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CORPORATIONS — DIRECTORS — VALIDITY OF BY-LAW PERMITTING REMOVAL OF DIRECTORS WITHOUT CAUSE — A by-law of defendant, a Delaware corporation, permitted removal of a director with or without cause by a majority vote of the stockholders.[1] The certificate of incorporation provided for a staggered board system which divided the board of directors into three groups, the term of one group expiring at each annual meeting. At a special stockholders' meeting three directors were removed without cause. Plaintiff, majority stockholder of the corporation, instituted an action to determine the validity of the removal. *Held,* the three directors were improperly removed since the by-law which allowed removal without cause was inconsistent with the certificate of incorporation and therefore void. *Essential*

[1] The by-law involved in the principal case had become a common one for Delaware corporations and was generally thought, by the bar of that state, to be valid. *Proceedings at the Annual Meeting of the Section of Corporation, Banking, and Business Law,* 10 BUS. LAW 9, 10-11 (1954).

Enterprises Corp. v. Automatic Steel Products, Inc., 159 A.2d 288 (Del. Ch. 1960).

In deciding this case, the court stated that the issue involved was one of construction only.[2] However, this statement of the issue raises two difficulties. First, the court appears to have overlooked at least one essential difference between the certificate of incorporation and the by-laws. In Delaware the certificate of incorporation is required to set forth only a minimal amount of information which primarily concerns the corporation's external relations with the state.[3] The by-laws, on the other hand, are intended to supplement the certificate by filling in its skeletal structure with details governing the internal relationships of the members, directors, and officers of the corporation.[4] Therefore, the fact that the certificate does not authorize the removal of directors by the stockholders does not necessarily support the inference that the incorporators intended that the directors be immune from this form of stockholder control. Secondly, by laying the cornerstone of this decision on the issue of construction only, the court has chosen a logically unsound foundation. If the issue in this case actually involves construction only, the validity of a by-law which authorized the removal of directors for cause, when tested by the same criteria, would also be in jeopardy, for the court's construction seemed to be premised upon the fact that the by-law placed a limitation upon the director's tenure which was not specifically authorized by the certificate of incorporation. Moreover, this standard would also invalidate a by-law which allowed the removal of a member of a non-staggered board. Yet it appears settled that stockholders do have the right to remove a director for good cause, and to express this right in by-law form.[5]

Actually, the Delaware court was deciding not a problem of construction, but rather a policy conflict between greater stockholder control of the board and the desire for maximum stability in corporate management. The Delaware statutes[6] neither permit nor deny to stockholders the right to remove directors, with or without cause, although one statute contains language which seems to contemplate the possibility of removal of a director before

[2] Principal case at 290.

[3] In particular, the Delaware statute requires only that the certificate of incorporation set forth the name of the corporation; the principal office or place of business, and the name of the resident agent; the nature of the business to be carried on; the amount of authorized stock, and if more than one class of stock is to be issued, the powers and privileges of each class; the names and addresses of the incorporators; the duration of the corporation's existence; and whether the private property of the stockholders is to be subject to payment of corporate debts. DEL. CODE ANN. tit. 8, § 102 (1953).

[4] The statutes of several states expressly provide that the by-laws shall stipulate whether or not the stockholders shall possess the removal power; see, *e.g.*, ORE. REV. STAT. § 57.185 (1955); TEX. BUS. CORP. ACT art. 2.32 (1956); W. VA. CODE ANN. § 31-1-20 (1955).

[5] Campbell v. Loew's, Inc., 134 A.2d 852 (Del. Ch. 1957); Markovitz v. Markovitz, 336 Pa. 145, 8 A.2d 46 (1939); In the Matter of Koch, 257 N.Y. 318, 178 N.E. 545 (1931); Fox v. Cody, 141 Misc. 552, 252 N.Y. Supp. 395 (Sup. Ct. 1930); Toledo Traction, Light & Power Co. v. Smith, 205 Fed. 643 (N.D. Ohio 1913).

