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Presidential Power to Institute Corporate Litigation

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Notes

PRESIDENTIAL POWER TO INSTITUTE CORPORATE LITIGATION

The prima facie power of the president of a corporation to institute suit in the name of the corporation is generally thought to be incidental to the regular course of the corporation's business.[1] Where vital interests of the corporation are endangered a failure of the president to institute suit may render him liable to the corporation.[2] The power of the president to institute suit may be express,[3] implied[4] or an inherent function of the corporate office.[5] Regardless of the source of the authority it is normally restricted to litigation incidental to the regular course of the corporation's business.[6]

Where there is an intra-company dispute causing a deadlock among the shareholders and directors the presumptive authority of the president is negated.[7] This deadlock possibility seems to arise frequently in the closely held corporation where two factions have equal control of the board of directors.[8] Professor O'Neal explains the dilemma occurring in the close corporation by stating:

> In a publicly held corporation disputes among the shareholders or directors are settled by the principle of majority rule. In close corporations, on the other hand, voting shares and membership on the directorate may be evenly divided between opposing factions, or minority interests may hold veto powers over shareholders and director action; and deadlocks occur with alarming frequency. When a deadlock ensues is the corporation doomed to corporate paralysis until one faction yields? Or may the officers take action at least to conserve the corporate assets?[9]

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[1] 1 Hornstein, Corporation Law and Practice § 515 (1959); 2 Fletcher, Corporations § 618 (Rev. ed. 1954); Note, 48 Yale L.J. 1082, 1083 (1939).

[2] Elblum Holding Corp. v. Mintz, 120 N.J.L. 604, 1 A.2d 204 (1938); see 1 Hornstein, *op. cit. supra* note 1, at 641.

[3] N.Y. Stock Corp. Law § 60 provides:

The directors . . . may appoint . . . officers . . . who shall respectively have such powers and perform such duties in the management of the property and affairs of the corporation, subject to the control of the directors, as may be prescribed by them or in the by-laws.

[4] See Annot., 10 A.L.R.2d 701, 707 (1950).

[5] See 2 Fletcher, *op. cit. supra* note 1, § 618 at 764.

[6] 1 Hornstein, *op. cit. supra* note 1, at 640; Lattin, Corporations § 230 (1959); 89 U. Pa. L. Rev. 386 (1941); Note, 48 Yale L.J. 1082 (1939); 23 Wash. U.L.Q. 117 (1937).

[7] 1 Hornstein, *op. cit. supra* note 1, at 640.

[8] *Ibid.*

[9] 2 O'Neal, Close Corporations § 8.06 at 97 (1958).

The New York Court of Appeals has had occasion to consider Professor O'Neal's questions in an interesting series of decisions rendered during the last decade. In the first of these decisions, *Sterling Indus., Inc. v. Ball Bearing Pen Corp.*,[10] plaintiff corporation was formed and controlled by two factions. One of these factions on the board of directors also controlled the defendant corporation. The president of plaintiff corporation called a meeting of plaintiff's board of directors to consider whether plaintiff should sue defendant corporation for an alleged breach of contract. As could be expected the members of plaintiff's board who controlled defendant voted against the suit and since the other faction voted for the suit, the board was deadlocked. The president of plaintiff declared that the motion to bring suit had not passed, but he nevertheless instituted the suit. The court of appeals held that plaintiff corporation had not authorized the institution or prosecution of the action. The court emphasized that if the action had been allowed there would in effect have been an amendment to the New York statutory norm[11] relative to the powers of the board of directors to make it read that "the corporation shall be managed by its board of directors, except in the case of deadlock when it shall be managed by any director who happens to be president."[12] The court did not decide whether the president could have initiated a valid suit where emergency conditions existed as no emergency was alleged by plaintiff.[13]

