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The New Washington Business Corporation Act [Part 2]

Leslie J. Ayer
University of Washington School of Law

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THE NEW WASHINGTON BUSINESS CORPORATION ACT*

SECTION 20 sets forth the liability of incorporators, subscribers, shareholders, directors, and officers. Subdivision 1 limits the liability of a subscriber or holder of shares to his obligation to comply with the terms of his subscription with the qualification that a shareholder who acquires his shares in good faith and without knowing that the shares had not been fully paid for shall not be liable to the corporation. In general, this subdivision complies with the existing law.[43] While the latter part of this subdivision provides that one who becomes a shareholder in good faith without knowledge that the shares have been fully paid for shall not be liable to the corporation, it is submitted that unless he has in addition paid value for such shares that the lien of the corporation provided for in Section 22 hereafter will prevail over the donee's rights. Further, as SECTION 16 provides that a certificate shall not be issued until the shares have been fully paid for it will be only in the exceptional case that there can be a shareholder in good faith and without knowledge.

Subdivision 2 exempts a shareholder from personal liability except to the extent of the amount unpaid upon any subscription made by him. This states the customary rule for limited liability granted by statutes to shareholders through corporate organization upon the theory that the contributions of the stockholders are a substitute for personal liability[44] As the subdivision provides that every shareholder is to the extent of his unpaid subscription individually and personally liable for the debts and liability of the corporation, there is suggested a direct liability to the creditors of the corporation. However, it was held in the case of the *City of Montesano v. F L. Carr*[45] under a similar statute that an action

[43] Constitution of the State of Washington, Art. 12, sec. 4, *Eureka Mining Company v. Lively*, 59 Wash. 550, 110 Pac. 425 (1910) *Davies v. Ball*, 64 Wash. 292, 116 Pac. 833 (1911).

[44] *Gordon v. Cummings*, 78 Wash. 515, 139 Pac. 489 (1914) Ballantine, Corporations (1st ed.) 1927, sec. 213.

[45] *City of Montesano v. Carr* 80 Wash. 384, 141 Pac. 894 (1914).

* Continued from last issue.

"The Reserved Power of Legislature to Change," which appeared in the title of the preceding issue was fully covered and is omitted from this and the following article.

at law by a creditor of a corporation against a stock subscriber was unauthorized. This seems to be the general rule.[46]

Subdivision 3, providing that one holding shares in a fiduciary capacity shall not be personally liable merely for so holding such shares, is declaratory of existing law [47]

Subdivision 4 provides that nothing in this Act shall be construed in derogation of any rights which any person may have under the common law or equity because of any fraud practiced upon him by an incorporator, subscriber, shareholder, director, officer or the corporation, also that the Act shall not be construed in derogation of any rights the corporation may have through any fraud practised by any such persons. Of the various usual possible factual situations giving rise to such rights, that of the consequences of overvaluation or watered stock stands out. Various theories have been suggested both as to the validity of watered stock as against the corporation and as to the liability of the stockholders to the creditors on account of such stock. The usual theories advanced for explanation are those of "trust fund" or "fraud or holding out." Neither is satisfactory for each is fictitious being evolved for the sole purpose of rationalizing the decisions.[48]

Jurisdictions disagree as to what constitutes overvaluation of consideration and amounts to fraud, some making it depend upon

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[46] See annotation to last cited case in 7 A. L. R. 100; Ballantine, Corporations (1st ed.) 1927, sec. 219. See an excellent article by Bonbright, "Shareholders' Defenses Against Liability to Creditors on Watered Stock," 25 Col. L. Rev. 408 (1925) On page 416 he states with respect to the general principles of stockholders' liability to creditors the following:

> "1. At common law the general rule is that stockholders are not personally liable for the unpaid balance on shares issued below par under an agreement between the corporation and the stockholder that they shall be considered full paid, but to this rule most courts recognize one exception, namely, a 'fraud' liability to such creditors as may be presumed to have relied on the fictitious capitalization.
>
> "2. The presence of constitutional or statutory provisions forbidding the issuance of stock for any consideration less than par, results in little if any modification of the commmon law principles.
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> "3. In those states in which the statutes specifically declare that stockholders are liable to creditors for unpaid balances due on their shares, some courts hold, in effect, that the statute is simply declaratory of common law and that the rights of creditors are still to be determined on 'fraud' grounds. But other courts hold that the right to complain extends now to all creditors and not merely to creditors who presumably have relied on the false representation."

[47] Wash. Rem. Rev. Stats., 1933, sec. 3826.

[48] See Ballantine, Corporations (1st ed.) 1927, secs. 210 et seq., suggesting the different theories advanced for liability. In sec. 213, Mr. Ballantine sets forth what he terms the "statutory obligation theory" which seems the most plausible and is to the effect that the liability to contribute is the price paid for the privilege of limited liability granted by statute to those transacting business through the corporate form of organization. See also Ballantine, "Stockholders' Liability in Minnesota," 7 Minn. L. Rev. 79 (1923) and an article by Mr. Bonbright cited in note 46, *supra*.

the good faith of the directors and others upon the true value of the consideration. The cases in the state of Washington are inconsistent, although the later cases adopt the good faith rule. As SECTION 17 provides that the valuation of the incorporators, shareholders, or directors, as the case may be, shall be conclusive, and this subdivision permits the setting aside of such valuation only when dishonest, it would seem the good faith rule is finally fixed in this state.[49]

