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Corporations - The Effect of Unanimous Approval on Corporate Bylaws

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Much Ado About Nothing?

**INTRODUCTION**

Minority shareholders in a close corporation traditionally have been concerned about the protection of their interests—e.g., control, management, voting effectiveness, distribution of earnings and resolution of disputes. This group frequently has sought to safeguard its interest through the use of agreements regulating the activity of all the shareholders. In *Blount v. Taft*, the North Carolina Supreme Court has presented the minority shareholder with both a possible new alternative and an additional cause for concern. The court in that case found a bylaw to be a shareholders' agreement solely because it was unanimously adopted by the shareholders and even though no evidence of mutual intent among the shareholders to make such an agreement was shown. It then held the agreement subject to the amendment provisions contained in the bylaws. This note briefly surveys the subject of shareholders' agreements in close corporations and discusses the impact and practical consequences of the *Blount* decision.

**THE CASE**

Eastern Lumber and Supply Company (hereinafter "Eastern") was a closely held North Carolina corporation whose shares were not "generally traded in the markets maintained by securities dealers or brokers." Eastern's stock was held by the members of three families. The Blount family group owned 41% of Eastern's outstanding stock. Defendants Taft owned 41%; and defendant McGowan, 18%.

In 1969, plaintiff's concern about the nepotism which existed within the corporation led to a motion at a directors' meeting to require unanimous approval by the shareholders before any relatives or shareholders could be employed by the corporation. This motion was defeated by the defendants.

At a special joint meeting of all the directors and shareholders of Eastern on August 20, 1971, new bylaws were unanimously adopted.
adopted. Included therein was a provision, Article III, Section 7, which created an Executive Committee of the directors. Each family was to be represented on the committee, and the bylaws required unanimous approval by the Executive Committee prior to employment of any individual.\(^3\) Another provision, Article VIII, Section 4, provided for amendment or repeal of the bylaws by an affirmative vote of a majority of the board of directors.\(^4\) At no time during the meeting did anyone suggest that Article III, Section 7 was anything other than a bylaw. The minutes of the August 20, 1971, meeting, including the bylaws mentioned above, were approved unanimously at a shareholders' meeting on September 13, 1971.

In June of 1974, the board of directors adopted new bylaws, with the Taft and McGowan directors outvoting the Blount representatives. These bylaws deleted the provisions of the 1971 bylaws relating to (1) representation by each of the three families on the Executive Committee and (2) unanimous approval of employee hiring by the Executive Committee.

After defendants employed persons to work for the corporation without the consent of the Blount directors,\(^5\) plaintiffs brought this action for specific performance of the 1971 bylaws, specifically Article III, Section 7. Plaintiffs asserted that this provision constituted a shareholders' agreement because it had been unanimously adopted by the shareholders. The Superior Court of Pitt County,

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3. Article III. Board of Directors . . . . Section 7. Executive Committee. The Board of Directors may, by the vote of a majority of the entire board, designate three or more directors to constitute and serve as an Executive Committee, which committee to the extent provided in such resolution, shall have and may exercise all of the authority of the Board of Directors in the management of the corporation. Such committee shall consist of one member from the family of M. K. Blount, Sr., one member from the family of E. H. Taft, Jr., and one member from the family of Ford McGowan. Minutes of all such meetings shall be kept and a copy mailed to each member of the Board of Directors and action of the committee shall be submitted to the Board of Directors at its next meeting for ratification.

The Executive Committee shall have the exclusive authority to employ all persons who shall work for the corporation and that the employment of each individual shall be only after the unanimous consent of the committee and after interview.

Blount v. Taft, 295 N.C. at 475-76, 246 S.E.2d at 766.

4. "Article VIII. General Provisions . . . . Section 4. Amendments. Except as otherwise herein provided, these bylaws may be amended or repealed and new bylaws may be adopted by the affirmative vote of a majority of the directors then holding office at any regular or special meeting of the Board of Directors." Blount v. Taft, 295 N.C. at 475, 246 S.E.2d at 765.

sitting without a jury, found that Article III, Section 7 of the bylaws adopted on August 20, 1971, was a valid shareholders’ agreement which could not be amended as provided by Article VIII, Section 4 of said bylaws.

