CHAPTER SEVEN

SHAREHOLDERS

Section 7.01 Generally

RCW 23B.01.400(24) defines "shares" to mean:

the units into which the proprietary interests in a corporation are divided.

RCW 23B.01.400(25) defines a "shareholder" to mean:

> the person in whose name shares are registered in the records of a corporation or the beneficial owner of shares to the extent of the rights granted by a nominee certificate on file with a corporation.

Although the current Washington Act uses the terms "share" and "shareholder," the terms "share" and "stock" and the terms "shareholder" and "stockholder" are synonymous. These terms are used interchangeably throughout this book.

A. Shareholders are distinct from corporation.

A corporation is an artificial person, created by statute, which "is an entity separate, independent and apart from the associates who compose its stockholders." *Sneed v. Santiam River Timber Co.*, 122 Or 652, 655, 260 P 237, 238 (1927).

> A corporation is by legislative enactment, an entity. It is such, separate and distinct from the persons who own its stock. This statutory entity, so long as it exists, is the owner of all of the property which the corporation possesses. An individual shareholder has no property interest in its physical corporate assets. The persons who are shareholders have only rights of participation in the management of the corporate affairs. (citations omitted) *State of California v. Tax Commissioner of State*, 55 Wash 2d 155, 157, 346 P2d 1006, 1008 (1959).

"[A] corporation is a legal entity separate from its shareholders, directors, and officers." *Lee v. Mitchell*, 152 Or App 159, 176, 953 P2d 414, 425 (1998).

> One of the hallmarks of Anglo-American corporate law is the status of the corporation as a distinct entity, an artificial person separate from its shareholders, having the capacity to own property and to sue and be sued. As our supreme court stated over half a century ago, "[t]he corporation is an independent legal entity, separate and distinct from its stockholders." From this basic principle it follows that a corporation's "capital stock belongs to the corporation considered as a legal person; the shares are the property of the individual shareholders." Shareholders have a claim for their aliquot share of corporate assets only "*after* the debts and liabilities of the corporation have been satisfied and the assets have been distributed in liquidation." Because of separate identity, shareholders simply are unable to sell corporate assets; they can sell only their shares. (emphasis in original; citations omitted) *SFN Shareholders Grantor Trust v. Indiana Department of State Revenue*, 603 NE2d 194, 197-8 (Ind Tax 1992).

Since a corporation "is an entity separate and distinct from the individual owning all of the stock," even a sole shareholder is not deemed the owner of corporate property. *Patterson v. Ford*, 167 Wash 121, 125, 8 P2d 1006, 1008 (1932).

B. Directors, not shareholders, manage corporation.

Directors, not shareholders, manage the corporation. Officers and other agents act on the corporation's behalf. Shareholders have little

power with respect to the actual management of their corporation. The shareholders' role generally is limited to electing directors and to voting on extraordinary corporate events put before the shareholders by the board of directors. *Lycette v. Green River Gorge, Inc.*, 21 Wash 2d 859, 862, 153 P2d 873, 875 (1944); *Fidelity & Casualty Company of New York v. Central Bank of Houston*, 672 SW2d 641 (Tex App 1984); *Kelly v. Galloway*, 156 Or 301, 66 P2d 272, 68 P2d 474 (1937); *Baillie v. Columbia Gold Mining Co.*, 86 Or 1, 16, 166 P 965, 969, 167 P 1167 (1917).

> The power of management of the corporate affairs and the power to contract so as to bind the corporation is vested primarily in the board of directors and not in the stockholders; the principal rights of the latter, in ordinary business or trading corporations, are to attend and vote at corporate meetings, to pass and amend by-laws, to elect directors, to participate in dividends and profits, and to receive their proportionate shares of the corporate property or its proceeds upon dissolution and winding up of the corporation after payment of its debts. *Trethewey v. Green River Gorge, Inc.*, 17 Wash 2d 697, 724, 136 P2d 999, 1010 (1943).

However, these principles do not necessarily apply to a Washington corporation which has eliminated its board of directors pursuant to RCW 23B.08.010(3) or where its shareholders have entered into an agreement pursuant to RCW 23B.07.320 to eliminate the board of directors or otherwise change many of the fundamental rules which normally govern a corporation. *See:* Section 4.07 of this book. However since these options are seldom exercised, nearly all Washington corporations have a board of directors.

C. Shareholders are not agents of corporation.

Although a corporation may appoint an individual shareholder as its agent, no shareholder is inherently the agent of the corporation. Shareholders have no inherent right to act on behalf of the corporation, either individually or collectively. *Opportunity Christian Church v. Washington Water Power Co.*, 136 Wash 116, 238 P 641 (1925); *Feenaughty v. Beall*, 91 Or 654, 178 P 600 (1919); *Powell v. Oregonian Ry. Co.*, 38 F 187 (D Or 1889). The United States Supreme Court has held:

> In *Smith v. Hurd*, 12 Met 371, 385, the relations of stockholders to the rights and property of a banking corporation are stated with his usual clearness and precision by Chief Justice Shaw, speaking for the Supreme Court of Massachusetts, and the same doctrine applies to the relations of stockholders in all business corporations. Said the Chief Justice: "The individual members of a corporation, whether they should all join, or each act severally, have no right or power to intermeddle with

> the property or concerns of the bank, or call any officer, agent or servant to account, or discharge them from any liability. Should all the stockholders join in a power of attorney to any one, he could not take possession of any real or personal estate, any security, or chose in action; could not collect a debt, or discharge a claim, or release damage arising from any default; simply because they are not the legal owners of the property, and damage done to such property is not an injury to them. Their rights and their powers are limited and well defined." *Humphreys v. McKissock*, 140 US 304, 312-3 (1891).

D. Shareholders' role may be expanded under RCW 23B.07.320.

Under the Washington Act, by written agreement the shareholders may eliminate or restrict the discretion or powers of the board of directors or may reallocate the division of voting powers between the shareholders and the directors. RCW 23B.07.320(1). *See:* Section 4.07 of this book.

Some of the principles discussed in this Chapter do not necessarily apply to a Washington corporation which has eliminated its board of directors pursuant to RCW 23B.08.010(3) or where its shareholders have entered into an agreement pursuant to RCW 23B.07.320 to eliminate the board of directors or otherwise change many of the fundamental rules which normally govern a corporation. A discussion of RCW 23B.07.320 appears in Section 4.07 of this book.

Section 7.02 Subscriptions & Other Contracts to Purchase Shares

A "subscription" is an offer to acquire shares directly from the corporation. As discussed below, a subscription before incorporation may also operate as a contract among the subscribers. Subscriptions are governed by general principles of contract law. *Finley v. Curley*, 54 Wash App 514, 774 P2d 538 (1989); *Jackson v. Southern Pan and Shoring Co.*, 258 Ga 401, 369 SE2d 239 (1988). Absent a statute or provision in the articles of incorporation to the contrary, a subscription may be either written or oral and the subscription need not be in any particular form. *Molina v. Largosa*, 465 P2d 293 (Haw 1970); *White County Guaranty Savings and Loan Association v. Searcy Federal Savings & Loan Association*, 241 Ark 878, 410 SW2d 760 (1967); *Gibson v. Oswalt*, 269 Mich 300, 257 NW 825 (1934); Kummert, *Stock Subscription Law for Practitioners*, 63 WASH L REV 21, 25 (1988).

RCW 23B.06.200 does not specify the form that a subscription need take nor does it require that a subscription be in writing. A limited number of cases have applied the statute of frauds provision of Article VIII of the Uniform Commercial Code (Article 8-319) to stock subscriptions and

these cases have required that a subscription be in writing. Kummert, *Stock Subscription Law for Practitioners*, 63 WASH L REV 21, 27 (1988).

A board of directors may authorize the issuance of shares for cash or for consideration other than cash. Such consideration may include notes, other securities, and past and future services. RCW 23B.06.210(2). As to the adequacy of the consideration, the good faith determination of the board is conclusive. RCW 23B.06.210(3). *See:* Section 5.13.

Article 12, Section 6 of the Washington Constitution may limit the authority of the board of directors to issue shares for little or no consideration. Article 12, Section 6 provides:

> Corporations shall not issue stock, except to *bona fide* subscribers therefor, or their assignees; nor shall any corporation issue any bond, or other obligation, for he payment of money, except for money or property received or labor done. . . . All fictitious increase of stock or indebtedness shall be void.

See: Spokane Concrete Products, Inc. v. U. S. Bank of Washington, 126 Wash 2d 269, 892 P2d 98 (1995).

A. Definitions.

The term "subscription" describes an offer to acquire shares directly from a corporation. The term "subscription" does not include offers to purchase shares from anyone other than the corporation nor does it include an offer to acquire shares held by the corporation as a trustee for a third party.

Some courts have reserved the term "subscription" for use in connection with corporations yet-to-be-formed and used the term "contracts to purchase stock" in connection with corporations already in existence. *Sprague v. Straub*, 252 Or 507, 451 P2d 49 (1969); *Commercial State Bank v. Eilers*, 124 Or 379, 264 P 452 (1928). But the prevailing view is that an offer to purchase original issue shares constituted a "subscription," regardless of whether or not the corporation has as already been formed. 4 FLETCHER CYC CORP § 1363 (Perm Ed 1996).

Under the Washington Act, the term "subscription" applies to offers both before and after incorporation (although RCW 23B.06.200 makes some distinctions between pre-incorporation and post-incorporation subscriptions). *See:* RCW 23B.01.400(27) and RCW 23B.06.200. For example, RCW 23B.01.400(27) defines a subscriber to mean "a person who subscribes for shares in a corporation, whether before or after

incorporation." But under the Washington Act, a "subscription" is still limited to offers to acquire shares directly from a corporation, not offers made to third party owners of shares.

Persons may become shareholders of a corporation either: (i) by acquiring shares directly from the corporation; or (ii) by acquiring shares from third parties who previously purchased the shares from the corporation (or the last person in the line of such purchasers). The term "original issue" is commonly used to refer to shares acquired directly from a corporation. The term "secondary transaction" is one commonly used to refer to a transfer or resale of shares by a transferor other than an issuing corporation.

"Treasury shares" are shares which were once sold to a shareholder, but have been subsequently re-acquired by the corporation and held in a state of suspended animation - that is, treasury shares do not confer on the corporation the right to vote such shares, nor do such shares confer on the corporation the right to receive dividends or to possess any of the other rights normally associated with the ownership of shares - until the shares are again sold by the corporation. *Kisrchenbaun v. Commissioner of Internal Revenue*, 155 F2d 23 (2nd Cir), *cert denied*, 329 US 726 (1946). Some older cases do not apply the term "subscription" to offers to purchase treasury shares from a corporation.

The concept of "treasury shares" has been abandoned by the Revised Model Business Corporation Act and the current Washington Business Corporation Act. Shares re-acquired by a Washington corporation now simply disappear into the amorphous category of authorized, but unissued, shares.

***B. Subscriptions are contracts*.**

Case law generally refers to a subscription as an "agreement" or "contract," but those terms do not adequately describe the relationship created. Before a corporation is organized, a subscription may more properly be characterized as both a *contract* among the prospective shareholders and an irrevocable *offer* from the subscriber to the corporation.

> It is, first, a contract between the subscribers themselves to become stockholders, without further act on their part, immediately on the formation of the corporation and is binding from the date of the subscription; and, second, it is in the nature of a continuing offer to the proposed corporation, which, upon acceptance by it after its formation, becomes, as to each subscriber, a contract between him and the corporation. *Balfour v. Baker City Gas Co.*, 27 Or 300, 306, 41 P 164, 165 (1895).

Section 7.02

A subscription agreement entered into after incorporation is a contract between the subscriber and the corporation. RCW 23B.06.200(5). Such subscription contracts are subject to RCW 23B.06.210.

