Chapter 8: Corporations

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CHAPTER 8

Corporations

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§8.1. Restrictions on transfer of stock. One of the paradoxes associated with the modern corporation is its continued popularity as a business unit, notwithstanding the fact that some of the corporate attributes are often distasteful to the owners. Businessmen continue to adopt the corporate form because they seek limited liability or the acquisition of transferable interests, and then face the problem, in some instances at least, of alleviating the increased tax burdens resulting from incorporation.¹ A partnership is incorporated for what appears to be valid reasons, and the stockholders, unhappy with corporate procedure, often continue to conduct their business as though they were still partners.

Perhaps the most common example of this desire to modify normal corporate characteristics is the restriction on the transfer of stock. Shareholders in a closely held corporation will almost inevitably insist that some form of restriction be imposed to prevent the introduction of new members into the enterprise without their consent. The validity of such restrictions is well established.² In the typical case the stockholder is prohibited from transferring his shares without first offering them to the corporation at a price fixed by appraisal or by reference to some standard such as book value.³

In a significant decision in 1954, Kentucky Package Store, Inc. v. Checani,⁴ such a restriction failed to accomplish its objective when the corporation sought to enforce it against the estate of the majority stockholder. Upon his decease the corporation was left with a board of four directors, which was deadlocked on the question as to whether the corporation should exercise its option to purchase the decedent's

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§8.1. ¹This is not intended to suggest that incorporation always results in increased taxes, since frequently an over-all reduction in taxes is sought and achieved by the use of the corporate form.
²Boston Safe Deposit & Trust Co. v. North Attleborough Chapter of the American Red Cross, 330 Mass. 114, 111 N.E.2d 447 (1953); see also G.L., c. 156, §6(f).
equity proceeding (actions at law are forbidden) in the Probate Court without a time limit except that real estate of the testator is not reachable unless such proceeding is filed within twenty years after the testator's death.

Chapter 478 of the Acts of 1954 amends Chapter 195, Section 11 of the General Laws by dispensing with the need for filing a separate petition for the appointment of a suitable person as executor or administrator to succeed an unsuitable person removed under petition filed under said section. Similar provisions apply to the appointment of successor trustees and successor guardians and conservators.

In another very helpful new law, temporary conservators are permitted to function from the date of their appointment, thus eliminating an increasingly troublesome hiatus during the twenty-day period.

Chapter 562 of the Acts of 1954, applying to estates of persons dying on or after June 3, 1954, provides an elaborate series of steps for settlement by a "voluntary" administrator under an "informal" probate proceeding of an intestate estate not in excess of $500 and consisting entirely of personal property.

§ G.L., c. 203, §12.
§ G.L., c. 201, §33.
a case of first instance, Lewis v. H. P. Hood & Sons, Inc., the Supreme Judicial Court upheld the validity of such a provision.

The Lewis case is perhaps another example of the stockholders' tendency to rebel against normal corporate practice in a closely held enterprise. Although literally no restriction on transfer was involved, the same objective, namely, to control the identity of the stockholders, was sought. The challenged provision had been inserted by amendments to the agreement of association and the articles of organization and stated that by unanimous vote of the full board of directors all or any part of the common stock held by a designated holder or holders could be called at any time at book value for purchase by the corporation or for retirement or cancellation in connection with any reduction of capital. All the stock, except for certain shares held by two charitable trusts established by one of the officers, was owned by directors and executives of the corporation and their families, and it was apparent that the principal purpose of the callability provision was to keep the common stock in the hands of those closely connected with the management of the business. The plaintiff was a director at the time the amendments were adopted and subsequently purchased additional shares subject to the same callability provision.

Upon the plaintiff's voluntary retirement in 1951 he failed to follow the practice of other retiring executives and made no arrangements to sell his stock to the corporation or to other active stockholders. Subsequently the directors called approximately 40 percent of the stock owned by the plaintiff in the first exercise of the callability provision which had ever been made. The plaintiff's bill to enjoin the corporation from enforcing the provisions was dismissed.

