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Corporations

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(1) go into the practice of patent law or patent soliciting in Ohio and Michigan within a period of five years, or (2) deal with any clients that employer had while the employee worked for the employer, was held valid and enforceable as to the first part; but was held to be ambiguous, unreasonable, illegal and in restraint of trade as to the second part.

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CORPORATIONS

During the past year there were an unusual number of important cases in this area. The most significant development, of course, was the enactment of the new General Corporation Law[1] effective October 11, 1955. So far, all of the cases have been decided under the old statute.

Subscriptions for Shares

In *Froug v. Miami Savings and Loan Co.*[2] the court held that the plaintiff was a depositor in the defendant savings company rather than a subscriber for shares. The case is interesting only because of the broad statement by the court that a subscription for shares must be in writing. As applied to the particular case, the statement is correct, since the building and loan association statute does indicate that subscriptions must be written.[3] However, the statement of the court should not be viewed as a binding precedent establishing a general rule of corporation law. The new General Corporation Law is silent on this problem and the weight of authority elsewhere is that subscriptions need not be written. However, both in Ohio and in other jurisdictions, it is held that a contract for the purchase of shares, as opposed to a share subscription, is within the statute of frauds of the Uniform Sales Act.[4]

Tort Liability of Corporate Director

An interesting and novel situation was presented in *Young v. Featherstone Motors.*[5] The plaintiff's airplane was damaged by a collision with a motorcycle owned by the defendant corporation and driven by the ser-

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[1] OHIO REV. CODE c. 1701.

[2] 128 N.E.2d 449 (Ohio App. 1953).

[3] OHIO REV. CODE § 1151.20.

[4] On the distinction between a subscription and a contract of purchase, and the statute of frauds problem relative to both, see 1 DAVIES OHIO CORP. LAW 264, 269, and 510 (1942).

[5] 97 Ohio App. 158, 124 N.E.2d 158 (1954).

vant of the corporation. The corporation was held liable, not under respondeat superior, but for negligence in failing to furnish the driver with a safe motorcycle.[6] In this case the plaintiff was an officer and director of the defendant corporation, and the argument was made that in such capacity the plaintiff was ultimately responsible for the negligence of the corporation, so its negligence should be imputed to him and bar recovery. The court recognized that the case was one of first impression in Ohio, and followed the clear weight of authority in allowing recovery. The negligence would have been imputed to the plaintiff director if he had been specifically responsible for the negligent act.

Problems of Corporate Control

An issue of first impression in Ohio was presented by *Mills v. Mills.*[7] Plaintiff and defendant formed a partnership for the purpose of carrying on a business in corporate form. The court of appeals properly denied an injunction against breach of the partnership agreement. Where the parties use the corporate form to achieve limited liability their rights as to control of the business are governed exclusively by principles of corporation law. The case is in accord with the cases from other states.

> The law never contemplated that persons engaged in business as partners may incorporate, with intent to obtain the advantages and immunities of a corporate form, and then Proteus-like, become at will a copartnership or a corporation, as the exigencies or purposes of their joint enterprise may from time to time require.[8]

Barsan v. Pioneer Savings and Loan[9] is not only a case of first impression in Ohio, but a new case in the United States. A corporation issued a new block of shares without granting the old shareholders their statutory pre-emptive rights. Apparently the failure to grant the right was an innocent mistake of law on the part of all concerned. When the directors discovered their error, they cancelled the new issue and offered to refund the purchase price to the new shareholders. On suit of a new shareholder, the court of appeals enjoined the cancellation, on the ground that the old shareholders, and not the corporation, were the only ones harmed by the violation of the pre-emptive rights statute and were the only ones who could object.[10] The court of appeals decision was discussed in last year's

[6] Other aspects of this case are commented on in the AGENCY and CIVIL PROCEDURE sections in this survey *supra.*

[7] 127 N.E.2d 222 (Ohio App. 1952).

[8] Boag v. Thompson, 208 App. Div. 132, 136, 203 N.Y. Supp. 395, 398 (2d Dep't. 1924).

[9] 163 Ohio St. 424, 127 N.E.2d 614 (1955).