The next in the series of New York cases was that of *Rothman & Schneider v. Beckerman*,[14] in which an action for conversion of corporate assets was instituted by the secretary-treasurer of plaintiff corporation against defendant Beckerman, the president's son-in-law. The president had retired some months previously, leaving the secretary-treasurer to manage and operate the business. The president and the secretary-treasurer, along with their respective wives, each owned fifty per cent of the corporation's stock and all four individuals comprised the board of directors. The secretary-treasurer had not submitted the question of the suit against Beckerman to the board for its consideration. Nevertheless, the court of appeals held that the secretary-treasurer had implied authority to institute and prosecute the action commenting that "where there has been no direct prohibition by the board . . . the president has presumptive authority . . . to

[10] 298 N.Y. 483, 84 N.E.2d 790 (1949).

[11] N. Y. Gen. Corp. Law § 27: "The business of a corporation shall be managed by its board of directors. . . ."

[12] Sterling Indus., Inc. v. Ball Bearing Pen Corp., 298 N.Y. 483, 492, 84 N.E.2d 790, 794 (1949). (Court's emphasis omitted.)

[13] *Ibid.*

[14] 2 N.Y.2d 493, 141 N.E.2d 610, 161 N.Y.S.2d 118 (1957).

defend and prosecute suits in the name of the corporation."[15] The court pointed out that the corporation was of the closely held variety operating informally, and that "having in mind the realities of the situation"[16] the courts below were warranted in allowing the secretary-treasurer to bring the action, and that the "defendants . . ., complete strangers to the corporation . . . , should not be permitted to question his authority. . . ."[17] Thus the primary factors distinguishing this decision from *Sterling Indus., Inc. v. Ball Bearing Pen Corp.*, were that here the suit was against "outsiders" and there was not a direct prohibition against the suit by the board of directors.

In *Paloma Frocks v. Shamokin Sportswear Corp.*,[18] decided in 1958, Judge Desmond stated the issue before the court as follows:

> [W]hen a contract between two corporations includes a general arbitration clause, may the president of one contracting party without specific authorization from his directors commence an arbitration of an alleged dispute, when half of the directors of his corporation represent the other contracting party on his corporation's board and presumably would not vote in favor of bringing the dispute before arbitrators?[19]

The court answered the question in the affirmative, again distinguishing the *Sterling* decision by pointing out that here the board of directors had not passed upon the president's action while in the *Sterling* case the board had considered but failed to affirm the president's conduct.[20] The court also relied upon the theory that the president was "merely carrying out an *existing* agreement that all disputes under this contract would be submitted to arbitration."[21] Thus the board of directors had already affirmed the arbitration agreement in general and the president's submission of the dispute to arbitrators "was a routine step in the performance of an authorized contract."[22] The court did recognize that the board of directors could have forbidden a particular arbitration, but in the absence of such a prohibition an "authorization of a corporation president to agree to a general arbitration clause amounts to an authorization to the president to carry on arbitrations of such disputes as may arise."[23] It should be noted that here, as in *Rothman & Schneider v. Beckerman*,[24] the suit was against "outsiders" and there

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[15] *Id.* at 497, 141 N.E.2d at 613, 161 N.Y.S.2d at 121. (Emphasis added.)
[16] *Id.* at 499, 141 N.E. 2d at 614, 161 N.Y.S.2d at 123 (1957).
[17] *Ibid.*
[18] 3 N.Y.2d 572, 147 N.E.2d 777, 170 N.Y.S.2d 509 (1958).
[19] *Id.* at 573, 147 N.E.2d at 780, 170 N.Y.S.2d at 510.
[20] *Id.* at 575, 147 N.E.2d at 781, 170 N.Y.S.2d at 511.
[21] *Ibid.* (Emphasis added.)
[22] *Ibid.*
[23] *Ibid.*
[24] 2 N.Y.2d 493, 141 N.E.2d 610, 161 N.Y.S.2d 118 (1957).

was not a direct prohibition of the president's action by the board of directors.