Although the Court agreed with the plaintiff's contention that decisions upholding restrictions on transfer were not completely pertinent, some reliance was placed on precedents in that area. An agreement under which an employee upon terminating his employment had to offer his stock to the corporation, which was obligated to purchase it at book value, had been approved a few years earlier in Winchell v. Plywood Corp. Actually, the only practical difference between the situations in the Winchell and Lewis cases was that in the former the stock would have been called automatically upon termination of employment; in Lewis the restriction made no reference to employment, so that the directors had to take affirmative action to acquire the shares of the retired employee.

Since the challenged provision was not literally keyed to the termination of employment, however, the plaintiff was able to contend that it destroyed "the independence of stockholders," placed them "at the

\[\text{\$8.2. 1 1954 Mass. Adv. Sh. 769, 121 N.E.2d 850.}
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\[\text{\$8.2. 2 1954 Mass. Adv. Sh. at 771, 121 N.E.2d at 851-852.}
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\[\text{\$8.2. 3 The trial judge found that the directors in calling the plaintiff's stock acted in good faith, a finding on which the Court placed considerable emphasis. 1954 Mass. Adv. Sh. at 774, 121 N.E.2d at 853.}
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\[\text{\$8.2. 4 324 Mass. 171, 85 N.E.2d 313 (1949).}
\]
The corporation brought suit to prevent the decedent's administratrix from transferring the shares and to restrain her from voting on the question of exercising the option. The Court held that the administratrix could not be disenfranchised from voting her shares on this issue.

The effect of the Checani decision appears to be that a majority stockholder can defeat a restriction on the transfer of his stock by voting his shares against their purchase by the corporation. Normally, the stock is offered to the corporation through the directors, but if a majority of the board is susceptible to the wishes of the principal stockholder, the same result would follow. Conceivably, if the stockholder was a member of the board, he might be disqualified from voting on the ground of personal interest. However, unless a majority of the remaining directors were independent of the controlling stockholder, his desires would in all likelihood be followed; and if a deadlock resulted as in the Checani case, the matter would be resolved by the stockholders. A stockholder, unlike a director, is normally not under any fiduciary restraint and can vote on matters in which he has a personal stake.

The Checani decision has been criticized for permitting an apparent circumvention of the restriction on transfer. The suggestion is made that by consenting to the restrictions a stockholder impliedly contracts not to vote his shares against the exercise of the option. Techniques to avoid the Checani result, principally the drafting of appropriate language in the restrictions, have been offered. Whether this criticism is warranted, however, is far from clear. A majority stockholder may intend to use the restriction to prevent the transfer of minority interests to undesirable associates. But it does not follow that he expects to surrender one of his prerogatives of control and permit the minority to dictate to him what he may do with his stock. Certainly, where one individual owns substantially all the outstanding stock, the tail would be wagging the dog if the minority could prevent a transfer of the shares.

§8.2. The callability of common stock. The very title of this section appears to be self-contradictory, since a provision by which common stock can be called for retirement by the directors seems at first glance to be incompatible with the inherent nature of common stock. Yet in
mercy of directors,” and “cut through all the basic attributes of common stock ownership.” The Court rejected this contention and concluded that although the provisions “go very far,” they represented a contract made by the plaintiff with his eyes open and were “not contrary to the corporation laws of the Commonwealth nor to public policy.”

Two decisions can hardly be said to represent a trend. If the Checani case permitted the objectives of a restriction on transfer to be thwarted, it certainly did not indicate any hostility on the part of the Court to this type of device. And by approving the callability provision in the Lewis decision the Court demonstrated its willingness to permit stockholders of a closely held corporation in pursuit of a legitimate objective to modify drastically a traditional corporate concept.

§8.3. Directors' fiduciary duty; Validity of bonuses. Hardly a year passes during which the Supreme Judicial Court is not faced with the problem of re-examining the fiduciary duty owed by directors and applying it to the facts of a particular case. The current year was no exception, and the case was *Beacon Wool Corp. v. Johnson*.

Because directors are normally permitted to fix their own compensation despite the obvious conflict of interest involved, the courts have established rigid standards of good faith which the board must exercise in this situation. Therefore, the decision in the *Johnson* case was, in part at least, not surprising. The Court required two surviving directors to repay bonuses voted to themselves after the death of the sole stockholder, who had dictated the entire policy of the company and whose demise, as the directors knew, threatened the continuation of the business.