SECTION 21 provides that the transfer of certificates of stock and the transfers of shares thereby may be regulated by the by-laws so far as is consistent with the laws of this state.[50]

SECTION 22 gives the corporation a lien upon such shares as there shall be an indebtedness for unpaid subscriptions. It should be noted that the lien is restricted to the indebtedness for the shares and does not cover any general indebtedness of the subscriber to the corporation. Definite procedure is provided for the enforcement of the lien by a sale of these shares. This procedure should be contrasted with and differentiated from the prior statute[51] which provided for the sale of stock on the failure of the stockholder to pay assessments. Passing on this last mentioned statute, the Supreme Court held[52] that the statute did not give the corporation a lien, and further that there could not even be a sale unless provided for by the by-laws as required by the statute. Accordingly, SECTION 22 of the present Act changes the law by providing for a lien. Moreover, there is a change in practically every detail of the procedure in making a sale.

The further question is presented. Shall a sale be permitted in the case of par stock which will not realize a par value considera-

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[49] The writer wishes to acknowledge an opinion of Mr. Joseph C. Cheney with an inclusion of the following citations to the decisions in the State of Washington: *Turner v. Bailey*, 12 Wash. 634, 42 Pac. 115 (1895) *Manhattan Trust Co. v. Seattle Coal and Iron Co.*, 16 Wash. 499, 48 Pac. 333, 737 (1897) *Adamant Manufacturing Co. v. Wallace*, 16 Wash. 614, 48 Pac. 415 (1897) *Kroenert v. Johnson*, 19 Wash. 96, 52 Pac. 605 (1898) *Inland Nursery and Floral Co. v. Wright*, 57 Wash. 67, 106 Pac. 499 (1910) *Lantz v. Moeller*, 76 Wash. 429, 136 Pac. 687 (1913) *Northern Bank and Trust Co. v. Day*, 83 Wash. 296, 145 Pac. 182 (1915) *Eagleston v. Pantages*, 93 Wash. 221, 160 Pac. 425 (1916) *Murphy v. Penton*, 96 Wash. 637, 165 Pac. 1074 (1917) *Colville Valley Coal Co. v. Rogers*, 123 Wash. 360, 212 Pac. 732 (1923) *Connor v. Robinson*, 137 Wash. 672, 243 Pac. 849 (1926), *Crowl v. Asia*, 143 Wash. 694, 253 Pac. 597 (1927) and *Johnsen v. Pheasant Pickling Co.*, 74 Wash. Dec. 229, 24 Pac. (2d) 628 (1933).

The reader is also referred to notes in sec. 23 to 28, inclusive, in the Report of Committees in the Fifth Draft of the General Corporation Act and Foreign Corporation Act of the Ohio Corporation Law, Dec. 28, 1926.

[50] See former statute to substantially the same effect, Wash. Rem. Rev. Stats., 1933, sec. 3819.

[51] Wash. Rem. Rev. Stats., 1933, sec. 3820.

[52] See *Dearborn v. Washington Savings Bank*, 18 Wash. 8, 50 Pac. 575 (1897).

tion? The Act provides in SECTION 15, subdivision 3, that "par value shares shall be made payable with cash in amount not less than the aggregate of the value of the shares of par value subscribed for," and in SECTION 16, subdivision 1, that "a certificate of stock shall not be issued until the shares represented thereby have been fully paid for." However, provision is made in SECTION 39 for changes of par value into no par value shares and the sale might thus be effected. Influenced by these provisions and the possibility that permitting such sales might be used as a device for making sales at less than par value, it is likely that courts will require the sale of par value shares to realize a par value consideration. It has been held that a corporation may purchase its own stock at a sale for unpaid assessments for stock subscriptions. [53] Finally, referring to SECTION 20, subdivision 1, it would seem that the lien could be cut off only in the event of the issue of the certificate and a transfer to a bona fide purchaser for value, in which case the corporation should be estopped or bound by the apparent authority of its agents in issuing the certificate.[54]

SECTION 23 provides that upon the allotment of shares having no par value that part of the consideration received for such shares may be treated as "paid-in surplus" rather than as payment upon the shares. Those fixing the value of the consideration for non par shares shall specify the proportion set aside as "paid-in surplus" which shall be shown on the books of the corporation as a separate item. That part, of course, which is paid for the shares will become capital stock. "Paid-in surplus" originally consisted of the surplus realized by the sale of par value stock at a price above par. It may also arise from payment by incoming shareholders to equalize an earned surplus previously built up, or it may arise on reorganization where the surplus of the old business is carried forward[55] in the new business as a surplus, or it may arise through original contribution.[56]

Often it is desirable at the outset for a corporation to maintain a portion of its assets free from the restrictions which surround capital stock. This would be true where the corporation wishes funds for payment of dividends on its preferred stock during its

[53] *Mitchell v. Blue Star Mining Co.*, 68 Wash. 191, 167 Pac. 130 (1917).

[54] See generally as to the lien of a corporation on shares, Ballantine, Corporations (1st ed.) 1927, sec. 154.

[55] This required some juggling of transfers prior to the adoption of the present section as the transfer of the entire assets of the old corporation in consideration of and payment for par value and non-par value stock would freeze the entire assets into capital stock and leave no surplus.