[10] 121 N.E.2d 76 (Ohio App. 1954).

survey[11] and was predicated on the assumption that all of the old shareholders not only failed to ask for pre-emptive rights, but specifically waived them by voting in favor of the new issue. The Ohio Supreme Court reversed, finding from the record that there were old shareholders who had not voted for the new issue. The Supreme Court expressly approved the court of appeals theory, i.e., that the corporation has no legal or equitable privilege to enforce the shareholder's rights. However, the result reached by the court seems contrary to the theory. The Supreme Court sent the case back to the trial court with instructions to enjoin cancellation and also to compel the corporation to grant pre-emptive rights to the old shareholders on terms fixed by the trial court. Significantly, this relief is granted the old shareholders, even though none of them have claimed their rights. The effect is to leave the new shares outstanding, but subject to an option in the old shareholders, the terms and duration of the option to be determined by the trial court. Thus the court held that where none of the shareholders objects to a denial of pre-emptive rights, the corporation cannot unilaterally enforce the right after sale of the issue, but an equity court can and will do so.

Under cumulative voting, the smaller the number of directors who are up for election, the greater is the proportion of shares needed by the minority group to place a director on the board. Thus the effectiveness of cumulative voting as a protection for the minority can be severely limited by a system of classifying directors so that only one class is elected each year.[12] About half of the states, including Ohio, have provided for both staggered elections and mandatory cumulative voting. In spite of the inherent conflict between these provisions, there have been no cases on the subject until this year. A number of suits are now pending throughout the country attacking the classified boards. The catalyst for this rash of litigation was the Montgomery Ward proxy fight last spring. In *Wolfson v. Avery*[13] the Illinois Supreme Court held that the constitutional provision for cumulative voting overruled the statute authorizing classified boards, on the ground that the cumulative voting provision should be interpreted so that a shareholder can cumulate his vote with maximum effectiveness. The situation in Ohio is somewhat different, as the cumulative voting provision is in a statute rather than in the constitution. However, shortly

[11] 6 WEST. RES. L. REV. 236 (1955).

[12] As a policy matter, staggered elections do tend to preserve stability and continuity of management. However, the evil of staggered elections is not only that they restrict minority representation rights, but also that they may tend towards perpetuation of mismanagement. Thus in the absence of a provision for removal of directors without cause, a slight majority would have to wage two or even three successive proxy battles to elect a majority of directors to a staggered board.

[13] 6 Ill.2d 78, 126 N.E.2d 701 (1955).

after the Illinois decision, an Ohio court of appeals applied the same basic theory. The court held that since the Ohio cumulative voting statute is both older and more specific than the classification statute, the former reflects the paramount public policy and controls in case of a conflict.[14]

Shareholders Derivative Actions

The important question of whether or not a majority of shareholders can ratify the fraud of a director was answered in the affirmative by the Supreme Court in *Claman v. Robertson.*[15] A shareholder brought a derivative action against certain directors alleging fraud on the corporation and a corrupt refusal by the corporation to enforce its rights against the guilty directors. The normal rule is that the plaintiff in such an action must allege that he has first exhausted his remedies within the corporation, or show a valid excuse. The plaintiff was excused from asking the directors to sue because the directors alleged to be guilty of fraud were still in control of the corporation. However, the shareholders had ratified the fraud, and no attempt was made by the plaintiff to ask the shareholders to rescind their approval. In a number of cases in other states the courts have held that where fraud is involved the plaintiff does not have to appeal to the shareholders because such an appeal would be a useless act, as a majority have no power to ratify a fraud.[16] In an ably written opinion the Supreme Court rejects this view and holds that a majority of shareholders can bind the minority by a ratification. This rule has the advantage of discouraging "strike" suits or nuisance litigation. However, as pointed out by Judge Zimmerman in his dissent, the rule adopted by the majority of the court tends to encourage fraud, especially in a large corporation like the defendant which has many shareholders, most of whom vote by proxies solicited by the management.

The *Claman* case was decided under the old corporation statute which was silent on the issue. The new code, enacted, but not effective, at the

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[14] Humphrys v. Winous Company, 125 N.E.2d 204 (Ohio App. 1955), *appeal as a matter of right denied, appeal granted and now pending,* 164 Ohio St. 254, 129 N.E.2d 822 (1955). The classification system in the Ohio case was a much more flagrant violation of the cumulative voting statute than that which was upset by the Illinois Court. In the Illinois case three directors out of nine were elected annually while in the Ohio case only one out of a three man board was elected each year. Note: After this article went to press, the decision of the court of appeals was reversed by the Supreme Court. 165 Ohio St. 45 (1956). The decision was 4 to 2 and will be commented on in next year's Survey.

[15] 164 Ohio St. 61, 128 N.E.2d 429 (1955).

[16] This is the so-called "New York rule." Continental Securities Co. v. Belmont, 206 N.Y. 7, 99 N.E. 138 (1912).