A corporation does not become a party to the subscription contract until its board of directors accepts the subscription. This usually occurs at the organizational meeting. The board of directors may properly reject any subscription offer.

A board of directors may authorize the issuance of shares for cash or for other consideration, such as notes, other securities, and past and future services. RCW 23B.06.210(2). As to the adequacy of the consideration, the good faith determination of the board is conclusive. RCW 23B.06.210(3). *See:* Section 5.13 of this book.

A written subscription entered into before incorporation is irrevocable for a six-month period after execution, unless the subscription itself provides for a different term, or unless **all** subscribers agree to its revocation. RCW 23B.06.200(1); *National Realty Co. v. Neilson*, 73 Wash 89, 131 P 446 (1913). The majority rule under the common law was that subscribers could to revoke their subscription offer anytime before acceptance, barring any agreement to the contrary. *Collins v. Morgan Grain Co*., 16 F2d 671 (9th Cir 1926).

A contract by an existing shareholder to sell his/her own shares to a third party is governed by the general rules of contract construction. *Finley v. Curley*, 54 Wash App 514, 774 P2d 538 (1989); *Lindgren v. Dowis*, 236 Ga 278, 223 SE2d 682 (1976). Such a contracct is not a "subscription" contract.

***C. Subscriber's rights & liabilities once subscription accepted*.**

A subscriber becomes liable for the subscription price as soon as the board of directors accepts the subscription and calls for payment. A subscriber acquires the status of shareholder upon the corporation's acceptance of the subscription, even though stock certificates have not been issued. *M/V La Conte, Inc. v. Leisure*, 55 Wash App 396, 777 P2d 1061 (1989); *Child v. Idaho Hewer Mines*, 155 Wash 280, 284 P 80 (1930). "An original subscriber has the rights and obligations of a stockholder, whether or not he has paid for the shares, unless the subscription is lawfully revoked." *Peifer v. DME Liquidating, Inc.*, 91 Or App 47, 753 P2d 1389 (1988), *appeal after remand*, 101 Or App 106, 789

P2d 266 (1990)(interpreting Washington law). Unless a subscription provides otherwise, a subscriber whose subscription is accepted by the corporation becomes a shareholder even if the subscriber fails to pay the consideration described in the subscription. *Babbitt v. Pacco Investors Corp.*, 246 Or 261, 425 P2d 489 (1967). *See also:* Section 3.10. of this book.

If a subscriber pays for the stock but, despite demand, the corporation refuses to deliver a share certificate, the subscriber may elect one of three remedies:

> (1) He may, is some jurisdictions, maintain a suit in equity for specific performance, and compel delivery of the stock; (2) he may treat the executory agreement as subsisting and recover the damages occasioned by the breach; or (3) he may rescind the contract and maintain an action in *assumpsit* for the recovery of the sum paid as money had and received. *Watkins v. Record Photographing Abstract Co.*, 76 Or 421, 426, 149 P 478, 480 (1915).

Under the Washington Act, a corporation "may authorize the issue of some or all of the shares . . . without certificates." RCW 23B.06.260(1). The owners of such shares must be sent a written statement containing specified information. RCW 23B.06.260(2).

D. Qualifications to acquire shares.

It was not uncommon for early case law and early statutes to either establish qualifications for shareholders or to prohibit certain persons from owning stock.

Washington law once prohibited a corporation from owning stock in other corporation. *Day v. Hecla Mining Co.*, 126 Wash 50, 217 P 1 (1923). At one time, Washington law prohibited a corporation, a majority of whose stock was owned by aliens, from owning real property in Washington. *Hastings v. Anacortes Packing Co.*, 29 Wash 224, 69 P 776 (1902). Likewise, Connecticut once barred aliens from holding stock in a Connecticut corporation. *State v. The Travelers Insurance Co.*, 70 Conn 590, 40 A 465 (1898).

Today there are few, if any, qualification requirements related to who may acquire shares. Even a minor may be a shareholder. *Wuller v. Chuse Grocery Co.*, 241 Ill 398, 89 NE 796 (1909). But a minor's contract to purchase shares is likely a voidable contract due to the minor's lack of capacity. *The Indianapolis Chair Manufacturing Co. v. Wilcox*, 59 Ind 429 (1877).

A corporate shareholder may not vote its shares in a second corporation if the second corporation owns a majority of the shares of the

first corporation. RCW 23B.07.210(2). Two corporation cannot own 100% of each other; there has to be a human being involved in ownership at some level.

***E. Miscellaneous*.**

State and federal securities laws generally apply to the sale of stock. *See:* RCW 21.20.005 *et seq*.

A more detailed discussion of shareholder liability for an unpaid subscription appears in Section 10.11 of this book.

Section 7.03 Limited Liability

The limited liability afforded to the owners of a corporation is probably the most important attribute of corporate ownership.

> A purchaser from a corporation of its own shares is not liable to the corporation or its creditors with respect to the shares except to pay the consideration for which the shares were authorized to be issued under RCW 23B.06.210 or specified in the subscription agreement under RCW 23B.06.200. RCW 23B.06.220.

Circumstances under which the shareholders may be liable for unpaid subscriptions, or otherwise liable to third parties, are discussed in Chapter Ten of this book.

Section 7.04 Meetings

There are four ways for the shareholders to take action: annual meetings (RCW 23B.07.010); special meetings (RCW 23B.07.020); court ordered meetings (RCW 23B.07.030); and an action taken without a meeting (RCW 23B.07.040). In theory, shareholders do not meet often enough for there to be "regular meetings," like those held by directors.

***A. Annual meetings*.**

Shareholders meet annually to elect directors. RCW 23B.08.030(2). The annual shareholder meeting occurs at the time set out in, or fixed in, the bylaws. RCW 23B.07.010(1).

The Washington Act provides that annual meetings are to be held at the place stated in, or fixed in accordance with, the bylaws. RCW 23B.07.010(1). Some corporations comply with this "place" requirement by including in the bylaws a provision which provides that "the annual meetings may be held at any place determined by the board of directors," or words of like effect.

If the bylaws fail to fix a place for the meeting, and also fail to provide for a mechanism for fixing such a site, the annual meeting must be held at the corporation's principal office. RCW 23B.07.010(3).

Corporate actions are not invalid simply because the corporation fails to hold its annual shareholder meeting at the prescribed time and place. RCW 23B.07.010(4).

Special rules exist for any corporation registered as an investment company under the Investment Company Act of 1940. RCW 23B.07.010(2).

***B. Special meetings*.**

A special meeting of the shareholders may only be called by those persons authorized by statute to call such meetings. *Comolli v. Comolli Granite Co.*, 233 Ga 461, 211 SE2d 750 (1975). The Washington Act provides that a special meeting may be called by the board of directors or by any person or persons authorized to call meetings by the articles of incorporation or by the bylaws. RCW 23B.07.020(2). Most commonly, the bylaws authorize one or more officers, and sometimes the board chairman, to call a special shareholder meeting. Permitting an officer to call a special shareholder meeting minimizes the time and administrative difficulties involved in calling a meeting. Absent such a provision, a two-step process would be necessary: a meeting of the board of directors would need be called and the board would, in turn, need to call a meeting of the shareholders.

A special meeting of the shareholders must be called by a corporation upon demand by shareholders holding at least ten percent of the votes entitled to be cast at the special meeting so demanded. RCW 23B.07.020(1)(b). For nonpublic companies, the articles of incorporation may increase the demand requirement up to twenty-five percent of such votes. RCW 23B.07.020(3). In a public company, this right may be limited or denied. RCW 23B.07.020(2).

NOTE: RCW 23B.01.400(21) defines a "public company" to mean:

> a corporation that has a class of shares registered with the federal securities and exchange commission pursuant to section 12 or 15 of the securities exchange act of 1934, or section 8 of the investment company act of 1940, or any successor statute.

Although shareholders may demand a meeting, they do not directly call the meeting. The corporation calls the meeting after proper demand is delivered to its secretary.

> Upon receipt of writings evidencing a demand by holders of 10 percent of the votes, the corporation (through an appropriate officer) must call the special meeting at a reasonable time and place. The shareholders' demand may suggest a time and place but the final decision on such matters is the corporation's. Official Comment to Revised Model

> Business Act § 7.02.

The corporation sets the time and place of the meeting, not the shareholders who are demanding the meeting.

The Washington Act provides that special shareholder meetings are held at the place stated in, or fixed in accordance with, the bylaws. RCW 23B.07.020(5). Some corporations comply with this requirement by including in the bylaws a provision that such meetings may be held at any place determined by the board of directors. If the bylaws fail to fix a meeting site, and fail to provide for a mechanism for fixing such a site, special meetings must be held at the corporation's principal office. RCW 23B.07.020(5).

***C. Court-ordered meetings*.**

If a corporation delays too long in calling the annual shareholder meeting, or if a corporation ignores a demand for a meeting by shareholders owning 10% or more of the shares, its shareholders may seek to have the court call a shareholder meeting. RCW 23B.07.030. If the court orders a meeting, it may set the time and place for the meeting and it may establish special rules regarding record date, notice, quorum and other matters. RCW 23B.07.030(2).

***D. Action without a meeting*.**

Shareholders may take action without a meeting. RCW 23B.07.040; *Hansen v. Singmaster Insurance Agency, Inc.*, 80 Or App 329, 722 P2d 1254, *opinion adhered to*, 82 Or App 219, 728 P2d 69 (1986), *rehearing denied*, 302 Or 594, 732 P2d 915 (1987). Generally, such action is effective only if all shareholders entitled to vote on the action consent to the action in writing. RCW 23B.07.040(1)(i).

But if the corporation is not a public company and its articles of incorporation so provide, such action may be approved:

> by shareholders holding of record or otherwise entitled to vote in the aggregate not less than the minimum number of votes that would be necessary to authorize or take such action at a meeting at which all shares entitled to vote on the action were present and voted. RCW 23B.07.040(1)(ii).

If a nonpublic company elects to permit actions to be taken by less than unanimous shareholder consent, before the date on which the action becomes effective, the corporation must give written notice to all shareholders entitled to vote on the action but who have not consented. If such a procedure is authorized by the articles of incorporation, the articles must specify the timing and form of the notice. Special rules exist

if the action constitutes a "significant business transaction" under RCW 23B.19.020(15) or if the action gives rise to dissenters' rights. RCW 23B.07.040(6).

Unless a later date is specified in the consent, an action taken by written consent becomes effective when written consents sufficient in number to authorize taking the action have been delivered to the corporation and, if so required, the advance notice period has been satisfied. RCW 23B.07.040(4). A shareholder may withdraw consent only by delivery of written notice of withdrawal, provided such notice is delivered before the action becomes effective. RCW 23B.07.040(3).

> **NOTE:** Shareholders often forget to date their signatures. It is important to verify that all shareholder signatures are dated before the consent is filed away in the corporate book.

Under certain circumstances, nonvoting shareholders must be given notice of the proposed action before the voting shareholders begin signing the consent. RCW 23B.07.040(6).

E. Bylaws should contain rules for meetings.

A corporation can and should enact bylaws to control issues of internal corporate management, issues such as shareholder meetings. RCW 23B.02.060(4); *Jacobson v. Moskowitz*, 27 NY2d 67, 313 NYS2d 684, 261 NE2d 613 (1970); *Burt v. Irvine Co.*, 224 Cal App 2d 50, 36 Cal Rptr 270 (1964). These provisions must not be inconsistent with the articles of incorporation or with the general statutes.