[56] *Johns v. Clother* 78 Wash. 602, 139 Pac. 755 (1914). There may be some difficulty in treating such a contribution as having the usual incidents of surplus. It was suggested in this case that it might be considered a trust fund for the creditors.

initial period of operation of business when no money is made. There being no fixed value to non par stock, this class of stock offers a simple solution for obtaining the "paid-in surplus" as provided for in this section. There is the possible danger that shareholders and the public may be misled by the payment of dividends out of such a surplus, as they may believe it to be paid out of profits rather than from money contributed by the shareholders. In the Ohio Corporation Act this is safeguarded by a provision that "Whenever a dividend is paid in whole, or in part, out of other than the earned excess of assets, the shareholders receiving such dividends shall be notified as to its source."[57] It may finally be observed that SECTION 23 is patterned upon a similar provision found in the Ohio Corporation Act which was founded upon a suggestion contained in an article by Mr. A. A. Berle.[58]

SECTION 24 sets forth the method for estimating the fund for the payment of dividends. It requires that the amount of its capital stock as defined by the Act [59] shall be carried upon its books as a liability Surplus arising from an unrealized appreciation or revaluation of fixed assets must be carried upon the books as a separate item apart from surplus profits as "paid-in surplus." Next in computing the aggregate assets of the corporation proper allowance must be made for depreciation, depletion and losses, and deferred assets or prepaid expenses must be written off at least annually in proportion to their use. With the foregoing considerations in mind the corporation can pay no dividends in cash or property except from the surplus of the aggregate assets over the aggregate liabilities, including in the latter its capital stock and deducting from the aggregate assets such amount as they may have been increased by unrealized appreciation or revaluation of fixed assets.

The payment of share dividends is similarly restricted except the aggregate assets may include unrealized appreciation or revaluation of fixed assets. The reason for the distinction obviously is because of the difficulty of estimating accurately an unrealized appreciation. The provisions already mentioned, as well as those following, show that the policy of the Act is to maintain the integrity of the capital stock of the corporation. A false appreciation of the fixed assets cannot affect the fund available for the creditors in the case of a share or stock dividend, as no property will be withdrawn from the capital stock of the corporation.

Cash dividends cannot be paid out of surplus arising from profits

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[57] Ohio General Corporation Act sec. 38 (d). Modified slightly. See Ohio Laws of 1931, sec. 8623-38 (d) (e).

[58] Ohio General Corporation act, sec. 23.

[59] Sec. 1, subdiv. 10, *supra.*

on treasury shares before resale, or unrealized profits due to increase in valuation of inventories before sale, or from the unaccrued or unrealized profits on notes, bonds, or obligations for the payment of money acquired at a discount unless they are readily marketable, or from the unaccrued or unearned portion of any unrealized profit.

An additional subdivision provides the further restriction that dividends payable in shares of any class may not be paid to shareholders of any other class unless the articles so provide or it is authorized by the vote of the holders of the shares of the class from which the payment is to be made. Finally subdivision 7 provides for payment of dividends from wasting assets, in which case the corporation may pay dividends from the net profits without deduction for depletion. This is subject, however, to the rights of shareholders of different classes.[60]

The section in the main is modelled on SECTION 38 of the Ohio General Corporation Act. As stated above, the policy of the section is to maintain the integrity of its capital stock. This is in accord with existing law[61] It may be noted, however, that this policy has been questioned and some of the late corporation codes in other jurisdictions permit the payment of dividends where there are current earnings, although the stated capital or capital stock has become impaired.[62] As SECTION 40 of our present Act, as well as our former statute,[63] provides for the reduction of capital stock, substantially the same result could be obtained by a reduction under these statutes. It is stated that the committee in the consideration of the Minnesota Act felt that the corporation's management should be permitted gradually to restore the stated capital when impaired out of the earnings over a period of years, rather than be required to choose immediately between the declaration of no dividends and the reduction of stated capital.[64] It should be noted, however, that the reduction of capital stock is secured usually only through a two-thirds vote of the shareholders and is a matter of fundamental concern calling for and requiring careful consideration and is hardly to be considered comparable with the action of the board of directors in the declaration of a dividend. Whether or not the directors shall be permitted to declare divi-

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[60] See *Wittenberg v. Federal Mining and Smelting Company*, 133 A. 48 (Del. 1926), 12 Corn. L. Quar, 79, 75 Univ. Pa. L. Rev. 350.

[61] Wash. Rem. Rev. Stats., 1933, sec. 3823. See also *Northern Bank and Trust Co. v. Day*, 83 Wash. 296, 145 Pac. 182 (1915) *Joyce v. Congdon*, 114 Wash. 239, 195 Pac. 29 (1921).

[62] Cal. Civ. Code (1931) sec. 346, Del. Laws of 1931, sec. 34, Minn. Law of 1933, Chap. 300, sec. 21 II (c).

[63] Wash. Rem. Rev. Stats., 1933, sec. 3830.

[64] Hoshour, "Minnesota Business Corporation Act," 17 Minn. L. Rev. 700 (1933).

dends from current earnings presents the usual problem, namely that of deciding between flexible operation and the dangers of abuse.

It is to be noted further that our Act places no restriction and makes no differentiation except as a matter of bookkeeping between "paid-in surplus" and surplus arising from profits. As already suggested,[65] there is danger when paying dividends from such a surplus that those receiving the dividends will believe they are paid from profits and will accordingly be misled as to the financial condition of the corporation. Another danger lies in the possible abuse of the use of the "paid-in surplus" for payment of dividends on shares not contemplated. The Minnesota Act makes the following limitation. "If there are outstanding shares entitled to preferential dividends, then dividends may be declared out of 'paid-in surplus' only on such shares."[66] It may be suggested that some more general limitation is desirable.