On appeal, the North Carolina Court of Appeals vacated and remanded, holding that the bylaws in question did not constitute a shareholders’ agreement.6

On discretionary review,7 the North Carolina Supreme Court upheld the result of the court of appeals, but on different grounds. That court held that the entire set of bylaws of August 20, 1971, constituted a shareholders’ agreement and was subject to the amendment provisions of Article VIII, Section 4 contained therein.8

**BACKGROUND**

The North Carolina Business Corporation Act9 is “one of the most liberal in the extent to which it expressly permits the normal control and management of a corporation to be restructured” through the use of shareholders’ agreements.10 A valid, written agreement among shareholders may effectively regulate the control and management of a close corporation in a manner similar to that of a partnership.11 No longer is it impermissible for shareholders to be “partners inter se and a corporation as to the rest of the world.”12 Investors can, through the use of shareholders’ agreements, “adopt the decision-making procedures of partnership, avoid the consequences of majority rule (the standard operating procedure for corporations), and still enjoy the tax advantages and limited liability of a corporation.”13

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7. The plaintiffs’ first petition for discretionary review was denied by the North Carolina Supreme Court on September 1, 1976. A petition for a rehearing of the denial of the previous petition for discretionary review, including inter alia an affidavit from Dean Elvin R. Latty, one of the drafters of the North Carolina Business Corporation Act, was filed with the Supreme Court in a manner not expressly provided for by the North Carolina Rules of Appellate Procedure. In his affidavit, Dean Latty expressed his opinion that “the narrow technical construction of N.C. GEN. STAT. § 55-73(b) by the Court of Appeals violates the intent of its draftsmen for that statute to be a Magna Carta for close corporations.”
11. Id., § 7-7, at 149.
An agreement among shareholders may be embodied "in the charter or bylaws or in any side agreement in writing and signed by all the parties thereto." Close corporation statutes of several jurisdictions have borrowed the language of the North Carolina statute; however, none of these jurisdictions have considered the questions of whether a bylaw also may be a shareholders' agreement solely by virtue of its unanimous approval by the shareholders, and if so, how the bylaw/shareholders' agreement may be amended or repealed.

By statute, non-initial corporate bylaws "may be adopted, amended or repealed either by shareholders or by the board of directors." If the shareholders adopt the bylaws, however, they may be amended only by the shareholders unless otherwise provided in the bylaws themselves. Additional restrictions regarding bylaw changes may be imposed pursuant to the statute which authorizes (1) the limitation or elimination of "the power of the board of directors to adopt, amend or repeal the bylaws or any specific bylaw" or (2) a requirement of greater than majority vote for the adoption, amendment or repeal of a bylaw. Furthermore, bylaws changing the statutory requirement for action by directors may be adopted, "amended or repealed only by shareholders acting pursuant to any . . . greater vote so prescribed."

The negative phrasing of the statute regarding shareholders' agreements reflects the flexibility and liberal attitude of the Business Corporation Act in this area. Shareholders' agreements should be construed and enforced so as to allow the express intent of the parties to control unless the agreements "violate the express charter or statutory provision, contemplate an illegal object, involve . . .

17. Id.
18. Id.
20. N.C. GEN. STAT. § 55-16(b) (1975). See also R. ROBINSON, supra note 7, at § 4-8.
21. N.C. GEN. STAT. § 55-16(a)(2) (1975). In Blount, the plaintiffs were precluded from the benefit of this statute because the bylaw appearing in Article III, Section 7 was both enacted and amended prior to the effective date of the 1973 amendment of that subsection (October 1, 1973). 1973 N.C. Sess. Laws, ch. 469, ss. 4, 47. A discussion of the effect of this statute on situations where it may be applied is found in the text following note 41, infra.
fraud, oppression or wrong against other shareholders, or are made in consideration of a private benefit to the promisor." 23

ANALYSIS

To fully understand the decision of the supreme court, it is helpful to analyze the rationales of the trial court and the court of appeals.