[6] DEL. CODE ANN. tit. 8, §§ 101-517 (1953).

the expiration of his term.[7] Only the New York courts have previously faced the issue of removal without cause without the aid of express statutory provision for such removal. The New York courts have consistently upheld the right of stockholders to adopt a by-law permitting the removal of directors at any time, with or without cause.[8] These decisions rest upon the premise that the denial of this right to stockholders tends to result in the denial of adequate stockholder control over the policy-making body of the corporation.[9]

The court in the principal case argued that the exercise of the power granted in this by-law would frustrate the "plan and purpose" behind the staggered board system.[10] With this rather expansive statement, the court has, in effect, concluded that the section of the Delaware corporation law which permits classification of the board contains a legislative policy prohibiting, at least in the absence of an express provision in the certificate, stockholder removal of directors without cause. There is no language in this statute, or in any other Delaware statute, which would support this conclusion. In so deciding, the court ignored the fact that the defendant corporation was the product of a merger, and that the merger agreement constituted a contract between the stockholders of the constituent corporations. In this agreement the parties contracted both to classify the board of directors of the new corporation and to reserve for themselves, in a by-law, an effective form of control over the board. Only a very clear statement of legislative policy should be allowed to nullify the provisions of this contract.

The avowed purpose of the classified directorate is to preserve continuity of management; this can be obtained only by the sacrifice of a certain degree of stockholder control over the board.[11] Contrary to the court's reaction, it can be argued that where a corporation has classified its board of directors, the stockholders' removal power might produce an appropriate balance of power between the board and the stockholders. The state legislatures in the past have not proved to be effective catalysts in the solution of this problem, though there now appears to be a legislative trend toward

[7] DEL. CODE ANN. tit. 8, § 223 (1953) provides in part: "Vacancies and newly created directorships . . . may be filled by a majority of the directors then in office . . . and the directors so chosen shall hold office until the next annual election and until their successors are duly elected and qualified, *unless sooner displaced. . . .*" (Emphasis added.)

[8] In the Matter of Singer, 189 Misc. 150 (Sup. Ct. 1947); Abberger v. Kulp, 156 Misc. 210, 281 N.Y. Supp. 373 (Sup. Ct. 1935); In the Matter of Schwartz, 119 Misc. 387, 196 N.Y. Supp. 679 (Sup. Ct. 1922). These cases would seem to be peculiarly applicable to the principal case since neither New York nor Delaware provide a statutory scheme for removal of directors, while both states permit classification of boards of directors.

[9] General stockholder apathy prevents effective utilization of this control device. However, its existence is important where majority control shifts, or changes hands altogether between annual elections.

[10] Principal case at 291.

[11] Additionally, a staggered board may effectively sterilize the ability of minority interests to gain representation on the board through cumulative voting. See Sell & Fuge, *Impact of Classified Corporate Directorates on the Constitutional Right of Cumulative Voting,* 17 U. PITT. L. REV. 151 (1956).

protection and expansion of the stockholder democracy.[12] In the absence of any indication from the court's opinion that the removal power has been abused in those instances when it has been exercised,[13] it is suggested that the Delaware court has exceeded the limits of judicial restraint in striking down this by-law. If, as the court said,[14] "reasonable predictability in our business society" is of such paramount importance that it must prevail over the interests of the owners of the corporation, then it is for the legislature to make this decision by expressly denying to the stockholders the power to remove directors without cause.

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[12] The statutes of eighteen states now permit directors to be removed by the stockholders without cause. HORNSTEIN, CORPORATION LAW AND PRACTICE § 389 n.68 (1959). Fifteen of these states also permit classification of boards of directors. *Id.*, § 384 nn. 33-38. In addition, twenty-one states have, by constitutional provision, made cumulative voting for directors mandatory, and seventeen other states have adopted permissive cumulative voting statutes. Young, *The Case for Cumulative Voting*, 1950 WIS. L. REV. 49, 54.

[13] Where the power has been conferred by statute, there is little evidence that it has been frequently used. WILLIAMS, CUMULATIVE VOTING FOR DIRECTORS 57 (1951).

[14] Principal case at 291.