SECTION 25 sets forth the liability of both directors and shareholders for dividends unlawfully paid or for corporate assets unlawfully returned in any other way Guilty or negligent directors are made liable jointly and severally to the corporation to the extent of the dividend paid or the sum otherwise unlawfully returned. In the event no director is liable, and to the extent that the directors though liable are not able to respond in damages to the corporation, the shareholder is individually liable to the corporation for the amount received by him. Actions must be brought within two years of the wrongful payment or return, except when the directors are liable it must be brought within two years from the date of the judgment against the directors.

This section, as contrasted with the former statute,[67] provides specifically for a liability on the part of the shareholders as well as the directors. Further, the shareholders' liability is conditioned upon the inability of the corporation to recover from the directors. The former statute contained no such provision and the case law

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[65] See sec. 23, *supra*.

[66] Minn. Laws of 1933, Chap. 300, sec. 21, II (b).

[67] Wash. Rem. Rev. Stats., 1933, sec. 3823. "It shall not be lawful for the trustees to make any dividend except from the net profits arising from the business of the corporation, nor divide, withdraw or in any way pay to the stockholders, or any of them, any part of the capital stock of the company nor to reduce the capital stock of the company unless in the manner prescribed in this chapter, or in the articles of incorporation or the by-laws; and in case of any violation of the provisions of this section, the trustees, under whose administration the same may have happened, except those who have caused their dissent therefrom to be entered at large on the minutes of the board of trustees at the time, or were not present when the same did happen, shall, in their individual or private capacities, be jointly or severally liable to the corporation and the creditors thereof in the event of its dissolution, to the full amount so divided, or reduced, or paid out."

fixed no order of liability nor was there special provision in the former law limiting such actions.

Commenting on this section, it may be noted that no specific test of care is provided for the liability of the directors except that they shall have acted knowingly, or without making reasonable inquiry The former statute, at least in its wording, states an absolute test. The Ohio statute, while making the test one of negligence, specifically exempts the director who relies in good faith upon the books or a balance sheet duly certified.[68]

Shareholders are liable under this section irrespective of the fact that they did not know the payments were unlawful. This is in accord with the common law[69] It should be noted further that the liability is to the corporation. While the corporation can recover the full amount on the apparent intent that the capital shall be kept intact, the creditors' right seems clearly to be derivative only Therefore, for a creditor to pursue his remedy it will be permitted only under such circumstances as he can reach the shareholders' liability as an asset of the corporation. This suggests the further question in the state of Washington as to the amount that may be recovered from the shareholder. It has been held that when a receiver brings the action recovery may be had only for the amount necessitated to satisfy claims on a pro rata basis and that all delinquent stockholders must be joined in the action.[70]

SECTION 26 provides that the shareholders may make by-laws not inconsistent with law or the articles of incorporation. This authority may be expressly vested by the articles of incorporation in the board of directors subject to the power of the shareholders to change or repeal, except that the directors may not make or alter by-laws fixing their qualifications, classifications, terms of office, or compensation. Our former statute[71] provided that the corporation "shall have power to make by-laws not inconsistent with the laws of the State or the United States." The new section is declaratory of the existing law except subdivision 3, which pro-

[68] Ohio General Corporation Act, sec. 8623-123 (b). "A director shall not be held to have been negligent within the meaning of this section if he relied and acted in good faith upon the books of the corporation, or upon a balance sheet and profit and loss statement of the corporation and a statement of the assets available for a dividend or distribution represented to him to be correct by the president or the officer of the corporation having charge of or supervision of its accounts, or certified to be correct by a public accountant or firm of public accountants of good reputation, nor shall he be held to have been negligent if in good faith he considered assets at their book values, nor if in any case he followed what he believed in good faith to be sound accounting and business practice.

[69] Ballantine, Corporations (1st ed.) 1927, sec. 162.

[70] See *Einar Johnsen v. Pheasant Pickling Co.*, 74 Wash. Dec. 229, 24 Pac. (2d) 628, 8 Wash. L. Rev. 89 (1933). See generally as to liability for wrongful payment of dividends, 55 A. L. R. 73, 98.

[71] Wash. Rem. Rev. Stats., 1933, sec. 3809.

hibits the delegation of authority to the directors to make or alter by-laws affecting their office.[72]

SECTION 27 provides for holding, calling, and adjourning shareholders' meetings. Contrasted with the former statute[73] which required stockholders' meetings to be held at the principal place of business of the corporation within the state, this section permits stockholders' meetings to be held without the state unless otherwise provided in the articles of incorporation or by-laws.

It is further provided that the by-laws may specify the time and place of holding shareholders' meetings with the one exception that the time and place of holding a meeting for the election of directors may not be changed within sixty days before the date fixed for election. If the by-laws provide the time and place for a meeting no notice need be given as to such meetings unless expressly required by the by-laws. The by-laws customarily provide for the time and the place of the annual meeting and subdivision 1 of this section requires at least one meeting of the shareholders in each calendar year. Outside of provisions in the by-laws and articles, and special provisions in the statute, subdivision 4 specifies that at least ten days' notice shall be given when calling shareholders' meetings, fulfilled by notice properly mailed and addressed to the shareholder at his last known post office address. The effect of this section generally is to detail and make procedure more specific.