The noteworthy element in the *Johnson* decision, however, was the ruling that the directors were also liable for bonuses they authorized for clerical employees after the death of the stockholder. Such bonuses, of course, are normally free from attack on fiduciary grounds, since there is no conflict of interest involved. Under the circumstances, however, the Court found that the directors' action was “a misuse of . . . authority amounting to lack of good faith.”

§8.4. Sale or transfer of assets and liquidation: Statutory changes. A reminder that all the statutory provisions pertaining to Massachusetts business corporations are not located in Chapters 155 and 156 of the

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General Laws is found in Chapter 461 of the Acts of 1954. This enactment amended an important and frequently overlooked statute which required a corporation to notify the Commissioner of Corporations and Taxation of any sale or transfer of all or any part of its assets, otherwise than in the ordinary course of business, at least five days prior to the transaction. The notice was to contain the terms and conditions of the sale or transfer as well as the location and character of the assets. Failure to give such notice made the transfer fraudulent and void as against the Commonwealth.

The statute was, of course, designed to protect the Commonwealth’s claim to unpaid corporation excise taxes. The 1954 amendment narrowed the scope of the act by making it applicable only where all or substantially all the corporate assets were involved, but in other respects the law was strengthened and clarified. In addition to filing the notice the corporation must now file corporation excise tax returns, including a return for the period ending with the date of the transfer, and pay the taxes shown on the returns at or before the time of the transfer. Failure to comply with these requirements does not invalidate the transfer as was provided in the original statute but instead gives the Commonwealth a lien for its exclusive benefit upon all the corporate assets for a period of three years to the extent necessary to satisfy the unpaid taxes. The Commissioner may, however, issue a written waiver of the lien and the other statutory requirements either before or after the transfer. Since the waiver may be recorded in the appropriate registry of deeds or city or town clerk’s office, the purchaser or other transferee is now given a method of satisfying himself that the lien does not exist.

Sales or transfers by receivers, trustees in bankruptcy, and similar officials are exempted from the provisions of the statute as are mortgages and pledges given for obligations incurred in good faith. Although transfers in liquidation are not specifically mentioned, it seems desirable, at least where real estate is involved, to obtain and record the waiver of lien now provided for by the amendment.

§§8.4. 1 The act took effect on September 1, 1954, but Section 3 governs certain transactions which occurred prior to that date.

2 G.L., c. 63, §76.

3 Attempts have been made by trustees in bankruptcy proceedings to step into the shoes of the Commonwealth and set aside transfers made in violation of this statute pursuant to the provisions of Section 70(e)(1) of the Bankruptcy Act, 11 U.S.C. §110 (1952). There appear to be no reported court decisions, however, in which the validity of such a proceeding has been adjudicated.

4 The phrase “for its exclusive benefit” would seem to weaken the standing of a trustee in bankruptcy to invoke the act. See note 3 supra.

5 The original act was silent with respect to transfers made as security for the performance of obligations, so that such transactions were presumably not exempt.

6 Where liquidation is followed by the corporation’s request for dissolution under G.L., c. 155, §50A, the Commonwealth’s interest in unpaid corporation excise taxes is protected by the personal assumption of tax liabilities which the officers and directors undertake in executing the required Form 355D. Where complete liquidation is not followed by dissolution, however, the transfer of the assets appears to require compliance with the statute.
§8.5. Closing stock transfer books or establishing record date: Statutory changes. Prior to 1953 no statutory authority existed for a Massachusetts corporation to close its stock transfer books or to establish a record date for the purpose of determining the list of stockholders entitled to vote at a meeting or to receive a dividend or other distribution. Despite this lack of legislative sanction it is likely that many corporations used one of these methods to establish its list of eligible stockholders. The legislature in its 1953 session 1 validated this practice by giving the board of directors the right to close the transfer books or to establish a record date not more than thirty days 2 before the date of the meeting or the date for the payment of the dividend or other distribution. In 1954 the new act was amended 3 to enlarge the period to sixty days, unless a shorter period is provided for in the agreement of association, the articles of organization, or the by-laws.

§8.5. 1 Acts of 1953, c. 185, amending G.L., c. 155, §22.
2 Unless otherwise provided in the agreement of association, articles of organization, or the by-laws. The ambiguous nature of this proviso, which might have permitted the board to enlarge the thirty-day period as it saw fit, probably led to the 1954 amendment.
3 Acts of 1954, c. 50.