> It is a general rule that a corporation may enact any bylaw for its internal management so long as such bylaws are not contrary to its charter, a controlling statute, its articles of incorporation, or violative of any general law or public policy. Subject to the above qualifications, a corporation may adopt bylaws regulating the calling and conduct of corporate meetings and election of its officers. *Booker v. First Federal Savings and Loan Association*, 215 Ga 277, 280, 110 SE2d 360, 361, *cert denied*, 361 US 916 (1959).

See also: Sabre Farms, Inc. v. Jordan, 78 Or App 323, 717 P2d 156 (1986); *State ex rel Brewster v. Ostrander*, 212 Or 177, 318 P2d 284 (1957).

F. Notice.

A corporation is required to notify shareholders of the date, time, and place of each annual and special shareholder meeting. RCW 23B.07.050(1). Notice of such meetings must be given to shareholders not more than sixty days and not less than ten days before the meeting is to occur, except that notice for shareholder meetings called to vote on

four issues (i.e., on an amendment to the articles, on a plan of merger or share exchange, on certain sales of assets, and on the corporation's dissolution), must be given at least **twenty** days, and not more than sixty days, before the meeting. RCW 23B.07.050(1).

> **NOTE:** Under prior law, notice could not be given more than fifty days before the shareholder meeting. RCW 23A.08.250. As a consequence, many corporations formed before 1990 have bylaw provisions which prohibit notice to be sent more than fifty days before the meeting. For such corporations, these more restrictive bylaw provisions, not the present statute, will govern.

A notice for a special meeting, but not for an annual meeting, must include the purpose for the meeting. *Compare:* RCW 23B.07.0050(2) and (3).

Shareholders may waive proper notice of a meeting. RCW 23B.07.060. Attendance at a meeting waives improper notice, unless the shareholder objects at the beginning of the meeting. RCW 23B.07.060(2).

***G. Telephone meetings*.**

If the bylaws so permit, or if the board of directors in advance of the meeting adopt a resolution so permitting, a shareholder may participate at a shareholder meeting "by any means of communication in which all persons participating in the meeting can hear each other during the meeting." RCW 23B.07.080.

Under this statute, speaker telephones and conference calls are permitted. Passing a telephone back and forth among shareholders in the same room probably is not permitted.

The articles of incorporation or the bylaws may prohibit such telephone (or internet) participation.

***H. Record date*.**

The "record date" is the date on which a corporation determines the identity of its shareholders and of their shareholdings for purposes of notice and voting at a shareholder meeting. RCW 23B.01.400(22).

The bylaws should fix a record date, a date which can be no more than seventy days before the meeting. RCW 23B.07.070(5).

For actions taken without a meeting, the record date generally will be the date that the first shareholder signs the consent. RCW 23B.07.040(2).

I. Shareholder list.

Each corporation is required to "maintain a record of its shareholders, in a form that permits preparation of a list of the names and addresses of all shareholders, in alphabetical order by class of shares showing the number and class of shares held by each." RCW 23B.16.010(3). For the period beginning ten days prior to a shareholder meeting, and continuing through the meeting, the shareholder list must be available for inspection by any shareholder. RCW 23B.07.200(2).

Generally, a corporation can only look to the shareholder list to determine who is entitled to vote at the meeting. *State ex rel Breger v. Rusche*, 219 Ind 559, 39 NE2d 433 (1942). There are exceptions. For instance, a corporation may establish a recognition procedure which permits the beneficial owner of the shares to cast the share's vote. RCW 23B.07.230. Shareholders may vote by proxy. RCW 23B.07.220. (Proxies are discussed in Section 7.05 of this book.) If the corporation acts in good faith, it may permit a person other than the record holder to vote the shares under those circumstances described in RCW 23B.07.240.

J. Voting.

For purposes of shareholder voting, each share is generally entitled to one vote. RCW 23B.07.210. A shareholder owning five shares has five votes; a shareholder owning one share has one vote.

There is an exception. Shares owned by a corporation's subsidiary, if the corporation owns a majority interest in the subsidiary, are generally not entitled to vote. RCW 23B.07.210(2).

K. Quorum.

A quorum is the number of shareholders who must be present in order for an action of the shareholders to be binding. BLACK'S LAW DICTIONARY; *Griffith v. Sprowl*, 45 Ind App 504, 91 NE 25 (1910). The quorum necessary to vote on a matter at a shareholder meeting is a majority of the votes entitled to be cast on that matter, unless the articles of incorporation or bylaws provide otherwise. RCW 23B.07.250(1); *Gregory v. J. T. Gregory & Son, Inc.*, 176 Ga App 788, 338 SE2d 7 (1985); *Benintendi v. Kenton Hotel, Inc.*, 294 NY 112, 60 NE2d 829, 831-2 (1945). The articles of incorporation or bylaws may require a quorum of more or less than a majority, but not less than one-third of the votes entitled to be cast. RCW 23B.07.270(1).

Voters may be present at the meeting either in person or by proxy. RCW 23B.07.220(1). (Proxies are discussed in Section 7.05 of this book.) Under the conditions described above, voters may participate in the meeting by telephone.

A quorum is measured at the start of the meeting. Once a quorum is achieved, a quorum is deemed present throughout rest of the meeting, and any adjournments thereof, even though some shareholders leave the meeting before any particular vote. RCW 23B.07.250(2). This is different than the quorum rule for director meetings. RCW 23B.08.240(3).

If voting is required by voting group, a majority of each voting group, participating as a voting group, is required for a quorum. RCW 23B.07.250(1).

Unless the articles of incorporation, the bylaws, or a statute requires a higher vote, a majority of the votes present (in person or by proxy), entitled to vote on that issue and voting, are required to pass a matter put to a vote by the shareholders.

There are exceptions. RCW 23B.07.280 provides that directors are elected by cumulative voting, unless the articles of incorporation provide otherwise. *See:* Section 5.03. In general, a two-thirds supermajority is required to approve a merger or share exchange, RCW 23B.11.030(5), to approve the sale of substantially all assets out of the ordinary course of business, RCW 23B.12.020(5), or to approve dissolution of the corporation, RCW 23B.14.020(5). *See:* Chapter Twelve. While a public company may require only a simple majority vote to amend its articles of incorporation, other corporations must obtain approval from two-thirds of their shares. RCW 23B.10.030(5). If the bylaws contain a greater quorum or voting requirement, amendment of the bylaws requires a greater vote. RCW 23B.10.210(2).

***L. Minutes*.**

RCW 23B.16.010(1) requires that minutes of shareholder meetings be kept. *See:* Section 4.04 of this book. Nevertheless, at least in close corporations and in family-owned corporations, the failure to keep minutes will not invalidate the actions taken. *Block v. Olympic Health Spa, Inc.*, 24 Wash App 938, 604 P2d 1317 (1979); *Barrett v. Joseph Mayer & Bros.*, 119 Wash 323, 205 P 396 (1922).

> Although it would have been more orderly and businesslike, if the directors of the corporation had evidenced the understandings between the different stockholders by formal resolutions, rather than to proceed in the informal manner which they chose, nevertheless in such an instance as this, wherein all the stock of the corporation is owned by a

> few, and all or most of the stockholders are actively engaged in the enterprise of the corporation, it is often the practice to transact ordinary business without formal resolutions. (citations omitted) *Roles v. Roles Shingle Co.*, 147 Or 365, 371, 31 P2d 180, 182 (1934).

See also: McMunn v. ML&H Lumber, Inc., 247 Or 319, 429 P2d 798 (1967); *Galler v. Galler*, 32 Ill2d 16, 203 NE2d 577 (1964); *In re B-F Building Corp.*, 284 F2d 679 (6th Cir 1960); *Alpha Phi of Sigma Kappa v. Kincaid*, 180 Or 568, 178 P2d 156 (1947). *See also:* Section 5.06 of this book.

M. Attendance by attorneys & other nonshareholders.

It is unclear whether an individual shareholder has a right to have the shareholder's attorney or other advisor present during a meeting. Orlinsky, *Conduct unbecoming a stockholder?*, 8 BUS L TODAY 20 (Jan/Feb 1999). As a practical matter, the shareholder need only grant a proxy for one share to the attorney or advisor to confer necessary status on such attorney or advisor to permit the attorney or advisor to attend.

N. Rules governing meeting conduct.

The American Bar Association Corporate Governance Committee has established a Subcommittee on the Conduct of Directors' and Stockholders' Meetings. This Subcommittee has published Guidelines for the Conduct of Stockholders' Meetings.

Other rules regarding the shareholders' meetings are discussed in Orlinsky, *Conduct unbecoming a stockholder?*, 8 BUS L TODAY 20 (Jan/Feb 1999). Mr. Eric G. Orlinsky is the chair of the ABA Subcommittee.

Section 7.05 Proxies

The right of a shareholder to vote is one of the most important rights incident to stock ownership. *Washington State Labor Council v. Federated American Insurance Co.*, 78 Wash 2d 263, 474 P2d 98 (1970).

At common law, shareholders could only vote in person, not by proxy. *Westland Development Co. v. Saavedra*, 80 NM 615, 459 P2d 141 (1969); *Klein v. United Theaters Co.*, 80 Ohio App 173, 75 NE2d 67, 70 (1947); *Harvey v. Linville Imp. Co.*, 118 NC 693, 24 SE 489 (1896). Today, a shareholder may vote by proxy.

A "proxy" is a:

> Written authorization given by one person to another so that the second person can act for the first, such as that given by a shareholder to someone else to represent him and vote his shares at a shareholders' meeting. Depending on the context, proxy may also refer to the grant of authority itself (the appointment), or the document granting the authority (the appointment form). BLACK'S LAW DICTIONARY (6th Ed 1990).

Section 7.05

The Delaware courts have described a proxy as follows:

> A "proxy" or "proxy card" is merely written evidence of an agency relationship in which a principal (the shareholder of record entitled to vote) authorizes an agent (the person designated on the proxy card) to vote the principal's shares with respect to the matters and in the manner specified in the proxy. *Parshalle v. Roy*, 567 A2d 19, 27 (Del Ch 1989).

The right to vote by proxy is not a general or common law right, but rather a right granted and governed by statute. *Westland Development Co. v. Saavedra*, 80 NM 615, 459 P2d 141 (1969); *Skora v. Great Sweet Grass Oils Limited*, 30 Misc 2d 572, 205 NYS2d 98 (1960); 14 *Op Or Atty Gen* 162 (1929). In Washington, the right of shareholders to vote by proxy is granted and governed by RCW 23B.07.220.

NOTE: Proxy solicitations for most public companies are subject to detailed rules promulgated under the Securities Exchange Act of 1934, the Public Utility Holding Company Act of 1935, and/or the Investment Company Act of 1940. The rules promulgated by the federal Securities & Exchange Commission under these three statutes do not apply to corporations which do not otherwise fall within the scope of these federal Acts. *Carter v. Portland General Electric Co.*, 227 Or 401, 362 P2d 766 (1961).

The right to vote by proxy may not be taken away from a shareholder by the articles of incorporation, by the bylaws or by resolution of the board of directors. But a corporation may adopt rules regulating the exercise of the right to vote by proxy, so long as such rules "are not unreasonable, arbitrary, or capricious." *Dixie Electric Power Association v. Hosey*, 208 So2d 751, 753 (Miss 1968); 14 *Op Or Atty Gen* 162 (1929).

Subject to such reasonable rules, a proxy may be given to any person. *People's Home Sav. Bank v. Superior Court of City & County of San Francisco*, 104 Cal 649, 38 P 452 (1894); 14 *Op Or Atty Gen* 162 (1929). A proxy given to a corporation's board of directors, as a group, should be voted as a majority of the board so determines. *Keough v. Kittleman*, 74 Wash 2d 814, 447 P2d 77 (1968). Proxies may be accompanied by secret instructions to the proxy-holder. *State ex rel Lally v. Cadigan*, 103 Wash 254, 174 P 965 (1918).

