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NOTES

ENFORCEMENT OF AN INVALID BY-LAW AS A CONTRACT AMONG THE SHAREHOLDERS

This article will deal with the question of whether a by-law which has been declared invalid as a by-law may nevertheless be sustained as a contract among the shareholders. The related question of what constitutes sufficient cause to declare a by-law invalid is beyond the purview of this article.

This subject was suggested by the recent Montana decision, *Sensabaugh v. Polson Plywood Company*.¹ In that case the shareholders unanimously adopted a by-law which attempted to dispense with cumulative voting. In the decision in which three justices concurred and two justices, writing separate opinions, dissented in part and concurred in part, the court held that the by-law in question was invalid as being contra to the constitutional provision which, they determined, mandatorily required cumulative voting.

On the question of whether this by-law was enforceable as a contract, the court held that the invalid by-law was not enforceable, even among those shareholders assenting to it, as a contract. The majority opinion

1. Mont., 342 P.2d 1064 (1959).

made a distinction between shareholders' contracts made without the realm of corporate structure and those carried on or attempted within the corporate structure. The court stated that the shareholders could have entered into a contract among themselves to eliminate cumulative voting, but by their attempt to put this contract into the form of a by-law, the majority attempted to bind all stockholders, including those not represented at the meeting when the by-law was approved. The majority opinion, taking the view that this type of agreement was valid but that the mechanics were in error, makes this an especially interesting case since the other two justices not only took opposite views from the majority but also from each other. Justice Angstman agreed that the shareholders could make a valid contract whereby they surrendered the right to cumulative voting but disagreed with the majority in their holding that such an agreement could not be expressed in the form of a by-law to which the shareholder assented. He stated, "I know of no rule of law which prescribes any particular form that such a contract must take." Justice Bottomly stated, as did the majority, that the Montana Constitution prohibited the by-law in question, and stated further, "It is my opinion that any contract between stockholders for the election of directors or trustees of such a corporation other than prescribed by the Constitution is void and courts have no more power or authority than has an individual or a combination of stockholders to ignore, set aside or disrupt this established public policy of the state." Thus Justice Bottomly was of the opinion that the shareholders agreement, being contra to the constitutional provision, was invalid per se, and could not be sustained as a contract among the shareholders regardless of the form they choose for expressing their agreement.

Justice Bottomly's opinion has the support of a group of cases which seem to state that where the by-law is invalid because it is unconstitutional or contrary to public policy, the by-law may not be enforced as a contract among the shareholders, even as against a shareholder assenting to it.² The New York Court of Appeals would apparently approve of Justice Bottomly's reasoning.³ In the *Benintendi* case the New York Court, holding that an agreement expressed in the form of invalid by-laws was unenforceable because it was in contravention of state policy, stated that:

Those who own all the stock of a corporation may, so long as they conduct the corporate affairs in accordance with the statutory rules, deal as they will with the corporation's property (always assuming nothing is done prejudicial to creditors' rights). They may, individually, bind themselves in advance to vote in a certain way or for certain persons. But this State has decreed that every stock corporation chartered by it must have a representative government, with voting conducted conformably to the statutes, and the power of decision lodged in certain fractions, always more than half, of the stock. That whole concept is destroyed when the stockholders, by agreement, by-law, or certificate of incorporation provision, as to unanimous action, give the minority interest an absolute, permanent, all-inclusive power of

2. See collection of cases 159 A.L.R. 296.

3. *Beneintendi v. Kenton Hotel*, 294 N.Y. 112, 60 N.E.2d, 159 A.L.R. 280 (1945).

veto. We do not hold that an arrangement would necessarily be invalid, which, for particular decisions, would require unanimous consent of all stockholders.⁴

Thus the court supports the view that a by-law which contravenes public policy will not be enforced as a contract. The dissenting opinion in the *Benintendi* case (a four to three decision) denied that there was any public policy involved. The dissenters felt that the stockholders' agreement which had been expressed as a by-law could be specifically enforced through the injunctive process of an equity court by forbidding a breach of the agreement.⁵ The dissenting opinion stated, "To implement their agreement they chose a method forbidden by statute. The agreement, however was valid without the method chosen." Even though the dissenters wanted the agreement upheld, they conceded that, "Despite power of 100% of the stockholders, they may not write into a certificate of incorporation nor adopt in by-laws provisions contrary to applicable statutes. Since corporations are creatures of statute, their charters and by-laws must conform to the will of the creating power."

The basis for the court's distinction in the *Sensabaugh* case, between shareholders' contracts made without the realm of the corporate structure and those carried on or attempted within the corporate structure, is apparently derived from the *Buck* case, a recent Nebraska decision.⁶ Although the Nebraska case did not involve an invalid by-law, the facts were very similar to those in the Montana case in that there was a constitutional provision requiring cumulative voting. The shareholders entered into a separate agreement which the defendant contended was in violation of the constitution. The court, in enforcing the agreement, after referring to the constitutional provision requiring cumulative voting and reciting the provision that such directors or managers shall not be elected in any other manner, said:

The latter prohibition, as we view it, operates to prevent a corporation by its articles of incorporation, by-laws, or any act of its directors or stockholders from depriving a stockholder of the right to vote his stock in the manner specified in the Constitution and statute. But such provision does not purport to limit the right of the stockholder to contract with reference to his stock. It grants him a right or privilege which he may or may not exercise as he sees fit, but it is one of the corporation of any agency cannot deprive him. Neither the constitutional provision nor statute purports to limit the right of the stockholder to contract with other stockholders with respect to such a right.⁷

This reasoning is further supported by a Missouri case which states, "A construction has nowhere been given . . . within our knowledge or research, so as to constitute it a prohibition or restriction on the right of

4. *Id.* 159 A.L.R. at 283.