The trial court, through Judge James, held that only Article III, Section 7 of the 1971 bylaws was a shareholders' agreement 24 though all of the bylaws were adopted at the same time and by unanimous vote. The court further concluded that as a shareholders' agreement, it required the unanimous consent of all the shareholders for amendment or repeal. 25 The plaintiffs having refused to consent, the court found that the shareholders' agreement was not validly repealed and that plaintiffs were entitled to specific enforcement of the agreement. 26 The trial court gave no effect to the amendment provision contained in Article VIII, Section 4 of the bylaws.

The North Carolina Court of Appeals reasoned that in order for a shareholders' agreement to be incorporated into the bylaws, N.C.G.S. § 55-73(b), by implication, required the prior existence of the shareholders' agreement. 27 "There is no provision in the Business Corporation Act that the by-laws of a corporation, or any one or more of the by-laws, becomes a shareholders' agreement solely because of unanimous adoption thereof by the shareholders." 28 Finding no competent evidence to support the trial court's conclusions that Article III, Section 7 was a shareholders' agreement which could not be amended by Article VIII, Section 4, the court of appeals held that the trial court erred in granting plaintiffs specific performance of Article III, Section 7. 29

In the petition for rehearing, Dean Latty's affidavit 30 posited that the construction given N.C.G.S. § 55-73(b) by the court of appeals violated the draftsmen's intent for that statute. Dean Latty's concern was that the requirement of "a previous agreement or . . . the explicit designation as a shareholders' agreement . . .

25. Id. at 158.
26. Id. at 157.
27. Blount v. Taft, 29 N.C. App. at 630, 225 S.E.2d at 586.
28. Id. at 631, 225 S.E.2d at 586.
29. Id. at 633, 225 S.E.2d at 588.
30. See note 4 supra.
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[would] manufacture technicalities and set traps for unwary business operators.\textsuperscript{31}

The supreme court apparently found merit in Dean Latty's position. Nearly twenty months after oral arguments,\textsuperscript{32} the court held that not only Article III, Section 7, but the entire set of bylaws adopted in 1971, constituted a shareholders' agreement because unanimously adopted by the shareholders.\textsuperscript{33} However, the entire set of bylaws/shareholders' agreement was subject to the amendment provisions of Article VIII, Section 4.\textsuperscript{34} Having been amended properly pursuant to the latter section, there was no breach of the agreement by the defendants, and plaintiffs were not entitled to specific enforcement.

CONCLUSION

What effect does this decision have on the operation of the North Carolina close corporation in the future? Will minority shareholders find the desired protection of their interests in unanimously adopted bylaws which will be construed to be shareholders' agreements? The answer is "not necessarily."

According to the \textit{Blount} court, whenever bylaws are adopted unanimously, they will be deemed to constitute a shareholders' agreement even though there was no overtly expressed intent to that effect. But at that point the assurance to the minority group may end. If the bylaws/shareholders' agreements contain an internal provision allowing amendment or repeal by the affirmative vote of a majority of the directors, as was the case in \textit{Blount}, this provision controls, and the minority again may find itself subject to the will of the majority. Only by having an internal provision which requires the unanimous vote of the shareholders to amend or repeal the bylaw/shareholders' agreement will the minority shareholders find the protection which they sought and believed they had. "Requiring the insertion of such an amendment provision works no undue hardship on the parties if all are agreed upon its inclusion."\textsuperscript{35}

The court, per dictum, alluded to the situation where there was no provision within the bylaws/shareholders' agreements governing