Washington law requires a proxy to be in writing, but otherwise, the statute does not set out any particular requirements as to the content of a proxy. RCW 23B.07.220(2). The Delaware courts have held that a proxy "must appoint someone to vote the shares and it must include some indication of authenticity, such as a signature." (citations omitted) *Lobato*

v. Health Concepts IV, Inc., 606 A2d 1343, 1347 (Del Ch 1991).

A proxy is presumed effective for eleven months, unless a shorter or longer period is expressly set out in the proxy. RCW 23B.07.220(3); *Williams v. Williams*, 427 NE2d 727 (Ind App 1981), *rehearing granted in part*, 432 NE2d 417 (1982).

A proxy is generally revocable by the shareholder at any time, even if the proxy states on its face that it is irrevocable. *McKelvie v. Hackney*, 58 Wash 2d 23, 360 P2d 746 (1961); *State ex rel Everett Trust & Savings Bank v. Pacific Waxed Paper Co.*, 22 Wash 2d 844, 157 P2d 707 (1945); *State ex rel Breger v. Rusche*, 219 Ind 559, 39 NE2d 433 (1942); *Bridgers v. First Nat. Bank of Tarboro*, 152 NC 293, 67 SE 770 (1910).

There is an exception to this rule. A proxy "coupled with an interest" is irrevocable, unless the proxy itself provides otherwise. RCW 23B.07.220(4) provides a non-exhaustive list illustrating interests which constitute appointments "coupled with an interest":

> (a) A pledgee;
>
> (b) A person who purchased or agreed to purchase the shares;
>
> (c) A creditor of the corporation who extended it credit under terms requiring the appointment;
>
> (d) An employee of the corporation whose employment contract requires the appointment; or
>
> (e) A party to a voting agreement created under RCW 23B.07.310.

See also: State ex rel Everett Trust & Savings Bank v. Pacific Waxed Paper Co., 22 Wash 2d 844, 157 P2d 707 (1945).

Once the "interest" with which the proxy is coupled is extinguished, the proxy becomes a revocable proxy. RCW 23B.07.220(6).

Proxy rights are important rights and courts are reluctant to apply rules which disenfranchise a shareholder by disqualifying his/her proxy.

> a shareholder, who through inadvertence, mistake, or other reasonable cause is unable to vote or is prevented from casting his vote or his proxy votes during the regular time of balloting, will not be precluded from voting after the balloting has closed and before the final results are officially announced; provided, such belated voting is not prohibited by statute, corporate bylaw, or other officially authorized and announced rules and is free of fraud, bad faith and/or overreaching. *Washington State Labor Council v. Federated American Insurance Co.*, 78 Wash 2d 263, 272, 474 P2d 98, 103-4 (1970).

See also: People's Home Savings Bank v. Superior Court of San Francisco, 104 Cal 649, 38 P 452 (1894).

A corporation is entitled to recognize the authority of a proxy, except for any express limitations appearing within the written proxy itself. RCW 23B.07.220(8).

Section 7.06 Dividends & Other Distributions

A distribution is a transfer of corporate property to the shareholders. Distributions include dividends.

The Washington Act defines the term "distribution" to mean:

> a direct or indirect transfer of money or other property, except its own shares, or incurrence of indebtedness by a corporation to or for the benefit of its shareholders in respect to any of its shares. A distribution may be in the form of a declaration or payment of dividend; a purchase, redemption, or other acquisition of shares; a distribution of indebtedness; or otherwise. RCW 23B.01.400(6).

Corporate "profits" and "dividends" are not synonymous. *Boothe v. Summit Coal Mining Co.*, 55 Wash 167, 104 P 207 (1909)(Rudkin concurring). "It is fundamental that corporate earnings, though amounting to corporate assets, are not the equivalent of dividends until declared such by the directors of the corporation." *In re Clark's Trust*, 29 Misc 2d 253, 217 NYS2d 396, 399 (1961).

Dividends are usually distributed pro rata among the shares of the class receiving the dividend. *Cobb v. Galloway*, 167 Or 604, 119 P2d 285 (1941). Both distributions and dividends may involve transfers of cash or of other property. *Grants Pass Hardware Co. v. Calvert*, 71 Or 103, 142 P 569 (1914).

Directors, not shareholders, decide when the corporation will issue a dividend or other distribution. RCW 23B.06.400(1). "In most states, the power to declare dividends is vested solely in the directors." *United States v. Byrum*, 408 US 125, 141 n 19 (1972). A corporation has broad power to distribute its assets. *Spokane Concrete Products, Inc. v. U. S. Bank of Washington*, 126 Wash 2d 269, 892 P2d 98 (1995). There may be exceptions to this rule. *See:* Sections 4.02 and 4.07 of this book.

Dividends and other distributions are discussed in much greater detail in Section 4.02 of this book. The power of the directors to make distributions and director liability for improper distributions are discussed Section 5.08 and 9.07 of this book.

Section 7.07 Preemptive Rights

A. Generally.

A preemptive right is the right of all shareholders to maintain their proportionate ownership in a corporation. It is the right:

> granted on uniform terms and conditions prescribed by the board of directors to provide a fair and reasonable opportunity to exercise the right to acquire proportional amounts of the corporation's unissued shares upon the decision of the board of directors to issue them. RCW 23B.06.300(1).

Washington did not statutorily recognize preemptive rights until it adopted (with modifications) the Model Business Corporation Act, which became effective July 1, 1967. Kummert, "The Financial Provisions of the New Washington Business Corporation Act," 41 WASH L REV 207, 221 (1966). When it did so, the Legislature enacted a statute which provided that all Washington corporations have preemptive rights, unless the articles of incorporation provide otherwise. RCW 23A.08.220.

When Washington revised its Act in 1990 to closely track the Revised Model Business Corporation Act, it left in place the presumption in favor of preemptive rights, the presumption first adopted in 1967. Washington did **not** adopt the Revised Model Act provision that provides that preemptive rights exist only when the articles of incorporation specifically state that they exist. Compare RMBCA § 6.30 with RCW 23B.06.300(1).

Corporations formed in Washington before July 1, 1967 may not have preemptive rights, even though their articles of incorporation are silent on this issue. *Seattle Trust & Savings Bank v. McCarthy*, 94 Wash 2d 605, 617 P2d 1023 (1980); *State ex rel Swanson v. Perham*, 30 Wash 2d 368, 191 P2d 689 (1948). This is not true, however, if such a pre-1967 corporation amended its articles of incorporation after the effective date of the 1967 act and the amendment is deemed to have conferred "significant benefits made available by" the 1967 Business Corporation Act (or later Acts). By so amending their articles of incorporation, such pre-1967 Act corporations are deemed to have preemptive rights even though their amended articles of incorporation are silent on this issue. *Golconda Mining Corp. v. Hecla Mining Co.*, 80 Wash 2d 372, 494 P2d 1365 (1972).

> **NOTE:** Based on the above, it is the preferred practice to state specifically in the articles of incorporation whether or not the shareholders have, or do not have, preemptive rights.

Section 7.07

While preemptive rights are extremely rare in any corporation with a large number of shareholders, such rights are more common in closely held corporations. Preemptive rights give minority shareholders a chance to maintain their ratio of ownership.

EXAMPLE: A, B, and C each contribute $10,000 to ABC, Inc. and each receives 100 shares of ABC, Inc. common stock. Each is elected as a director. At a later date, animosity develops. A and B wish to decrease C's relative ownership interest. Without preemptive rights, A and B could prevail in a vote to issue an additional 1000 shares of stock to themselves. (A and B would still be bound by their fiduciary duty to the corporation regarding fair consideration for the new shares.) C's proportional ownership interest in ABC, Inc. could be reduced to insignificance.

With preemptive rights, C would first have the opportunity to purchase the number of these additional shares which is in the ratio of C's current stock ownership to the entire outstanding stock ownership and to purchase these shares on the same terms as could A and B. Thus, if C has access to sufficient funds and desires to do so, C could purchase 333.3 shares of ABC, Inc. stock and could maintain C's one-third ownership interest in ABC, Inc.

Preemptive rights are not vested rights and a corporation's articles of incorporation may be amended to eliminate preemptive rights by less than a unanimous vote. *Seattle Trust & Savings Bank v. McCarthy*, 94 Wash 2d 605, 617 P2d 1023 (1980).

Some courts have held that even though a corporation does not grant its shareholders preemptive rights, the directors have a duty not to discriminate among shareholders and, particularly, not to use their positions for their own personal advantage. *Schwartz v. Marien*, 37 NY2d 487, 335 NE2d 334 (1975); *Sheppard v. Wilcox*, 210 Cal App 2d 53, 26 Cal Rptr 412 (1963).

B. How long open?

RCW 23B.06.300 is silent on the issue of how long the offer to purchase a proportionate number of shares must remain open to the shareholders. The directors are merely required "to provide a fair and reasonable opportunity" for the shareholders to come forward and purchase their proportionate number of shares. RCW 23B.06.300(1). There are few cases on how long is "fair and reasonable." *Jones v. Morrison*, 31 Minn 140, 16 NW 854 (1883); *Bennett v. Baum*, 90 Neb 320,

133 NW 439, 442 (1911) (five days is unreasonable); *Van Slyke v. Norris*, 159 Minn 63, 198 NW 409, 412 (1924)(60 days is reasonable).

***C. Securities laws apply*.**

The time and expense associated with preemptive rights increase dramatically if a corporation has many shareholders. For instance, since preemptive rights involve the offer and sale of stock for new value, compliance with the securities laws is required. A corporation will likely need to comply with the federal securities laws and with the securities laws of each and every state in which it makes an offer (*i.e.,* every state in which one of its shareholders resides and in the state where the corporation's business office is located).

Washington has an exemption from registration for proportionate offerings made to existing shareholders which may apply for on offering pursuant to preemptive rights. RCW 21.20.320(11). But many states have no such exemption. Regardless, a corporation must comply with the disclosure requirements of the various securities laws, even if exempt from registration, and the costs associated with disclosure can be high.

Public companies rarely, if ever, grant preemptive rights to their shareholders.

***D. Exceptions to preemptive rights*.**

RCW 23B.06.300(3) provides that no preemptive rights exist with respect to:

> (a) Shares issued as compensation to directors, officers, agents, or employees of the corporation, or its subsidiaries or affiliates;
>
> (b) Shares issued to satisfy conversion or option rights created to provide compensation to directors, officers, agents, or employees of the corporation, or its subsidiaries or affiliates;
>
> (c) Shares issued pursuant to the corporation's initial plan of financing; and
>
> (d) Shares sold other than for money.

Given the scope of preemptive rights exceptions under current law, the merit of preemptive rights today is questionable. Preemptive rights offer little protection where the majority is legally astute.

For instance, a corporation is often indebted to some of its shareholders. Preemptive rights do not apply to shares issued in good faith for other than money. RCW 23B.06.300(e)(d); *Robinson v. Malheur Publishing Co.*, 272 F Supp 57 (D Or 1967).

Similarly, majority shareholders are often directors, officers, and employees of the corporation. Preemptive rights do not apply to shares awarded as compensation to directors, officers, and employees. RCW 23B.06.300(3)(a).

Likewise, majority shareholders may be able to amend the articles of incorporation to eliminate preemptive rights. *McCallum v. Gray*, 273 Or 617, 542 P2d 1025 (1975).