SECTION 28 deals with the right to vote, establishes a fiduciary relationship for the management class of stock, if any, authorizes voting by proxy, defining irrevocable proxy and setting forth specifically periods for expiration of proxies when not specified, provides for voting pledged stock, and for voting stock held in a fiduciary capacity, whether individually or jointly, provides for voting of a stock owned by the corporation in other corporations, and restricts the corporation from voting its own stock.

Subdivision 1 expresses the common law rule that every shareholder shall have the right to one vote except as otherwise provided in the articles of incorporation. This implies that there may be non-voting stock, the provision for which has already been discussed under Section 13, *supra.* That section authorized stock with such rights, voting powers, preferences and restrictions as may be provided for in the articles of incorporation and made a change

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[72] This subdivision prohibits the delegation of the powers mentioned even by the articles. Such a delegation was not necessarily inconsistent with the prior statute.

[73] Wash. Rem. Rev. Stats., 1933, sec. 3816.

in what was probably the law before its adoption.[74] The balance of this subdivision makes specific provision for the closing of the books of the corporation prior to the date of stockholders' meetings for the transaction of certain business. This is in accord with quite common practice and fixes a limitation only in case the articles or by-laws do not otherwise provide.

Subdivision 2 places a fiduciary relation upon the class or classes of shareholders having voting powers when denied to other classes. There is much diversity of opinion as to the advisability of issuing large blocks of shares without the privilege of voting. It is argued on the one hand that placing control in a managing group beyond the power of removal adds to the efficiency of conducting the corporation's business. On the other hand it is urged that those who are interested in sharing the profits and losses should share in the control as a matter of protection and self-defense of their interests.[75] It has been suggested as a compromise that non-voting stocks be given certain voting rights when earnings have fallen below certain dividend or interest requirements. This could be accomplished through suitable provisions in the articles. This subdivision is an attempt to protect the non-voting class by the creation of the fiduciary relationship.[76]

Subdivision 3 provides for cumulative voting by the shareholder for the election of directors. He may multiply his number of votes by the number of directors to be elected and vote them for one or more directors as he sees fit. Prior to the adoption of this section there has been some question as to the right to provide for cumulative voting in the articles or by-laws without constitutional or statutory authority It will be observed that the present section not only authorizes cumulative voting, but does not permit the articles of incorporation to deprive the shareholders of this right. The purpose of this subdivision is to make possible minority representation on the board of directors. It may well be contended that instead of making cumulative voting obligatory that it would have been better to have made cumulative voting permissible unless otherwise expressly provided in the articles. This is the law in many jurisdictions.

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[74] See *Forquer v. Inland Finance Co.*, 142 Wash. 688, 253 Pac. 1086 (1927) and *State ex rel. Fibreboard Products Co. v. Hinkle*, 147 Wash. 10, 264 Pac. 1010 (1928).

[75] See Ripley "From Main Street to Wall Street," 137 Atlantic Monthly 94, Note, 13 Cal. L. Rev. 483 (1925) Seligman, "Broader Legal Aspects of Customer Stock Ownership," 50 Reports of Am. Bar Assn. 851 (1925).

[76] See Berle, "Non-Voting Stock and Bankers' Control," 39 Harv. L. Rev. 673 (1926) Wood, "Status of Management Stockholders," 38 Yale L. Jour. 57 (1928) Berle, "Corporate Powers as Powers in Trust," 44 Harv. L. Rev. 1049 (1931). Our Supreme Court is apparently in accord with the rule. See *Tefft v. Schaefer* 148 Wash. 602, 269 Pac. 1048 (1928).

No provision is made for giving notice that the privilege of cumulative voting will be exercised. Unless such notice is given it is quite possible that cumulating voting may lead to minority control.[77] On the other hand if notice is required and given to the shareholders the majority will be enabled to protect itself by cumulating its votes so as to maintain a majority control and at the same time will not defeat minority representation which is the purpose of the provision. Statutes to this effect have been passed in Ohio and Minnesota.[78] It would seem that a reasonable provision for such notice either in the articles or the by-laws would be upheld by the courts. A further difficulty in insuring the policy contemplated by this subdivision is the provision in a subsequent section[79] that any director may be removed by a vote of two-thirds of the stockholders. Comment will be reserved for discussion under that section.

Subdivision 4 gives the right to vote by proxy duly authorized in writing and filed with the secretary The proxy may be revoked unless coupled with an interest. If not coupled with an interest a proxy may be given not to exceed three years and in the event no time is specified expires eleven months after the date of its execution. A revocation to be effective must be given to the secretary These provisions are for the greater part to make the law more definite and certain. At common law voting could be done only in person and not by proxy The law in this State prior to the adoption of this subdivision provided generally for the right.[80]

Subdivision 5 provides that in the case of pledged stock the pledgor may vote until the shares have been transferred on the books of the corporation. This is in accord with the prior statute.[81] It is further provided that one holding shares in a fiduciary capacity may vote the same. This is also in accord with existing law[82] Finally it is provided that if shares are held jointly by three or more fiduciaries the will of the majority controls and if the fiduciaries are equally divided a court upon petition may appoint an additional person to act with the fiduciaries to secure a determination. These latter provisions will simplify procedure, as heretofore in the event of disagreement the determination of the control placed an unnecessary burden on the court in those cases where facts were complicated.

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[77] Such was the case of *Schwartz v. State ex rel. Schwartz*, 61 Ohio State 497, 56 N. E. 201 (1900).