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  \item 32. Oral arguments were heard in January, 1977; the supreme court filed its decision on August 29, 1978.
  \item 33. \textit{Blount v. Taft}, 295 N.C. at 485, 246 S.E.2d at 771.
  \item 34. \textit{Id.}
  \item 35. \textit{Id.} at 487, 246 S.E.2d at 773 (citation omitted).
\end{itemize}
amendments. What, if any, protection will the minority shareholders find in that situation? The court reasoned that because the shareholders chose to embody the shareholders’ agreement in the bylaws, “it must be concluded that they intended for these [statutory or common law] norms [regarding amendment] to apply absent an expressed intention to deviate from them.” By statute, bylaws adopted by shareholders may not be amended or repealed by the board of directors unless the bylaws grant this authority. Such authority being absent, a bylaw/shareholders’ agreement adopted in this manner is subject to amendment “by the affirmative vote of the shareholders entitled to exercise a majority of the voting power of the corporation.” Consequently, the protection which the minority believed it had is non-existent.

The logical extension of the rationale of the Blount court would indicate that the foregoing discussion of the effect of unanimity with regard to the adoption of bylaws would apply with equal force to the unanimous adoption of charter provisions. When the charter/shareholders’ agreement contains a provision regarding amendment or repeal, that provision will control. However, a shareholders’ agreement embodied in a charter having no internal amendment provision would be subject to amendment or repeal by “the affirmative vote of the holders of at least a majority of all the outstanding shares entitled to vote thereon, unless any class of shares is entitled to vote thereon as a class, in which event” the statute specifies the procedure to be followed. The statutory safeguard itself suggests the minority group’s solution to protect its interest—i.e., include a provision requiring unanimous vote for amendment or repeal of the shareholders’ agreement/charter provision.

As the Blount court pointed out, the minority shareholders were precluded from the benefit of N.C.G.S. § 55-16(a)(2) (1975), be-

36. Id. at 486, 487, 246 S.E.2d at 772.
37. Id. at 486, 246 S.E.2d at 772.
39. N.C. GEN. STAT. § 55-16(b) (1975) (emphasis added).
40. N.C. GEN. STAT. § 55-100(b)(3) (1975).
41. Id.
42. § 55-16. Bylaws.—(a) The initial bylaws may be adopted by the board of directors at its organization meeting. Thereafter bylaws may be adopted, amended or repealed either by the shareholders or by the board of directors, but . . . (2) Any bylaw changing the statutory requirement for a quorum of directors or action by directors as permitted by G.S. 55-28(d), or changing the statutory requirement for a quorum of shareholders or action by shareholders, as permitted by G.S. 55-65 and 55-66, may be
cause Article III, Section 7 of the bylaws was both enacted and amended prior to the effective date of the 1973 amendment to that statute's subsection. Had plaintiffs been able to argue this statute, the result in this case might have been different. Article III, Section 7 changed the statutory requirement for action by the directors, as permitted by N.C.G.S. § 55-28(d) (1975), by requiring the unanimous vote of the Executive Committee in the area of employment practices of the corporation. Therefore, this bylaw would require the affirmation of the shareholders by this greater vote—i.e., unanimity—for amendment or repeal where this statute is effective.

It would seem unlikely that a well-drawn bylaw or shareholders' agreement would lack an amendatory provision such that the statutory norms for amendment would come into effect. For this reason, the impact of the Blount decision upon minority shareholders may be insignificant indeed. Even if a bylaw does not contain an amendatory provision, the Blount decision may well be insignificant for two additional reasons. (1) Practically, it will be seldom that the majority shareholders will allow the adoption of a requirement of unanimity. (2) The benefit of N.C.G.S. § 55-16(a)(2) (1975) may well prevent the harsh result felt by the minority shareholders in Blount as to any bylaws enacted since 1973.

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adopted only by the shareholders, and any such bylaw can itself be amended or repealed only by the shareholders acting pursuant to any different quorum and greater vote so prescribed . . . .


43. 295 N.C. at 487, 246 S.E.2d at 773.

44. It must be carefully noted that not all bylaws regarding quorums and action by directors or by shareholders are covered by this statute. The bylaw must change a statutory requirement as permitted by N.C. GEN. STAT. §§ 55-28(d), 55-65 or 55-66 (1975).