> Then turning to the view that preemptive rights are designed to guarantee the stockholder his original fraction of voting control, we are unable to perceive any difference in the constitutional implications. We know of no authority holding, that voting rights are more sacred or less mutable than money rights. It has heretofore simply been taken for granted that voting rights, so far as the constitution is concerned, are as amendable as any other.
>
> * * *
>
> Any interpretation other than the one we feel bound to adopt would seriously impair the existing rights of the holders of a majority of the stock. They purchased their holdings under the assurance of the Delaware General Corporation Law, as well as of the terms of the particular contract of the State of Delaware with defendant, that the defendant corporation, in which they were about to buy an interest, would have the right from time to time to make amendments to its charter, at the direction and with the approval of the holders of a majority (or other specified percentage) of the stock, and would thus be in a position to adjust itself to the exigencies of changing business conditions. Similarly, the minority stockholders purchased their holdings with full notice of this same mutability. The majority, therefore, cannot now be frozen by the minority to a charter which the majority regards as out of date. *Gottlieb v. Heyden Chemical Corp.*, 33 Del Ch 82, 90 A2d 660, 667 (1952).

While the protection offered by preemptive rights may once have been worthwhile, today shareholder agreements and other contracts usually offer better protection.

E. Court protection.

If minority shareholders have preemptive rights and those rights are not honored, the minority may seek protection from the court. If either the corporation or the majority has acted improperly, a court may require the corporation to issue minority shareholders a proportionate number of shares at the same price paid by the majority. *Cressy v. Shannon Continental Corp.*, 177 Ind App 224, 378 NE2d 941 (1978); *Browning v. C & C Plywood Corp.*, 248 Or 574, 434 P2d 339 (1968).

F. Related issue.

A discussion of the duty that the majority shareholders owe to minority shareholders appears in Sections 7.10 and 7.11 of this book.

Section 7.08 Voting Trusts

A. Defined.

A voting trust is a device through which some or all of the shareholders transfer the voting rights of their shares to a trustee or trustees, thus pooling the votes of those shares with the votes of the other shares participating in the trust. In a voting trust, a shareholder retains all other ownership rights in the stock (*e.g.*, the right to dividends and other distributions).

> A voting trust as commonly understood is a device whereby two or more persons owning stock with voting powers, divorce the voting rights thereof from the ownership, retaining to all intents and purposes the latter in themselves and transferring the former to trustees in whom the voting rights of all the depositors in the trust are pooled. *Peyton v. William C. Peyton Corp.*, 194 A 106, 111 (Del Ch 1937), *reversed on other grounds*, 7 A2d 737 (Del Supr 1939).

All trusts which hold stock are not voting trusts. A voting trust can be distinguished from other trusts which own and vote stock by the following criteria:

> (1) the voting rights of the stock are separated from the other attributes of ownership; (2) the voting rights granted are intended to be irrevocable for a definite period of time; and (3) the principal purpose of the grant of voting rights is to acquire voting control of the corporation. (citations omitted). *Jackson v. Jackson*, 178 Conn 42, 420 A2d 893, 895 (1979).

See also: Oceanic Exploration Co. v. Grynberg, 428 A2d 1 (Del 1981).

B. Old rule - disfavored.

Courts were initially hostile to voting trusts, particularly voting trusts in which less than all shareholders participated. *Oceanic Exploration Co. v. Grynberg*, 428 A2d 1, 7 (Del 1981); *Kaufman v. Lombard*, 100 Or 378, 197 P 314 (1921); *Bridges v. First Nat. Bank of Tarboro*, 152 NC 293, 67 SE 770 (1910); *Bostwick v. Chapman*, 60 Conn 553, 24 A 32 (1890).

Beginning with a voting trust statute adopted by New York in 1908, followed by a pattern of condoning voting trusts in various versions of the Model Business Corporation Act, and followed by the eventual adoption of such provisions by nearly all states, judicial hostility to voting trusts has virtually disappeared. Official Comment to RMBCA § 7.30; 5 FLETCHER CYC CORP § 2080.1 (Perm Ed 1996). *See also: Jones v. Wallace*, 291 Or 11, 628 P2d 388 (1981); *Oceanic Exploration Co. v. Grynberg*, 428 A2d 1, 7-8 (Del 1981).

C. Modern view - permitted.

The modern view is that voting trusts are valid, even in the absence of a statute, provided no improper motive or object is demonstrated. H.W. BALLANTINE, BALLANTINE ON CORPORATIONS 146 (1946).

Washington recognized voting trusts as valid as early as 1911. *Winsor v. Commonwealth Coal Co.*, 63 Wash 62, 114 P 908 (1911).

> Whether a voting trust agreement is void as a matter of public policy is one upon which the courts have drawn many different conclusions. While it is stated broadly in many of the text-books and annotated notes that the courts have held on the one side that such contracts are void as against public policy and other courts have held they are not invalid, we are of the opinion that in most, if not quite all, of the cases to which our attention has been called the courts have, notwithstanding certain broad statements, inclined to look to the facts and equities of the particular case. As, for instance, where the duration of the trust agreement was fixed for a time unreasonably long, or without a definite period, or beyond the life of any of the participators, or where such agreements were made upon condition of an office to be granted, or for the sole benefit of the parties to the agreement and not for the general welfare of the corporation, or in fraud of the rights of the corporation or the other stockholders, the contract has been held void.
>
> On the contrary, it has been held where an agreement is made in good faith and is for the betterment of the corporation and apparent advantage of all of the stockholders, or to protect the security which sustains the corporation, and it does not appear that any illegal advantage is sought and the agreement is freely and voluntarily entered into, such contracts are not, in and of themselves, contrary to public policy. *Clark v. Foster*, 98 Wash 241, 244, 167 P 908, 909 (1917).

See also: Day v. Hecla Mining Co., 126 Wash 50, 217 P 1 (1923).

C. Current law.

RCW 23B.07.300 specifically recognizes voting trusts and sets out the procedure which must be followed in establishing and operating such trusts. The statute requires that a copy of the trust agreement and the names and addresses of all trust participants be delivered to the corporation. This simple disclosure requirement eliminates the possibility that the voting trust may be used to create "secret, uncontrolled combinations of stockholders to acquire control of the corporation to the possible detriment of non-participating shareholders." *Lehrman v. Cohen*, 222 A2d 800, 807 (Del 1966).

A voting trust is valid for no more than ten-years. RCW 23B.07.300(2). A voting trust may be extended for additional periods of not more than ten years each if some or all of the parties to the agreement assent in writing and the voting trustee delivers copies of the extension agreement and a list of beneficial owners to the corporation. RCW 23B.07.300(3). The extension agreement only binds those parties who

sign it. *Id*.

The Official Comments to the Revised Model Act indicates that a voting trust for more than ten years is valid, but only for its first ten years. Official Comment to RMBCA § 7.30. One older Washington case held that a voting trust for more than ten years is wholly invalid, not merely invalid for the excess period. *Hanley v. Most*, 9 Wash 2d 429, 115 P2d 933 (1941).

RCW 23B.07.310 specifically recognizes shareholder voting agreements other than voting trusts. Contracts granting shareholders the right to purchase each other's stock under specified circumstances are a common type of such agreement. *See, for example: Card v. Stirnweis*, 232 Or 123, 374 P2d 472 (1962). The bylaws are generally **not** an example of such a shareholder agreement. *Jones v. Wallace*, 291 Or 11, 628 P2d 388 (1981).

The trustee of a voting trust owes a fiduciary duty to its shareholder/beneficiaries. *Wool Growers Service Corp. v. Ragan*, 18 Wash 2d 655, 140 P2d 512, 527, *rehearing denied*, 18 Wash 2d 655, 141 P2d 875 (1943).

Under certain circumstances, the shareholders of a nonpublic corporation may enter into other voting agreements which contain provisions otherwise inconsistent with the Washington Business Corporation Act. RCW 23B.07.320. A discussion of RCW 23B.07.320 appears in Section 4.07 of this book.

Section 7.09 Shareholder's Duty to Corporation

As a general rule, an individual shareholder stands in no particular fiduciary relationship to the corporation and may deal with the corporation in an arms'-length manner. *Robbins v. Huntley Cattle Co.*, 3 Wash 2d 203, 100 P2d 386 (1940). Ordinarily, a shareholder may compete with the corporation. *Wagner v. Foote*, 128 Wash 2d 408, 908 P2d 884 (1996)(ordinarily, a noncompetition agreement entered into by a shareholder is not a corporate asset); *Penley v. Penley*, 101 NC App 225, 398 SE2d 671 (1990); *Witmer v. Arkansas Dailies, Inc.*, 202 Ark 470, 151 SW2d 971 (1941). A shareholder may lend money to the corporation and otherwise be a creditor. *Bellaire Securities Corp. v. Brown*, 124 Fla 47, 168 So 625 (1936). A shareholder may enforce his/her rights as a creditor and may sue or levy against corporate property. *H. K. McCann Co. v. Week*, 139 Wash 183, 246 P 292, *affirmed*, 141 Wash 702, 251 P 858 (1927). A shareholder generally does not owe a fiduciary duty to another

shareholder when buying or selling stock from that shareholder. *Hardy v. South Bend Sash & Door Co., Inc.*, 603 NE2d 895 (Ind App 1992).

A shareholder may vote his/her shares even though personally interested in the vote outcome since, in a meeting of shareholders, "each shareholder represents himself and his personal interests solely, and he in no sense acts as a trustee or representative of others." *Ostlind v. Ostlind Valve, Inc.*, 178 Or 161, 184, 165 P2d 779, 788 (1945). Likewise, a shareholder owes no duty to other shareholders when selling shares to an outside party, other than a duty not deceive other shareholders about the terms of the sale. *Dunnett v. Arn*, 71 F2d 912 (10th Cir 1934).

> There being no fiduciary relationship existing between the stockholders of the bank so far as the sale of individual stock was concerned, there was no duty upon the part of Smith to apprise minority stockholders of Transamerica's offer. The fact that Smith et al. received more for their stock than the minority is no evidence of fraud, since it is generally recognized that the stock of majority stockholders is of more value than that of the minority. (citations omitted) *Tyron v. Smith*, 191 Or 172, 180, 229 P2d 251, 254 (1951).

Although, as a general rule, shareholders owe no such fiduciary duty, the general rule may not apply to shareholders who are controlling/majority shareholders, officers or directors, all of whom can owe a fiduciary duty to the corporation and its shareholders. *See, for example: Merger Mines Corp. v. Grismer*, 137 F2d 335 (9th Cir), *cert denied*, 320 US 794 (1943). The fiduciary duty of directors and officers is discussed in Sections 5.14 and 6.11 of this book. The fiduciary duty of majority or controlling shareholders is discussed in Section 7.10 of this book.

Under some circumstances, all shareholders of a close corporation may owe a fiduciary duty to the corporation, as well as to each other. The duty of shareholders in close corporations is discussed in Section 7.11 of this book.

Section 7.10 Duty of Controlling Shareholders

A. Generally.

As a general rule, an individual shareholder stands in no particular fiduciary relationship to the corporation and may vote the shareholder's personal self-interest and may deal with the corporation in an arms'-length manner. *Robbins v. Huntley Cattle Co.*, 3 Wash 2d 203, 100 P2d 386 (1940); *Ostlind v. Ostlind Valve, Inc.*, 178 Or 161, 184, 165 P2d 779, 788 (1945). "[W]hen a person becomes a stockholder in a corporation, he assents to majority rule and impliedly agrees to abide thereby." *Benton*

v. United States, 114 F Supp 37, 45 (MD Ga 1953).

On the other hand, majority/controlling shareholders may owe a fiduciary duty to their fellow shareholders, at least under certain circumstances. The United States Supreme Court held:

> A director is a fiduciary. So is a dominant or controlling stockholder or group of shareholders. Their powers are powers in trust. Their dealings with the corporation are subject to rigorous scrutiny and where any of their contracts or engagements with the corporation is challenged the burden is on the director or stockholder not to prove the good faith of the transaction but also to show the inherent fairness from the viewpoint of the corporation and those interested therein. (citations omitted) *Pepper v. Litton*, 308 US 295, 307 (1939).