[78] Ohio General Corporation Act, secs. 8623-50. Minn. Laws of 1933, Chap. 300, sec. 25 III.

[79] Sec. 31, subsec. 4, *infra*.

[80] Wash. Rem. Rev. Stats., 1933, sec. 3812.

[81] Wash. Rem. Rev. Stats., 1933, sec. 3822.

[82] Wash. Rem. Rev. Stats., 1933, sec. 3821.

Subdivision 6 provides that a corporation owning shares in another corporation may vote the same by its president or his proxy subject to the right of the directors to appoint a proxy This again establishes a rule to apply where no other method of voting has been prescribed by the corporation. The language of the section is taken from the Ohio Corporation Act. It is substantially in accord with our prior law [83]

Subdivision 7 merely enacts the common law to the effect that a corporation may not vote its own stock nor count it in calculating the total voting power of all shareholders.

SECTION 29 provides in Subdivision 1 that two or more shareholders by an agreement in writing may transfer their shares in trust, including all voting or other rights, for a period not exceeding ten years upon the terms and conditions stated in their agreement. The object of a voting trust is to unite voting power and insure control and continuity in the management and policy of a corporation. Divorcing the voting power of stock from its real or beneficial ownership irrevocable for a fixed period is subject among others to these objections, namely, that the voting power was intended to protect the ownership, that it is a breach of duty of the mutual understanding that each shareholder was to exercise his personal judgment, that the majority may be subjected to the control of the minority, and that the power of the trustees may be used oppressively or fraudulently The modern cases as well as legislative enactments seem to favor the voting trust to be exercised within reasonable limitations. The welfare of the corporation necessitating the use of such a legal device is held to outweigh the objections. It has accordingly been held in the State of Washington that a voting trust is not void as against public policy where it was made in good faith for the advantage of the corporation and all the shareholders to protect security for a period of twenty years.[84]

Subdivision 2, providing that the trust agreement be filed in the registered office and open daily to the inspection of any shareholder, practically does away with the possibility of a certain group of shareholders taking advantage of another group. Particularly is this true as Subdivision 3 provides that any shareholder may transfer his shares to the same trustee and come under the terms of the agreement.

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[83] Wash. Rem. Rev. Stats., 1933, sec. 3810; *Day v. Hecla Mining Co.*, 126 Wash. 50, 217 Pac. 1 (1923) *First National Bank v. Walton*, 146 Wash. 367, 262 Pac. 984 (1928).

[84] See *Winsor v. Commonwealth Coal Co.*, 63 Wash. 62, 114 Pac. 908 (1911) *Gleason v. Earles*, 78 Wash. 491, 139 Pac. 213 (1914) *Clark v. Foster* 98 Wash. 241, 167 Pac. 908 (1917) and *Day v. Hecla Mining Co.*. 126 Wash. 50, 217 Pac. 1 (1923).

Subdivisions 4 and 5 provide the mechanics for carrying into effect the trust agreement through the transfer and surrender of the old stock certificates and the issue of voting trust certificates by the trustee. Provision is made for the transfer of voting trust certificates and Subdivision 6 empowers the trustee with the rights specified in the agreement.

Subdivision 7 permits the trustees, unless restricted by the agreement to vote by proxy, that their manner of voting shall be determined as provided in Section 28, Subdivision 5, that vacancies shall be filled by the remaining trustees, and that no trustee shall be responsible except for his own individual neglect or malfeasance. These provisions fix otherwise controversial matters.[85]

SECTION 30 provides for a quorum for shareholders' meetings. Subdivision 1 defines and specifies a quorum to be the representation requisite to be present in order to organize for the transaction of business. Subdivision 2 fixes this at a majority of the voting power, unless otherwise specified in the articles. Once duly organized the shareholders can continue to transact business until adjournment, notwithstanding that less than a quorum may be thereafter present. Further, in case the meeting is called for the election of directors and a quorum is not present, they may adjourn from day to day under Section 27, Subdivision 3, and at the second of such adjourned meetings, may elect directors even though a quorum is not present.

It may be observed that when a meeting is duly organized a majority of the votes present is sufficient to transact business, in fact, a majority of the votes actually cast will decide when all do not vote.[86] It should be noted that while it is quite customary to provide for a quorum in the by-laws, this section prohibits this practice, except of course the by-laws follow the section. The only exception to the provisions in Subdivision 2 is by control exercised by the shareholders to be expressed in the articles of incorporation. Under (c) of this subdivision, it may be questioned whether any adjournment should be necessary, and anyway enough grace would seem to be given by providing for an election at the first adjourned meeting. If the election is vital, a quorum will be present. On the whole this subdivision should accelerate the settlement of controversies over management.

SECTION 31 deals generally with the qualifications, election,

[85] Generally on voting trusts see Wormser, "The Legality of Corporate Voting Trusts and Pooling Agreements." 18 Col. L. Rev. 123 (1918) Smith, "Limitations on the Validity of Voting Trusts," 22 Col. L. Rev. 627 (1922) Finkelstein, "Voting Trust Agreements," 24 Mich. L. Rev. 344 (1926).

[86] Ballantine, Corporations (1st ed.) 1927, sec. 169.

tenure, and meetings of the board of directors. Subdivision 1 provides that the business of the corporation shall be managed by a board of at least three directors who need not be shareholders unless the articles so require. Further it is expressly stipulated that a director shall hold office until the expiration of the term for which he was named and until his successor shall have been elected and qualified. The prior statute provided for a board of "not less than two trustees, who shall be stockholders."[87] Changes therefore to be noted are a minimum of three directors instead of two and that they need not be shareholders.[88] Further qualifications will be reserved for discussion under Subdivision 3.