5. *Id.* 159 A.L.R. at 289.

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

7. *Id.* 62 N.W.2d at 294.

stockholders to make their contracts which violate no rule of the common law, and which affect no rights, except their own."⁸

It has been suggested that the court in the *Buck* case was influenced by the fact that the corporation involved was a closely-held corporation and that in that type of case there is greater merit in decreeing enforcement of the stockholders' agreement than in the case of a corporation with many shareholders.⁹ This thought cannot, of course, be overlooked since in the closely-held corporation the shareholders' transactions are usually culminated as a result of face-to-face negotiations. But it is submitted that in a corporation with numerous widely scattered shareholders, the placing of a shareholders' agreement in the by-laws is the most practical method to carry out the shareholders' wishes. Even though practical, there is a problem presented when all the shareholders will not assent to the by-law. Under the general rule of contract law, the contract binds only those assenting to the contract, while the general rule of corporation law states that a valid by-law is binding on all shareholders including those who resisted its adoption. Thus the problem becomes significant when a court holds the by-law invalid—will the court hold those not assenting to the by-law as bound by the agreement? As indicated in the *Sensabaugh* and *Buck* cases, the agreement will only be sustained as to those assenting to it.

Although the cases in which the question of enforcing an invalid by-law as a contract have been relatively limited, it is a reasonably safe statement that when a by-law, although held to be invalid, is not opposed to public policy, it will be held to be a contract among those assenting to it. This type of question will still be presented to the courts in the future for a determination of the public policy question.

These cases generally arise with the plaintiff attempting to have the court enjoin the breach of the agreement and the defendant claiming that "public policy" would be defeated by the enforcement of the agreement. The dissenting opinion in the *Benintendi* case in partially answering such a contention by the defendant stated:

The State does not need the assistance or leadership of Dondero in vindicating its public policy. That statement is but a paraphrase of the words of Gummere, Ch. J., . . . although in a different situation as follows: "So far as the vindication of our laws and policies is concerned, it is enough to say that the state does not need his aid for any such purpose, and that his assumed status as a representative of the state cannot be recognized. If we consider him as a mere individual, seeking to repudiate for his own personal advantage a fraud upon the state in which he was so long a participant, it is entirely settled that the court of Chancery is not open to him for any such purpose. . . ."¹⁰

8. *State ex rel. Frank v. Swanger*, 190 Mo. 561, 89 S.W. 872, 876, 2 L.R.A., N.S. 121 (1905).

9. Recent cases, 108 Pa. L. Rev. 754 (1960).

10. *Benintendi v. Kenton Hotel*, 294 N.Y. 112, 60 N.E.2d, 159 A.L.R. 280, 290 (1945).

CONCLUSIONS

The practical question presented by these cases is that to prevent unnecessary litigation the thoughtful attorney must concern himself with the appropriate method for expression of the shareholders' agreement which he is drafting. If a court followed the line of reasoning as in the Montana decision, then an agreement "without the realm of corporate structure" would seem to be called for, but when the contract is not one which is likely to be held as opposed to "public policy," then a by-law provision might be appropriate to bind the greatest amount of shareholders. In any event, it is a question which must be given due consideration before the agreement is submitted to the shareholders.

The proposed Wyoming Business Corporation Act eliminates this problem when the agreement concerns the transferability and sale of shares. Section 32 reads as follows:

The articles of incorporation or the by-laws of a corporation, or an agreement among all the shareholders of a corporation may impose restrictions on the sale or other disposition of its shares, and on the transfer thereof, which do not unreasonably restrain or prohibit transferability if each such restriction is copied at length or in summary form on the face, or so copied on the back and referred to on the face, of each certificate representing shares to the transfer of which restriction applies.

The importance of this provision is readily appreciated by making a brief survey of the cases involving the enforceability of an invalid by-law as a contract. Most of the cases cited involving this proposition involve by-laws restricting or regulating the right of shareholders to sell or transfer their stock.¹¹

FLOYD R. KING

THE END OF THE TRUSTEE IN BANKRUPTCY AS THE IDEAL
GENERAL CREDITOR: LEWIS v. MANUFACTURERS
NATIONAL BANK OF DETROIT

The second sentence of Section 70, sub. c of the Bankruptcy Act, popularly called the "strong-arm clause," reads as follows:

The trustee, as to all property, whether or not coming into possession or control of the court, upon which a creditor of the bankrupt could have obtained a lien by legal or equitable proceedings at the date of bankruptcy, shall be deemed vested as of such date with all the rights, remedies, and powers of a creditor then holding a lien thereon by such proceedings, whether or not such a creditor actually exists.¹

The rights therein conferred upon the trustee are not derivative from the rights of actual creditors; these rights are hypothetical.² The trustee's

11. Annot., ... Invalid Bylaw as Contract, 159 A.L.R. 291.

1. 11 U.S.C. § 110 (c) (1952 ed.)

2. Ibid. "... whether or not such a creditor actually exists."