See also: Tefft v. Schaefer, 148 Wash 602, 269 P 1048 (1928); *Westland v. Post Land Co.*, 115 Wash 329, 197 P 44 (1921).

Unfortunately, the analysis in this area is confused by the fact that majority/controlling shareholders quite frequently also serve as directors and officers of the corporation and the law is clear that officers and directors owe a fiduciary duty to the corporation and to the shareholders collectively. *See:* Sections 5.14 and 6.11 of this book.

But there are cases which hold that a person's status as a controlling shareholder alone creates a fiduciary duty. *Jones v. H.F Ahmanson & Co.*, 81 Cal Rptr 592, 460 P2d 464 (1969) is a "pure" shareholder fiduciary duty case, that is, a case in which "all actions of the defendant shareholders were taken by them in their capacity as shareholders of the operating company, not as directors." Murdock, *"The Evolution of Effective Remedies for Minority Shareholders and Its Impact Upon Valuation of Minority Shares*," 65 NOTRE DAME L REV 425, 433-4 (1990). In *Jones*, the California Supreme Court held:

> [M]ajority shareholders, either singly or acting in concert to accomplish a joint purpose, have a fiduciary responsibility to the minority and to the corporation to use their ability to control the corporation in a fair, just, and equitable manner. Majority shareholders may not use their power to control corporate activities to benefit themselves alone or in a manner detrimental to the minority. *Jones v. H.F Ahmanson & Co.*, 81 Cal Rptr 592, 460 P2d 464, 471 (1969).

See also: Retzer v. Retzer, 578 So2d 580 (Miss 1990); *Alaska Plastics, Inc. v. Coppock*, 621 P2d 270 (Alaska 1980).

NOTE: Older cases generally speak in terms of the duty owed by "majority shareholders." The trend, however, has been to speak in terms of the duty owed by "controlling shareholders." There is a now widespread recognition that one or more persons can control the corporation without necessarily owning 51% of the

stock. Several Washington statutes define control at less than 50% in specific contexts, usually where the corporation's stock is widely held or for purposes of imposing liability on persons in control. *See, for example:* RCW 32.32.226 and RCW 33.24.350 (defining control of savings banks to mean owning 25% or more of its stock); RCW 21.20.717 (defining control of a debenture company to mean owning 25% or more of its stock); RCW 23B.19.020(8)(owning 10% or more of a corporation's stock creates a rebuttable presumption of control for purposes of Antitakeover Act). *See also: Lynott v. National Union Fire Ins. Co.*, 123 Wash 2d 678, 692-3, 871 P2d 146, 153-4 (1994).

In modern times, the courts have been more inclined to refer to the relationship governing the conduct of controlling shareholders as a fiduciary relationship, at least to the extent that a duty of good faith and fair dealing may exist.

> The principal that a majority of stockholders must, at all times, exercise good faith toward the minority stockholders is well recognized. *Hay v. Big Bend Land Co.*, 32 Wash 2d 887, 897, 204 P2d 488, 494 (1949).

As a general rule, courts have held that "majority stockholders occupy a fiduciary relation toward the minority stockholders." *Wool Growers Service Corp. v. Ragan*, 18 Wash 2d 655, 691, 140 P2d 512, 527, *rehearing denied*, 18 Wash 2d 655, 141 P2d 875 (1943).

B. Other states.

Other state courts have also held that majority shareholders owe a fiduciary duty to the corporation and other shareholders, at least under some circumstances. For instance under Delaware law, a majority shareholder owes a fiduciary duty to the minority shareholders "in dealing with the latter's property" in a merger transaction. *Singer v. Magnavox Co.*, 380 A2d 969 (Del 1977).

Under California law, the majority shareholder "must exercise good faith and fairness" in situations "where the control of the corporation is material." *DeBaun v. First Western Bank & Trust Co.*, 46 Cal App 3d 686, 696, 120 Cal Rptr 354 (1975).

Under Connecticut law, "a dominant or majority shareholder bears the same fiduciary duty to the corporation and its minority shareholders as does a director." *Governors Grove Condominium Association, Inc. v. Hill Development Corp.*, 36 Conn Sup 144, 414 A2d 1177, 1183-4 (1980).

Under Oregon law, the courts "have recognized that those in control of corporate affairs have fiduciary duties of good faith and fair dealing toward the minority shareholders." (citations omitted) *Zidell v. Zidell*, Inc., 277 Or 413, 418, 560 P2d 1086, 1089 (1977).

See also: Estate of Schroer v. Stamco Supply, Inc., 19 Ohio App 3d 34, 482 NE2d 975 (1984); *Wilkes v. Springside Nursing Home, Inc.*, 353 NE2d 657 (Mass 1976); *Seagrave Corp. v. Mount*, 212 F2d 389 (6th Cir 1954).

***C. Exceptions*.**

Majority/controlling shareholders do not owe a fiduciary duty to the minority shareholders under all circumstances.

For instance, a majority/controlling shareholder may vote his/her shares even though personally interested in the vote outcome since, in a meeting of shareholders, "each shareholder represents himself and his own interests solely, and he in no sense acts as a trustee or representative of others." *Ostlind v. Ostlind Valve, Inc.*, 178 Or 161, 184, 165 P2d 779, 788 (1945). *See also: D'Arcangelo v. D'Arcangelo*, 137 NJ Eq 63, 43 A2d 169 (1945).

Ordinarily, a majority shareholder can receive payments from the purchaser of corporate assets for entering into a noncompetition agreement with the purchaser.

> In sum, we hold that the opportunity for a corporate officer/shareholder to enter into a noncompetition agreement in conjunction with the sale of the corporation's assets is not a corporate business opportunity. However, when the consideration for such an agreement made in conjunction with the sale of corporate assets results in the corporation receiving less than fair market value for the corporate assets, the corporate assets have been unlawfully diverted in violation of the corporate
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> officer/shareholder's fiduciary duty. *Wagner v. Foote*, 128 Wash 2d 408, 416, 908 P2d 884, 887-8 (1996).

A majority shareholder may sell his/her own stock to a third party, even at a premium, without breaching any duty to the minority shareholders, except for the duty to act in good faith and in a non-fraudulent manner.

> There being no fiduciary relationship existing between the stockholders of the bank so far as the sale of individual stock was concerned, there was no duty upon the part of Smith to apprise minority stockholders of Transamerica's offer. The fact that Smith et al. received more for their stock than the minority is no evidence of fraud, since it is generally recognized that the stock of majority stockholders is of more value than that of the minority. (citations omitted) *Tyron v. Smith*, 191 Or 172, 180, 229 P2d 251, 254 (1951).

In another decision, the court stated:

> the power to control the corporation through majority stock ownership is not a corporate asset which must be shared with all stockholders; in a sale of stock, the role as owner takes precedence over the role as fiduciary. Thus, as a general rule a director, officer, and majority shareholder may freely negotiate a sale at a premium price of his or her stock and the benefits incident to majority ownership. *Delano v. Kitch*, 667 F2d 990, 998 (10th Cir 1981).

See also: Draper v. Hay, 555 So2d 1306 (Fla App 1990); *Yerke v. Batman*, 376 NE2d 1211 (Ind App 1978).

Section 7.11 Duty of Shareholders in Close Corporation

A. Close corporation defined.

In a leading case on the duties of shareholders in close corporations, the Massachusetts Supreme Judicial Court described a close corporation to be:

> We deem a close corporation to be typified by: (1) a small number of stockholders; (2) no ready market for the corporate stock; and (3) substantial majority stockholder participation in the management, direction and operations of the corporation. *Donahue v. Rodd Electrotype Co.*, 367 Mass 578, 586, 328 NE2d 505 (1975).

The American Law Institute's Principles of Corporate Governance defines a close corporation as follows:

> "Closely held corporation" means a corporation the equity securities of which are owned by a small number of persons, and for which securities no active trading market exists. § 1.06 ALI Principles of Corporate Governance.

A close corporation involves shares held in only "a few hands, or in a few families" and rare "buying or selling" of its shares. *Galler v. Galler*, 32 Ill 2d 15, 203 NE2d 577, 583 (1964).

The terms "close corporation" and "closely held corporation" have the same meaning. These terms are used interchangeably in this book.

B. Close corporations are like partnerships.

Many cases and commentators have noted the similarity between close corporations and partnerships.

> Close corporations have been analogized and, for some purposes, judicially treated as partnerships. The basis for the comparison is that the characteristics associated with close corporations are generally found in partnerships. Corporate status is elected by the shareholders in order to "clothe" their partnership `with the benefits peculiar to a corporation, limited liability, perpetuity and the like.'" When a close corporation is formed, the shareholders often consider themselves partners, but treat the enterprise as a corporation when dealing with others. Flowing from this analogy to partnerships, courts have imposed a fiduciary duty upon shareholders in close corporations similar to the

> duty of general partners owe to each other. (footnotes omitted) Blaiklock, *Fiduciary Duties Owed by Frozen-Out Minority Shareholders in Close Corporations*, 30 IND L REV 763, 766-7 (1997).

The shareholders of close corporations often elect to have their business taxed as if it were a partnership, rather than a corporation.

> The United States Internal Revenue Code gives substantial recognition to the fact that close corporations are often merely incorporated partnerships. The so called Subchapter S enables "small business corporations," defined by statute, to make an election which generally exempts the corporation from taxation and causes inclusion of the corporation's undistributed, as well as distributed, taxable income in the gross income of the stockholders for the year. This is essentially the manner in which partnership earnings are taxed. (citations omitted) *Donahue v. Rodd Electrotype Co.*, 367 Mass 578, 328 NE2d 505, 512 n 12 (1975).

Many courts have noted that shareholders of close corporations often have a substantial personal investment in their corporations and often depend on the corporation for most of their income. When the majority acts improperly, there is no active market for their stock. *Rexford Rand Corp. v. Ancel*, 58 F3d 1215, 1219 (7th Cir 1995).

> At this point, the true plight of the minority shareholder in a close corporation becomes manifest. He cannot easily reclaim his capital. In a large public corporation, the oppressed or dissident minority could sell his stock in order to extradite some of his invested capital. By definition, this market is not available for shares in the close corporation.
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> * * * *
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> Thus, in a close corporation, the minority stockholders may be trapped in a disadvantageous situation. No outsider would knowingly assume the position of the disadvantaged minority. The outsider would have the same difficulties. To cut losses, the minority shareholder may be compelled to deal with the majority. This is the capstone of the majority plan. Majority "freeze-out" schemes which withhold dividends are designed to compel the minority to relinquish stock at inadequate prices. *Donahue v. Rodd Electrotype Co.*, 367 Mass 578, 328 NE2d 505, 514-5 (1975)).

As a consequence, many courts have analogized close corporations to partnerships. *Card v. Stirnweis*, 232 Or 123, 374 P2d 472 (1962). "The relationship among shareholders in closely held corporations is analogous to that of partners." *Pedro v. Pedro*, 489 NW2d 798, 801 (Minn App 1992).

Before treating a close corporation as a partnership, some courts look to whether the owners view themselves as "partners." *See, for example: Hartung v. Architects Hartung/Odle/Burke, Inc.*, 157 Ind App 546, 301 NE2d 240 (1973).

But the partnership analogy is not perfect. For instance unlike a general partner in a partnership, a minority shareholder in a close corporation may not unilaterally dissolve the corporation. *Baker v. Commercial Body Builders, Inc.*, 264 Or 614, 630, 507 P2d 387, 394 (1973).