The former statute provided that the acts of the trustees were valid and binding until their successors were elected and qualified.[89] Under that statute it was held that the trustees of a corporation did not hold over as a matter of law[90] Under the foregoing subdivision it is expressly provided that they hold over. Further under the subdivision as it is provided that a "director shall hold office for the term," it would seem by implication that he must be appointed or elected for a term and could not be removed except, of course, for cause and subject to the provision of Subdivision 4.

Subdivision 2 as to names and terms of office effects a change noted heretofore under Section 3. It is further provided that the directors shall be elected by the shareholders.[91] This is traditional.

Subdivision 3 provides that subject to the provisions of this Act that the number, qualifications, terms of office, manner of election, time and place of meeting, and the powers and duties of the directors may be prescribed by the articles or by-laws. As the only apparent limitation as to what may be prescribed by the articles or by-laws are the provisions of the Act, a strict construction would exclude similar provisions under prior statutes except so far as included in the Act. A liberal construction on the other hand, particularly in view of the generality of the provision in this subdivision, would not exclude former specific statutory provisions unless necessarily inconsistent with the spirit and provisions of this subdivision. It is submitted, therefore, that the provisions

[87] Wash. Rem. Rev Stats., 1933, sec. 3812.

[88] It was held in *Ouden and Bergman Co. v. Conlan*, 34 Wash. 216, 75 Pac. 798 (1904) that a trustee of a corporation by a sale of his stock *ipso facto* ceased to be a trustee.

[89] Wash. Rem. Rev. Stats., 1933, sec. 3813.

[90] *Barnard Manufacturing Co. v. Ralston Milling Co.*, 93 Wash. 111, 160 Pac. 309 (1916).

[91] Qualified in case of vacancies by subdiv 3 (b)

under the former statute[92] with respect to the qualifications as to residence, citizenship, and oath of office are still in force. Subject to the articles or by-laws otherwise prescribed, the subdivision provides (a) that the directors shall be elected for a term of one year, (b) that vacancies shall be filled by the board until successors are elected by the shareholders, (c) that meetings may be held in or without the state as the majority of directors may from time to time appoint, (d) what shall constitute a quorum, and (e) authority for the board to constitute an executive committee. Of these provisions (a), (b) and (d) are in accord with the usual practice.[93] With respect to (d) it should be noted that the votes of a majority of the directors present is necessitated.[94] The provision in (c) is in accord with the former statute[95] except that the place of meeting may be fixed as the majority of the directors may from time to time appoint, whereas formerly the place must be designated in the articles or by-laws.[96]

The last clause (e) permits the board of directors by resolution passed by the majority of the whole board to designate two or more of their number to constitute an executive committee who to the extent provided in said resolution shall have and exercise the authority of the board of directors in the management of the business of the corporation. This is a new provision and of vital significance. As a matter of business practice where there are large boards of directors, or where the members reside in different places or are not easily assembled, or where meetings are set at periods of long intervals, it has become customary to appoint an executive committee and the full board is little more than a ratifying body Courts are at variance as to the extent to which the board of directors may so delegate authority to an executive committee. On the one hand it has been held that they may delegate to an executive committee of their own number the power to do

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[92] Wash. Rem. Rev. Stats., 1933, sec. 3812. This section reads as follows: "The corporate powers of a corporation shall be exercised by a board of not less than two trustees, who shall be stockholders in the company, and at least one of whom shall be a resident of the state of Washington, and a majority of them citizens of the United States, who shall, before entering upon the duties of their office, respectively take and subscribe to an oath, as provided by the laws of this state."

It may be suggested that this provision for residence and citizenship is better adapted for effecting the purpose intended than a similar provision in sec. 2 of the Act fixing the qualifications of the incorporators.

[93] Wash. Rem. Rev. Stats., 1933, sec. 3814, is almost identical with (d).

[94] This should be taken in consideration in case of an interested director. See *Parsons v. Tacoma Smelting and Refining Co.*, 25 Wash. 492, 65 Pac. 765 (1901).

[95] Wash. Rem. Rev. Stats., 1933, sec. 3816.

[96] The provisions in Wash. Rem. Rev. Stats., 1933, sec. 3816, requiring copies of proceedings to be filed at the principal office, is provided for in sec. 35, subdiv. 1 (a) of this Act.

any act which they themselves might do;[97] on the other hand it has been held that the directors cannot confer power to discharge duties which are of discretionary character except in the transaction of ordinary business of the corporation, unless authorized so to do by charter.[98] In view of Subdivision 1 of this Section, it would seem that the directors cannot under (e) delegate the entire supervision and control of the corporation to an executive committee as Subdivision 1 is controlling in requiring that the business of every corporation shall be managed by the board. It should be noted, however, that the provision under (e) permits the executive committee to exercise the authority of the board of directors on the management of the business of the corporation and accordingly the acts of the executive committee will be binding upon the corporation as far as so exercised. This will raise the question of the standard of care and skill to be exercised by the two groups.[99] The laws of other jurisdictions contain provisions that the executive committee "shall act only in the interval between the meetings of the board, and shall be subject at all times to the control and direction of the board."[100] While such a provision would possibly be implied under (e) its specific inclusion will notify the directors that they cannot delegate their entire powers and duties to the executive committee.

