmerson, 302 Ill. 300, 134 N.E. 707 (1922); W.VA. CONST., art. XI § 4; State *ex rel.* Dewey Portland Cement Co. v. O'Brien, 142 W.Va. 451, 96 S.E.2d 171 (1956). *Contra,* Shapiro v. Tropicana Lanes, Inc., 371 S.W.2d 237 (Mo. 1963). Under a subsequent West Virginia Constitutional Amendment, a corporation can issue stock with limited voting power. See Diamond v. Parkesburg-Aetna Corp., 122 S.E.2d 436 (1961). The Illinois view is most extreme in holding arrangements which tend to limit cumulative voting as unconstitutional. There a statute providing for classification of directors was held invalid. Wolfson v. Avery, 6 Ill.2d 78, 126 N.E.2d 701 (1955). *Contra,* Bohaman v. Corporation Comm'n of Arizona, 82 Ariz. 299, 313 P.2d 379 (1957); Janney v Philadelphia Transp. Co., 387 Pa. 282, 128 A.2d 76 (1956). See Sell, *Impact of Classified Directorates on the Constitutional Right of Cumulative Voting,* 17 U. OF PITT. L. REV., 171 (1956).

103."The General Assembly shall provide by law for the election of directors, trustees or managers of all corporations so that each stockholder shall be allowed to cast, in person or by proxy, as many votes as the number of shares he owns multiplied by the number of directors, trustees or managers to be elected, the same to be cast for any one candidate or to be distributed among two or more candidates."—S. C. CONST., art. 9 § 11 (1895).

including Professor Folk, have felt that Article 9, section 11 may prohibit non-voting stock in South Carolina.[104]

Without speculating about the final outcome of non-voting shares in South Carolina, the legal uncertainty of such a control arrangement makes the shareholder agreements or other techniques preferable. A shareholder voting agreement can be used to accomplish the same results as classification of stock. The prohibition against varying voting power attaches only to attempts within the formal corporate rule structure—where the attempt is made by statute, articles of incorporation, or by-laws.[105] A shareholder voting agreement or voting trust, independent of the articles or by-laws, would probably not be subjected to the constitutional objection.[106] One important disadvantage of such an arrangement is the statutory time limitation.

Several classification arrangements may successfully avoid or lessen the constitutional difficulties. The use of non-voting shares has been the arrangement most frequently attacked. The use of classes of stock with each class electing a stated number of directors has not been overturned, although certainly such an arrangement limits cumulative voting.[107]

104. "Attorneys fear that the broad language of the constitutional provision might have two adverse effects. (1) It may render suspect any procedure, however reasonable, for regulating the exercise of the mandatory cumulative voting right, such as the requirement that one who proposes to cumulate his votes give notice of his intention either before the shareholders' meeting or at the meeting before voting begins. (2) Some think it renders suspect, in varying degrees, any provision which arguably cuts down the cumulative voting right." Folk, *The South Carolina Corporation Law: Reconsiderations and Prospects,* 15 S.C.L.REV. 467, 482 (1963); also see Freeman, *Directors and Officers,* 15 S.C.L.REV. 398, 400 (1963); Moore, *Shareholders,* 15 S.C.L.REV. 381-82 (1963); Nexsen, *Classes and Issues of Shares,* 15 S.C.L.REV. 357, 358-59 (1963).

105. The best discussion of this distinction can be found in Sensabaugh v. Polson Plywood Co., 135 Mont. 562, 342 P.2d 1064 (1959). There a by-law requiring straight voting was held in conflict with a mandatory cumulative voting provision of the state constitution, but a majority of the court would have enforced a shareholder contract requiring straight voting. Also see E. K. Buck Retail Stores v. Harkert, 157 Neb. 867, 62 N.W.2d 288 (1954).

106. But see *supra* note 46, and the text discussion.

107. While cumulative voting may be avoided, often the minority interest receives increased protection. Consider the following example:

> It is possible that situations may exist, however, in which cumulative voting will not fulfill the needs of a particular group. For example, Rich, Wells and Poor own, respectively, 50%, 30% and 20% interest in a business. They desire to incorporate and they wish a three-man board of directors so that each can have an active voice in the management of the business. Each likewise desires to be assured of a directorship, but cumulative voting will not answer Poor's needs since, in this example, the mathematics of cumulative voting would require control of one more than twenty-five percent of the voting shares.
>
> Under these circumstances, it would be wiser for the three men to use three classes of stock, "A", "B" and "C" with each entitled to elect one

A safer arrangement, and one which is seemingly used in Illinois, involves several classes of stock but retains intact cumulative voting.[108] Each share would be given a vote, but one class would have $1.00 par value stock and the other class would consist of $100.00 par value stock. The recipient of the $1.00 par value stock would have a favorable 100 to 1 ratio of voting power over the recipient of the $100.00 par value stock. Any number of variations of the above example could be worked out in order to meet the particular needs of the client. Care must be taken to specify the other features, such as dividend and liquidation rights, of the separate classes.

Conclusion To Part One

The impact of the new corporation law upon the close corporation is one of its most important contributions. Lawyers are given maximum latitude in drafting the business form to meet varying client needs. Several minor adjustments are still needed. Article 9, Section 11 of the South Carolina Constitution remains the major obstacle to flexibility. Imaginative judicial decisions could do much to dispel uncertainty. However, the paucity of cases that come before the Supreme Court of South Carolina involving corporation law does not suggest judicial solutions. A clarifying amendment to the Constitution would be the ideal resolution.

director. Since the shares would be equal in all other respects, Rich would get 50 shares of Class "A" voting stock, Wells would receive 30 shares of Class "B" voting stock and Poor would take 20 shares of Class "C" stock. In this manner Poor could always elect a director even if he sold any amount less than 50% of his stock. Steadman, *Maintaining Control of Close Corporations,* 14 Bus. Law. 1077, 1079-80 (1959).

108. This method is discussed in O'NEAL, *op. cit. supra* note 53, at 104-05; Hoban *Voting Control Methods,* 1958 U. OF ILL. L. R. 110, 112-13 (1958).