C. In close corporation, all shareholders may owe fiduciary duty.

Because close corporations are like partnerships, the trend has been for courts to say that shareholders in close corporations owe a fiduciary duty to the corporation and to each other.

> As fully discussed elsewhere in this treaties, shareholders in a close corporation stand in a fiduciary relationship to each other. Thus, for example, shareholders in a closely held corporation cannot compete for business or clients which in equity and fairness belong to the corporation. The relationship between shareholders in a close corporation vis-a-vis each other closely approximates the relationship between partners. (footnotes omitted) 1A FLETCHER CYC CORP § 70.10 (Perm Ed 1993).

Some courts have held that the fiduciary duty among shareholders in close corporations is even stronger than is the duty of directors and shareholders in public corporations.

> In the case of a close corporation, which resembles a partnership, duties of loyalty extend to shareholders, who owe one another substantially the same duty of utmost good faith and loyalty in the operation of the enterprise that partners owe to one another, a duty that is even stricter than that required of directors and shareholders in corporations generally. *Demoulas v. Demoulas Super Markets, Inc.*, 424 Mass 501, 677 NE2d 159, 179 (1997).

In *Donahue v. Rodd Electrotype Co.*, 367 Mass 578, 328 NE2d 505 (1975), the leading case on the fiduciary duty of shareholders in close corporations, the court extended the "more rigorous duty of partners" to shareholders in a close corporation. *Id*. at 516. The fiduciary duty standard set out in *Donahue* has gained "widespread acceptance." 2 O'Neal's Oppression of Minority Shareholders § 7.04, pg 39.

D. Majority shareholder in close corporation owes fiduciary duty.

Majority shareholders, in both public and close corporations, owe a fiduciary duty to the corporation and its minority shareholders. "The principal that a majority of stockholders must, at all times, exercise good faith toward the minority stockholders is well recognized." *Hay v. Big Bend Land Co.*, 32 Wash 2d 887, 897, 204 P2d 488, 494 (1949). *See also: Zidell v. Zidell, Inc.*, 277 Or 413, 560 P2d 1086 (1977).

Given the higher duty that has been recognized among shareholders of close corporations, it should come as no surprise that in a close corporation, a majority shareholder owes a fiduciary duty to the close corporation and its shareholders. "The majority shareholders of a close corporation owe the minority fiduciary duties of loyalty, good faith, fair dealing and full disclosure." *Chiles v. Robertson*, 94 Or App 604, 619, 769 P2d 903 (1989). *See also: Grato v. Grato*, 272 NJ Super 140, 639 A2d 390 (1994); *Noakes v. Schoenborn*, 116 Or App 464, 841 P2d 682 (1992); *Pedro v. Pedro*, 489 NW2d 798 (Minn App 1992).

"Ohio appellate courts have found a heightened fiduciary duty between majority and minority shareholders in a close corporation." *Cruz v. South Dayton Urological Associates, Inc.*, 121 Ohio App 3d 655, 700 NE2d 675, 679 (1997).

E. Business judgment rule.

A discussion of the business judgement rule in the context of a close corporation appears in Peeples, *The Use and Misuse of the Business Judgment Rule in the Close Corporation*, 60 NOTRE DAME L REV 456 (1985).

Section 7.12 Duty of Non-Controlling Shareholders

A. General rule - no fiduciary duty.

Ordinarily , a minority shareholder owes no fiduciary duty to the corporation or to the other shareholders. *Priddy v. Edelman*, 883 F2d 438 (6th Cir 1989); *Gilbert v. El Paso Co.*, 490 A2d 1050 (Del Ch 1984).

B. Exception - fifty percent shareholder.

In a close corporation with two equal shareholders, neither shareholder is a "majority" shareholder. Yet, most courts have imposed a fiduciary duty on both 50% shareholders. *See: Hagshenas v. Gaylord*, 199 Ill App 3d 60, 557 NE2d 316 (1990)(50% shareholder breached fiduciary duty by opening a competing business); *Lee v. Mitchell*, 152 Or App 159, 953 P2d 414 (1998) (50% shareholders are entitled to each other's fiduciary duty); *Bar H, Inc. v. Johnson*, 822 P2d 849 (Wyo 1991)(50% shareholder owes fiduciary duty, at least until squeezed-out by other shareholder); *McLaughlin v. Beeghly*, 84 Ohio App 3d 502, 617 NE2d 703 (1992); *Zimmerman v. Bogoff*, 402 Mass 650, 524 NE2d 849 (1988).

> Whether we consider the corporation as organized to carry out the purposes of a continuing joint venture, or simply regard the parties as equal owners of a close corporation, their relationship was such that each was entitled to the other's performance of fiduciary duties of loyalty,

> good faith, and full disclosure. (footnote omitted) *Delaney v. Georgia-Pacific Corp.*, 278 Or 305, 311, 564 P2d 277, 281 (1977), *supplemented*, 279 Or 653, 569 P2d 604 (1977), *appeal after remand*, 42 Or App 439, 601 P2d 475 (1979).

In one case, the court held that the fiduciary duty owed by one fifty percent shareholder to the other fifty percent shareholder terminated once either one ceased to be a shareholder. *Gangnes v. Lang*, 104 Or App 135, 799 P2d 670 (1990). In another case, the court held that a fifty percent shareholder's fiduciary duty terminated when the shareholder ceased to be actively involved with the corporation, even though she continued on as a shareholder. *Bar H, Inc. v. Johnson*, 822 P2d 849 (Wyo 1991). But this case was criticized in *Rexford Rand Corp. v. Ancel*, 58 F3d 1215, 1219 (7th Cir 1995).

C. Exception - a minority shareholder with veto power.

Although courts frequently recite that shareholders in close corporations owe a fiduciary duty to each other, in the overwhelming majority of such cases, the issue before the court is whether a majority shareholder, not a minority shareholder, acted improperly. Usually, an action of the minority shareholder is not at issue since an objecting minority shareholder, by definition, loses on a vote requiring affirmation of a bare majority. "In the literature of close corporations, the minority shareholder invariably appears in the role of victim of majority oppression." Hetherington, *The Minority's Duty of Loyalty in Close Corporations*, 1972 DUKE L J 921, 933 (1972).

But this is not always true. A minority shareholder may be in a control position when by statute, contract or a provision in the articles of incorporation or bylaws, the consent of the minority shareholder or a supermajority vote is required for approval of an action. "The purpose of unanimity and greater-than-majority voting requirements is to protect the minority against the majority." Hetherington, *The Minority's Duty of Loyalty in Close Corporations*, 1972 DUKE L J 921, 935 (1972). In a situation, some courts and commentators believe that a majority shareholder with control should be held to the same standards as is a majority shareholder.

> Efforts to obtain a disproportionate share of the value of a corporate enterprise should be accorded the same treatment whether the attempts are made by the majority or the minority. Conduct by any shareholder which is intended to be detrimental to the welfare of the enterprise or to subordinate its business interests to competing business interests of the shareholder is a breach of a duty of loyalty which all shareholders owe to the common venture. As far as minority interests are concerned, this

> proposition merely amounts to saying that were the minority's conduct makes a difference, it ought to be equally accountable for its behavior and motives as the majority. Hetherington, *The Minority's Duty of Loyalty in Close Corporations*, 1972 DUKE L J 921, 945 (1972).

There have only been a few cases which address this issue, but all appear to support the principle that a minority shareholder with a veto power has a fiduciary duty to the corporation with respect to the exercise of that veto power.

The leading case is *Smith v. Atlantic Properties, Inc.*, 12 Mass App 201, 422 NE 2d 798 (1981), which involved four shareholders each owning 25% of the corporation's stock. The articles of incorporation and the bylaws provided that all corporate actions must be approved by an 80% vote of the shareholders, a provision which "had the effect of giving any one of the four original shareholders a **veto** in corporate decisions." *Id.* at 799.

The business was profitable and three of the shareholders wanted to declare dividends, fearing that failure to due so would result in imposition of a federal tax penalty for an unreasonable accumulation of corporate profits. For several years, one shareholder vetoed dividends and the IRS repeatedly imposed a penalty. The majority sued the 25% shareholder, asserting that he had breached his fiduciary duty to the majority. The court agreed.

> The 80% provision may have substantially the effect of reversing the usual roles of the majority and the minority shareholders. The minority, under that provision, becomes an ad hoc controlling interest. *Smith v. Atlantic Properties, Inc.*, 12 Mass App 201, 422 NE 2d 798, 802 (1981).

Under *Smith*, a "minority shareholder whose conduct is controlling on a particular issue" is bound by the same fiduciary standard as is the majority. *Id*. at 803, n 9.

In *Rexford Rand Corp. v. Ancel*, 58 F3d 1215, 1219 (7th Cir 1995), a minority shareholder was fired as an employee of the corporation. Two years later, the minority shareholder discovered that the corporation had inadvertently neglected to file its annual report and had been involuntarily dissolved. The minority shareholder then reserved the corporate name for his own benefit, making the name unavailable to the corporation when it sought re-instatement. The corporation sued, claiming the minority shareholder had violated his fiduciary duty. In finding for the corporation, the court said:

> In addition, minority shareholders owe a duty of loyalty to a close corporation in certain circumstance. Minority shareholders have an

> obligation as *de facto* partners in the joint venture not to do damage to the corporate interests. If a minority shareholders [sic] harms the corporation through "unscrupulous and improper `sharp dealings'" with the majority, he has breached his duty of loyalty. 10.
>
> Footnote 10. In addition, a minority shareholder owes a fiduciary duty to the corporation when his interests are controlling on a particular issue. (citations omitted) *Rexford Rand Corp. v. Ancel*, 58 F3d 1215, 1219 (7th Cir 1995).

See also: A. W. Chesterton Co., Inc. v. Chesterton, 907 F Supp 19 (D Mass 1995); *Helms v. Duckworth*, 249 F2d 482 (DC Cir 1957).

One older Washington case implicitly recognizes this principle. In *Matteson v. Ziebarth*, 40 Wash 2d 286, 242 P2d 1025 (1952), the corporation which had run into financial difficulties found a buyer for all of the corporation's stock, but only if all shareholders agreed to sell. All but one of the shareholders agreed to the transaction, only one minority shareholder objected - Matteson. Matteson wanted a disproportionate share of the sales proceeds in exchange for his agreement to the transaction. To salvage the sale, the other shareholders then voted to merge the corporation with the buyer, a act which required less than unanimous consent. Matteson sought an injunction to block the merger, claiming the new scheme was fraudulent as to him. The court found that the proposed merger was not fraudulent as to Matteson and refused to issue an injunction.

Section 7.13 Power of Court to Protect Minority Shareholders

Courts have the equitable power to set aside acts of majority shareholders when necessary to protect minority shareholders. *Henry George & Sons, Inc. v. Cooper-George, Inc.*, 95 Wash 2d 944, 948, 632 P2d 512, 514 (1981); *Nelkin v. H.J.R. Realty Corp.*, 25 NY2d 543, 307 NYS2d 454, 255 NE2d 713 (1969); *Browning v. C & C Plywood Corp.*, 248 Or 574, 434 P2d 339 (1968). Yet historically, courts have been reluctant to substitute the court's judgment, or the minority shareholders' judgment, for the business judgment of the majority. *Nursing Home Building Corp. v. De Hart*, 13 Wash App 489, 535 P2d 137 (1975).

> At common law, many courts refused to intervene in shareholder disputes since the State licensed the corporation, and as such the State and not the courts had the authority to dissolve the corporation. In a few jurisdictions, courts of equity began to carve out areas in which they would use the powers of the chancellors to liquidate the assets and business of the corporation. A few courts asserted the power to liquidate on a showing of irreparable injury to the shareholders and the corporation due to gross or fraudulent mismanagement. *Henry George*

> *& Sons, Inc. v. Cooper-George, Inc.*, 95 Wash 2d 944, 948, 632 P2d 512, 514 (1981).