In 1959 the court of appeals of New York handed down its decision in *West View Hills, Inc. v. Lizau Realty Corp.*[25] Here the president of a three-man corporation initiated an action in the name of the corporation against defendant corporation whose controlling officers were the same as those in control of plaintiff corporation. Plaintiff alleged that the officers of defendant had so mismanaged plaintiff as to cause it to pay the construction costs of a building owned by defendant. Plaintiff's president did not ask the board of directors to consider the question of whether a suit should have been brought against defendant. It was obvious, of course, that permission to sue would have been denied. Thus the president of plaintiff relied only on an implied presumptive power of the president to bring the action. Emphasizing that a corporate entity has independent legal rights, the court affirmed the power of the president to initiate the action even though a majority of the board of directors was in a position to withhold authorization for the suit. The principle stated in *Rothman & Schneider v. Beckerman*[26] and followed in *Paloma Frocks, Inc. v. Shamokin Sportswear Corp.*,[27] that absent an express prohibition by the board of directors "the president has presumptive authority, in the discharge of his duties, to defend and prosecute suits in the name of the corporation"[28] was accepted as controlling by the court.[29]

Judge Froessel severely criticized the position taken by the majority of the court in the *West View Hills* case. In his dissenting opinion he said:

> The majority of the court is now holding that a minority stockholder, merely because he was president . . . may now sue, upon the theory of implied authority and *in the name of the corporation*, the majority stockholders who are the two remaining directors.[30]

Judge Froessel also criticized the continued adherence by the majority of the court to the proposition that the failure of the president to submit the question of the suit to the board of directors was a satisfactory basis for distinguishing the *Sterling* decision. On this point, he said:

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[25] 6 N.Y.2d 344, 160 N.E.2d 622, 189 N.Y.S.2d 863 (1959); *accord*, Berma Management Corp. v. 140 W. 42d St. Realty, Inc., 197 N.Y.S.2d 18 (Sup. Ct. 1960).

[26] 2 N.Y.2d 493, 141 N.E.2d 610, 161 N.Y.S.2d 118 (1957).

[27] 3 N.Y.2d 572, 147 N.E.2d 779, 170 N.Y.S.2d 509 (1958).

[28] Rothman & Schneider v. Beckerman, 2 N.Y.2d 493, 497, 141 N.E.2d 610, 613, 161 N.Y.S.2d 118, 121 (1957).

[29] West View Hills, Inc. v. Lizau Realty Corp., 6 N.Y.2d 344, 346, 160 N.E.2d 622, 623, 189 N.Y.S.2d 863, 864 (1959).

[30] *Id.* at 348, 160 N.E.2d at 625, 189 N.Y.S.2d at 866.

> However relevant the absence of direct prohibition may be in a *deadlock* situation, it can hardly be decisive where the president has actual knowledge that a *majority* of the board of directors oppose the suit. To consider it decisive would be to exalt form above substance to a degree never countenanced by this court.[31]

The majority of the court did not directly discuss one of the primary reasons for disallowing the implied presidental suit; if such suits are allowed then the management and control of the corporation tends to shift from the board of directors to the president.[32] Even though it be recognized that the corporation as a separate legal entity has separate, independent legal rights Judge Froessel commented that "such a decision . . . runs counter to the basic principles of corporate law and holds in effect that a corporation is to be managed by its president and not by its board of directors."[33] So it is possible now in New York for the president of a corporation to initiate a suit in the name of the corporation, even though a majority of the board of directors of the corporation would have voted against bringing the suit had the issue been submitted to the board. This result encompasses more than a mere solution of the deadlock problem which was first presented to the court in the *Sterling* case as there was no deadlock in the *West View Hills* case. In certain instances it may be imperative to allow the president of a corporation to act where the corporation's board of directors is deadlocked. But should the principles developed to allow the president to so act have any relevancy where there is not a deadlock?