Subdivision 4 provides that any director may be removed by two-thirds of the voting power and at the special meeting called for this purpose the shareholders may fill the vacancy created by this removal. This follows substantially the former law of this state except that it is more accurately expressed.[101] This would seem to defeat the purpose of Section 28, Subdivision 3, providing for cumulative voting except in those cases where the minority represents more than one-third of the voting power. In a number of jurisdictions where it is provided that a director may be removed from office by a majority of the voting power it is further provided that unless the entire board be removed, no individual director shall be removed in case the votes of a sufficient number of shares are cast against his removal which if then cumulatively voted at an election of a full board would be sufficient to elect

[97] *Hoyt Thompson, Executors*, 19 N. Y. 207 (1859).

[98] *Temple v. Dodge*, 86 Tex. 69, 32 S. W 514, 33 S. W 222 (1895) the by-laws gave the committee all the powers of the board of directors; see also *Young v. Schenck*, 64 Wash. 90, 116 Pac. 588 (1911)

[99] See sec. 33, *infra*.

[100] California General Corporation Law, sec. 308; Cal. Civ. Code (1931), sec. 308; Ohio Gen. Code (Page 1931), sec. 8623-60; Minn. Laws of 1933, Chap. 300, sec. 27 (h)

[101] Wash. Rem. Rev. Stats., 1933, sec. 3812. In construing this statute the court held in *State ex Rel. Mitchell v. Horan*, 22 Wash. 197, 60 Pac. 135 (1900) that two-thirds of the stockholders must be construed as two-thirds of the stock.

him.[102] A similar provision should be included in the Washington Act. The general policy expressed in the subdivision is contrary to the common law[103] and to that of most jurisdictions. Its apparent purpose is to make the board of directors either more or completely responsive to the will of the voting power designated. As the desirability of such policy may vary with the nature of the corporation, perhaps its determination should have been left to the articles.

SECTION 32 provides for the election or appointment of officers and agents, their authority and their removal. Primarily the power to elect directors and other officers is in the stockholders, but customarily the power is conferred upon the directors as to other officers. Subdivision 1 specifically provides that the directors shall elect a president, a secretary and treasurer, and may elect one or more vice-presidents. No one of said officers, except the president, need be a director, but a vice-president who is not a director cannot succeed to or fill the office of president. Any two of the offices of vice-president, secretary and treasurer may be held by one person. This subdivision will settle the somewhat doubtful question as to whether the officers need be members of the board of directors and in view of the preceding section whether they need even be shareholders. The prior statute was not definite.[104] Subdivisions 2 and 3 are merely declaratory of common practice. Attention is called to the former statute,[105] apparently not affected, which requires the corporation on or before the second Tuesday of January of each year to file with the county auditor a statement, sworn to by its president and attested by its secretary containing a list of all its officers and their respective titles of office, names and addresses, and the term of office for which they have been chosen.

Subdivision 4 makes a substantial change in the law It was formerly provided[106] that the corporation had the power to appoint such officers, agents, and servants as the business of the corporation should require, and had the further power to remove them at will. A long line of decisions has held that this authorized the removal of any employee notwithstanding a contract of employment for a definite period without incurring liability for the un-

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[102] Cal. Civ. Code (1931), sec. 310 (1) Minn. Laws of 1933, Chap. 300, sec. 28 II.

[103] Fletcher, Cyclopedia of the Law of Private Corporations, 1931, vol. 2, sec. 352.

[104] Wash. Rem. Rev. Stats., 1933, sec. 3809.

[105] Wash. Rem. Rev. Stats., 1933, sec. 3817.

[106] Wash. Rem. Rev. Stats., 1933, sec. 3809.

earned portion of the salary contracted for.[107] Subdivision 4 provides that any officer or agent may be removed by the board of directors whenever in their judgment the best interest of the corporation will be served thereby, such removal, however, to be without prejudice to the contract rights of the person so removed. This will put the law in Washington in line with other jurisdictions and seems desirable, as there is no justifiable reason for distinguishing employment contracts of corporations from those of individuals or other business organizations.

The question is accordingly raised as to the effect of the Act upon contracts existing at the time the Act went into effect. While the Act itself will not make existing contracts enforceable it is probable that in many instances subsequent acts by the parties in recognition of the contract will be construed to give it effect either through the principles of adoption or ratification.

SECTION 33 imposes a fiduciary relation upon the directors and officers of the corporation. It fixes the standard of care as that which ordinarily prudent men would exercise under similar circumstances in like positions. Some courts have held directors to the care which an ordinarily prudent man would exercise in his own business. The latter test in cases of boards of directors with executive committees as well as other cases where directors merely supervise would keep men of financial ability from assuming such positions.[108] There was no similar prior statute in the state of Washington.*

LESLIE J AYER.**

[107] Among these see *Murray v. MacDougall & Southwick Co.*, 88 Wash. 358, 153 Pac. 317 (1915) *Williams v. Great Northern Railway Co.*, 108 Wash. 344, 184 Pac. 340 (1919) and *O'Donnell v. Sipprell*, 163 Wash. 369, 1 Pac. (2d) 322 (1931).

[108] Hoshour, "Minnesota Business Corporation Act," 18 Minn. L. Rev. 7 (c) (1933).

* To be continued.

** Professor of Law, University of Washington.