In addition to their common law powers, Washington courts can look to statutory authority for judicial dissolution in a case of deadlock or in a case where irreparable injury to the shareholders or the corporation was threatened. RCW 23B.14.300. But the Washington courts will order dissolution under this statute only under the most egregious circumstances. *Henry George & Sons, Inc. v. Cooper-George, Inc.*, 95 Wash 2d 944, 632 P2d 512 (1981). The power to dissolve a corporation is clearly a discretionary power. *Interlake Porsche & Audi, Inc. v. Bucholz*, 45 Wash App 502, 728 P2d 597 (1986), *review denied*, 107 Wash 2d 1022 (1987).

A. Statutory authority - oppressive conduct.

RCW 23B.14.300(2)(b) permits a minority shareholder to seek judicial dissolution of a corporation if

> The directors or those in control of the corporation have acted, are acting, or will act in a manner that is illegal, oppressive, or fraudulent.

One Washington case discusses two tests which have been applied to determine whether conduct is "oppressive."

> Washington cases have not addressed the question of what constitutes "oppressive" action against a shareholder. A number of courts in other states have found oppression in minority shareholder settings. The court in *Gimpel v. Bolstein*, 125 Misc 2d 45, 477 NYS 2d 1014 (1984) attempted to set a standard for determining the existence of oppression, stating that "[t]he most prominent definition of oppression stems from the writings of F. Hodge O'Neal, which define "oppression" as a violation by the majority of the "reasonable expectations" of he minority." "Reasonable Expectations" are those spoken and unspoken understanding on which the founders of a venture rely when commencing the venture.
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> The Court in *Gimpel* did not use the reasonable expectations test because the corporation was 53 years old, the current shareholders were not the original shareholders, and the plaintiff had stolen from the corporation, thereby breaking all bargains. The court thus applied a secondary definition, describing oppression as
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> > burdensome, harsh and wrongful conduct; a lack of probity and fair dealing in the affairs of a company to the prejudice of some of its members; or a visible departure from the standards of fair dealing, and a violation of fair play on which every shareholder who entrusts his money to a company is entitled to rely.
>
> Under either of these test, the factual findings support the legal conclusion that [defendant] did not oppress [plaintiff] as a minority shareholder. (citations omitted) *Robblee v. Robblee*, 68 Wash App 69, 76, 841 P2d 1289, 1293 (1992).

The statute refers to "illegal, oppressive, or fraudulent" conduct. In interpreting a similarly-worded statute, one court held that the terms "illegal," "oppressive," and "fraudulent," are to be read in the disjunctive:

> In considering the meaning and application of the term "oppressive" conduct it is first to be noted that by the very terms of [the statute] conduct need not be fraudulent or illegal to be "oppressive" within the meaning of that statute.
>
> While general definitions of "oppressive" conduct are of little value for application in a specific case, perhaps the most widely quoted definitions are that "oppressive conduct" for the purposes of such a statute is:
>
> > "burdensome, harsh and wrongful conduct; a lack of probity and fair dealing in the affairs of a company to the prejudice of some of its members; or a visual departure from the standards of fair dealing, and a violation of fair play on which every shareholder who entrusts his money to a company is entitled to rely."
>
> We agree, however, that the question of what is "oppressive" conduct by those in control of a "close" corporation as its majority stockholders is closely related to what we agree to be the fiduciary duty of a good faith and fair dealing owed by them to its minority stockholders.
>
> Thus, an abuse of corporate position for private gain at the expense of the stockholders is "oppressive" conduct. Or the plundering of a "close" corporation by the siphoning off of profits by excessive salaries or bonus payments and the operation of the business for the sole benefit of the majority of the stockholders, to the detriment of the minority stockholders, would constitute such "oppressive" conduct as to authorize a dissolution of the corporation under the terms of ORS 57.595. (footnotes omitted) *Baker v. Commercial Body Builders, Inc.*, 264 Or 614, 628-9, 507 P2d 387, 393-4 (1973).

See also: Iwasaki v. Iwasaki Bros., Inc., 58 Or App 543, 649 P2d 598 (1982).

B. Statutory authority - deadlock.

RCW 23B.14.300(2)(a) permits a minority shareholder to seek judicial dissolution of a corporation if:

> The directors are deadlocked in the management of the corporate affairs, the shareholders are unable to break the deadlock, and irreparable injury to the corporation is threatened or being suffered, or the business and affairs of the corporation can no longer be conducted to the advantage of the shareholders generally, because of deadlock.

"Deadlock is the inaction which results when two equally powerful factions stake out opposing positions and refuse to budge." (footnote omitted) *Wilcox v.Stiles*, 127 Or App 671, 678, 873 P2d 1102, 1105 (1994). If one shareholder owns a majority of the shares, a corporation is not necessarily deadlocked simply because its board of directors is deadlocked since the statute also requires that "the shareholders are unable to break the deadlock." *Gregory v. J. T. Gregory & Son, Inc.*, 176

Ga App 788, 338 SE2d 7 (1985).

RCW 23B.14.300(2)(c) permits judicial dissolution on the basis of shareholder deadlock alone, but only if:

> The shareholders are deadlocked in voting power and have failed, for a period that includes at least two consecutive annual meeting dates, to elect successors to directors whose terms have expired, and irreparable injury to the corporation is threatened or being suffered, or the business and affairs of the corporation can no longer be conducted to the advantage of the shareholders generally, because of the deadlock.

Thus, a temporary shareholder deadlock over an issue is not enough to justify judicial intervention. A more serious, long-standing deadlock is required.

C. Courts are reluctant to intervene.

RCW 23B.14.300 confers power on the superior courts to dissolve a corporation in certain proceedings initiated by a shareholder. This power is discretionary. *Interlake Porsche & Audi, Inc. v. Bucholz*, 45 Wash App 502, 728 P2d 597 (1986), *review denied*, 107 Wash 2d 1022 (1987). Historically, courts have been disinclined to intervene and dissolve a corporation, even in cases involving deadlock or oppressive conduct.

> The shareholder deadlock provisions of the Illinois Business Corporation Act, of the Model Business Corporation Act, and of the Oregon Business Corporation Law are clearly couched in language of permission. It is incredible that the many able lawyers who worked from time to time on these three identical acts would have used such phraseology to express a mandate. The statute contemplates that the court of equity shall take jurisdiction once a requisite showing of fact is made and contemplates further that having taken jurisdiction it will bring its discretion to bear in granting or refusing to grant equitable relief. The very fact that the legislature has made the remedy of liquidation a matter of discretion for the courts is a mandate to us to use discretion, and we would not be carrying out the legislative will by simply decreeing liquidations as a matter of course once the jurisdictional facts and nothing more are proven. The common law rule was thought to be an insufficient safeguard of the rights of the half-owner of a corporation who happened to be out of power. As we read the statute its intent is to obligate the courts to thread their way from case to case without the assistance of sweeping generalizations. *Jackson V. Nicolai-Neppach Co.*, 219 Or 560, 574-5, 348 P2d 9, 16 (1959).

See also: Henry George & Sons, Inc. v. Cooper-George, Inc., 95 Wash 2d 944, 632 P2d 512, 514 (1981); *Boothe v. Summit Coal Mining Co.*, 55 Wash 167, 104 P 207 (1909); *McMunn v. ML&H Lumber, Inc.*, 247 Or 319, 429 P2d 798 (1967).

The courts have been reluctant to substitute the court's judgment, or the minority shareholders' judgment, for the business judgment of the majority. *Nursing Home Building Corp. v. De Hart*, 13 Wash App 489, 535

P2d 137 (1975).

> At common law, many courts refused to intervene in shareholder disputes since the State licensed the corporation, and as such the State and not the courts had the authority to dissolve the corporation. In a few jurisdictions, courts of equity began to carve out areas in which they would use the powers of the chancellors to liquidate the assets and business of the corporation. A few courts asserted the power to liquidate on a showing of irreparable injury to the shareholders and the corporation due to gross or fraudulent mismanagement. *Henry George & Sons, Inc. v. Cooper-George, Inc.*, 95 Wash 2d 944, 948, 632 P2d 512, 514 (1981).

The courts will not intervene even in the case of alleged director incompetence and mismanagement. *Beeler v. Standard Investment Co.*, 107 Wash 442, 181 P 896 (1919). One Washington decision recognized the right of the board of directors to shift the balance of voting power, stating that "directors . . . may in the exercise of their honest business judgment adopt a valid method of eliminating what appears to them a clear threat to the future of their business by any lawful means." *Hendricks v. Mill Engineering & Supply Co.*, 68 Wash 2d 490, 495, 413 P2d 811, 813-4 (1966).

In another decision, the court said:

> In the absence of a fraudulent or coercive design or purpose on the part of the management neither the judgment of the court nor that of a minority stockholder can properly be substituted for the judgment of the majority of the directors and stockholders of a corporation. *Horner v. Pleasant Creek Mining Corp.*, 165 Or 683, 699, 107 P2d 989, 995, 109 P2d 1044 (1941).

Another court put it more bluntly:

> No principle of law is more firmly fixed in our jurisprudence than the one which declares that the courts will not interfere in matters involving merely the judgment of the majority in exercising control over corporate affairs. *Regenstein v. J. Regenstein Co.*, 213 Ga 157, 159 97 SE2d 693, 695 (1957).

Usually, either bad faith or fraud must be present in order for a court to intervene in internal corporate affairs.

A court may find inequitable conduct, but order relief short of dissolution. *Agronic Corporation of America v. deBough*, 21 Wash App 459, 585 P2d 821 (1978); *Browning v. C & C Plywood Corp.*, 248 Or 574, 434 P2d 339 (1968); *Delaney v. Georgia-Pacific Corp.*, 278 Or 305, 564 P2d 277, *supplemented*, 279 Or 653, 569 P2d 604 (1977), *appeal after remand*, 42 Or App 439, 601 P2d 475 (1979).

***D. Courts retain equitable powers*.**

In addition to the rights granted by RCW 23B.14.300, courts retain the equitable power to dissolve or regulate the affairs of a corporation. *Henry George & Sons, Inc. v. Cooper-George, Inc.*, 95 Wash 2d 944, 948, 632 P2d 512, 514 (1981); *Baker v. Commercial Body Builders, Inc.*, 264 Or 614, 507 P2d 387 (1973); *Nelkin v. H.J.R. Realty Corp.*, 25 NY2d 543, 307 NYS2d 454, 255 NE2d 713 (1969). Some courts are more inclined to exercise their equitable powers to fashion remedies other than dissolution. *See, for example: Delaney v. Georgia-Pacific Corp.*, 278 Or 305, 564 P2d 277, *supplemented*, 279 Or 653, 569 P2d 604 (1977), *appeal after remand*, 42 Or App 439, 601 P2d 475 (1979); *Baker v. Commercial Body Builders, Inc.*, 264 Or 614, 507 P2d 387 (1973); *Browning v. C & C Plywood Corp*, 248 Or 574, 434 P2d 339 (1968).

***E. Miscellaneous*.**

The Washington courts have the power to appoint a receiver to wind up a corporation's business and affairs. RCW 23B.14.320. *See also: Boothe v. Summit Coal Mining Co.*, 55 Wash 167, 104 P 207 (1909).

The topic of judicial dissolution is also discussed in Section 12.06 of this book.

A more detailed discussion of the rights and remedies available to minority shareholders in close corporations appears in O'NEAL & THOMPSON, O'NEAL'S CLOSE CORP (3rd Ed); O'NEAL & THOMPSON, O'NEAL'S OPPRESSION OF MINORITY SHAREHOLDERS (2nd Ed).