The problem presented by this series of New York cases involves primarily two conflicting policies:[34] (1) that the corporation is a separate legal entity with independent legal rights which the president is under a duty to invoke when the situation so demands;[35] (2) that the president, as a minority shareholder, should not be allowed to use the corporate suit as a route through which to oppose the policies of fellow directors, but should be restricted to the minority shareholder's derivative suit.[36] Deadlock and disagreement occur frequently in

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[31] *Id.* at 349, 160 N.E.2d at 625, 189 N.Y.S.2d at 867.

[32] Sterling Indus., Inc. v. Ball Bearing Pen Corp., 298 N.Y. 483, 84 N.E.2d 790 (1949).

[33] West View Hills, Inc. v. Lizau Realty Corp., 6 N.Y.2d 344, 348, 160 N.E.2d 622, 625, 189 N.Y.S.2d 863, 866 (1959).

[34] See 32 Rocky Mt. L. Rev. 415 (1960); 34 St. John's L. Rev. 330 (1960); West View Hills, Inc. v. Lizau Realty Corp., *supra* note 33, at 350, 160 N.E.2d at 626. 189 N.Y.S.2d at 867 (dissenting opinion).

[35] See 2 O'Neal, *op. cit. supra* note 9, § 8.06 at 97, 104.

[36] *Ibid.*; see also 34 St. John's L. Rev. 330 (1960), for an exposition of the respective advantages and disadvantages between the president's suit in the name of the corporation and the minority shareholder's derivative suit.

closely held corporations.[37] Though it cannot always be said that such situations are unforseen at the initiation of the enterprise,[38] the present state of New York law, which emphasises formalisms such as the absence of direct prohibition by the board, can invite abuse of the policy of allowing presidental suits to represent the independent corporate entity.[39] Professor O'Neal suggests a solution which pierces the corporate veil to determine the actual relationship of the parties involved in the suit. He states the ingredients of his formula in the following language:

> Whenever the shareholders and directors of a corporation are deadlocked, an officer of the corporation will not be permitted to prosecute or defend litigation in the name of the corporation, if the inability of the shareholders and directors to reach a decision on whether to litigate is the result of an honest difference of opinion over corporate policy; but, he will be permitted to prosecute or defend in the name of the corporation litigation necessary to protect its vital interests, if a faction of the shareholders or directors is obviously using its power under a veto or shared control arrangement to bring about a deadlock for a fraudulent or unfair purpose.[40]

North Carolina, in accordance with the philosophy[41] of its new Business Corporation Act, stressing the particular needs of the close corporation, has enacted a statutory provision which would cure the deadlock problem facing many closely held corporations. The provision states that "the president has authority to institute or defend legal proceedings when directors are deadlocked."[42] It should be

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[37] 1 Hornstein, *op. cit. supra* note 1, § 515; 1 O'Neal, *op. cit. supra* note 9, § 8.06.

[38] See Israels, *The Sacred Cow of Corporate Existence*, 19 U. Chi. L. Rev. 778 (1952). The language of the New York court in a recent decision, Application of Paloma Frocks, Inc., 1 App. Div. 2d 640, 152 N.Y.S.2d 652, 654 (1956), *aff'd* mem., 2 N.Y.2d 934, 142 N.E.2d 205 (1957), is illustrative of the problem often facing promoters of small closely held enterprises:

> If the president of a corporation is considered to have carte blanche, the right to institute actions in the name of the corporation without approval of the board of directors, the result would be to destroy to a large extent the protection which is sought by parties who engage in a corporate enterprise under an agreement that the stock and directorate control will be equally divided. Thus if one of the parties to the agreement were allowed to act independently and against the wishes of the other . . . the very purpose of the agreement for equal control would be frustrated.

[39] See the dissenting opinion in West View Hills, Inc. v. Lizau Realty Corp., 6 N.Y. 2d 344, 348, 160 N.E.2d 622, 625, 189 N.Y.S.2d 863, 866 (1959) where Judge Froessel depicts in detail the economic inequities which followed the result in the *West View Hills* decision.

[40] 2 O'Neal, *op. cit. supra* note 9, § 8.06 at 104.

[41] See Latty, *The Close Corporation And The New North Carolina Business Corporation Act*, 34 N.C. L. Rev. 432, 438 (1956). The new North Carolina corporation law recognizes that many closely held corporations are little more than incorporated partnerships and as such have problems which are not aided by developments in the law of the public issue corporation.

[42] North Carolina Business Corporation Act § 55-34 (c) (Supp. 1957).

noted that this North Carolina statute provides only for suits in the case of deadlock and does not envisage allowing the president to sue in the name of the corporation when a majority of the board of directors is against the suit. Thus New York by judicial edict has gone further than the North Carolina legislature chose to go in that New York allows corporate suits to be initiated by the president where the president has not submitted the question of the suit to the board of directors even though a majority of the board disapproves of the action.

The problem of deadlock arising in the closely held corporation does demand a forthright solution such as the one reached in North Carolina.[43] New York sought to resolve the question in the series of decisions culminating in *West View Hills v. Lizau Realty Corp.* The New York solution to the deadlock problem in the close corporation may be criticized because of its extension to include a situation where there was not a deadlock, but regardless of the merits of the solution as related to close corporations, an important question may arise if the same reasoning is used in a situation of internal corporate conflict involving a public issue corporation. As a practical matter deadlock does not frequently arise in the public issue corporation.[44] Thus North Carolina's statutory solution will likely have no significance except as to the closely held corporation. But New York's solution meets not only the *deadlock* situation commonly found in the close corporation but also encompasses the situation where there is *not* a deadlock; the president of the corporation is in fact acting against the wishes of a majority of the board of directors. Now that the New York court will allow the president of a *closely held* corporation to bring a corporate action even though against the wishes of a majority of the board of directors, will it also allow the president of a *public issue* corporation to bring a corporate action when a majority of the board of directors is opposed to the suit? The management and operation of the typical public issue corporation is often a far different problem than the one facing the officers of the closely held corporation.[45] In fact, the controlling shareholders of the closely held corporation often operate the enterprise much in the manner of a partnership with little of the formality and patterns of procedure used in the operation of a public issue corporation.[46] The basic premise in controlling the operation of a public issue corporation is usually majority rule,[47] while the con-

[43] See Israels, *supra* note 38.
[44] See O'Neal, *op. cit. supra* note 9, § 8.06.
[45] See Israels, *supra* note 38; Latty, *supra* note 41.
[46] See Stevens, Private Corporations § 10 (2d ed. 1949).
[47] O'Neal, *op. cit. supra* note 9, § 8.06.

trolling shareholders of a closely held corporation may have specifically provided for deadlock situations should internal dissension arise within the group.[48] In the closely held enterprise the preservation of an independent legal right at the initiation of the president may be of utmost importance to the continued existence of the enterprise. Individual shareholders in the closely held corporation may sometime need every means available to protect their own and the corporation's interests. However, a solution for this problem which, if applied to the public issue corporation, would allow the president to ignore the wishes of a majority of the board of directors and sue in the corporate name violates the majority rule thesis of control in the public issue corporation. In those instances where the ownership of the public issue corporation is almost completely divorced from the control and management, gross inequities might occur if the president were allowed to use the corporate suit to foster personal interests in a fight for control.

Therefore, a solution for the deadlock problem arising in close corportions should encompass nothing more than a rectification of that problem alone, with no implications as to situations involving the public issue corporation. As a result of the *West View Hills* decision the possibility of such an application now exists in New York. Whether the reasoning of the New York court in the *West View Hills* decision will be limited to those instances involving close corporations remains to be seen. The problem of deadlock which plagues the closely held corporation can be adequately met by a statutory provision such as the one enacted in North Carolina; the provision in practical effect is limited in its application to closely held corporations.

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[48] Israels, *supra* note 38; Israels, *The Close Corporation and the Law*, 33 Cornell L.Q. 488 (1948); Latty, *supra* note 41.