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Corporations

Lewis Collens

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LEWIS COLLENS*

RECENT CASES

THE PAST year has not been a particularly active one for the legislature or the courts in the area of corporation law.[1] There were five cases and one amendment to the Business Corporation Act that merit attention.

In *Stroh v. Blackhawk Holding Corp.*,[2] the Illinois Supreme Court held that it is proper for a corporation to issue voting shares which have no right to receive current or liquidating dividends. The Blackhawk Holding Corporation had 3,000,000 shares of authorized Class A stock and 500,000 shares of authorized Class B stock. The Class B stock had no right to participate in ordinary or liquidating dividends. Upon formation, the company sold 500,000 Class A shares, representing 46% of the voting power, to the public for $2,000,000 ($4.00 per share). The corporate promoters and insiders purchased 87,868 Class A shares, representing 8% of the voting power, for about $300,000 ($3.40 per share), and 500,000 Class B shares, representing 46% of the voting power, for $1,250 (1/4th cent per share). Thus, the public paid $2,000,000 for 46% of the voting stock and the promoters paid slightly over $300,000 for 54% of the voting power. This information was fully disclosed in the company's prospectus; hence, no issue of fraud was involved.

In August 1964, the Class B percentage of voting power was reduced to approximately 29%. The reduction was the result of a two-for-one split of the Class A shares and the sale of an additional 61,945 shares to the public. Prior to the company's annual meeting in 1968, a contest for control developed and a group of Class A

* Associate Professor of Law, Chicago-Kent College of Law; B.S., M.A. University of Illinois; J.D. University of Chicago.

1. This survey does not cover the Illinois and Federal Securities Acts.

2. 48 Ill. 2d 471, 272 N.E.2d 1 (1971).

shareholders filed suit to enjoin the Class B shareholders from voting at the June meeting. The trial court enjoined the voting of shares on the ground that the issuance of the stock was an invalid *ultra vires* act.[3] This judgment was reversed by the appellate court, and the supreme court in a 4-2 decision concurred with the appellate court's decision.

The supreme court majority, in an opinion by Justice Davis, reasoned that "shares" are defined in the Business Corporation Act as the "proprietary interests in the corporation," that "proprietary" means "ownership" and that "ownership" means the "[1] right to participate in the control of the corporation, [2] in its surplus or profits, *or* [3] in the distribution of its assets."[4] (emphasis added). The court held that the use of the disjunctive "or" in the definition of ownership meant that a "share" need have only one of the three enumerated characteristics, subject to the requirement[5] that each share of stock in an Illinois corporation have the right to vote. This result was deemed consistent with Delaware decisions and with a legislative intent to permit individuals to make their own private contractual arrangements with regard to dividends and liquidation rights. The court found further support for its view in the fact that regulations of the Secretary of State provide for issuance of up to one-third "voting only" stock.[6]

Justices Schaefer and Ward dissented from the majority on four issues. First, they found in the statutory authorization of shares with dividend preferences[7] an implicit command that all shares must have some dividend rights; second, they felt there was a misplaced

3. The terminology of the court and presumably the parties is not technically correct. The plaintiffs would not have had standing to allege that issuance of the stock was *ultra vires, i.e.*, that this particular corporation was without power to act. ILL. REV. STAT. ch. 32, § 157.8 (1971). The plaintiffs had to be arguing that issuance of the shares was illegal, *i.e.*, that no corporation has power to issue the shares.

4. 48 Ill. 2d at 476-77, 272 N.E.2d at 3-4. This language is from former section 2(f) of the B.C.A., ILL. REV. STAT. ch. 32, § 157.2(f) (1955). The court said that the Committee Comments indicated the 1955 amendment caused "no change in legal effect" and therefore the old definition of "share" continued to be effective.

5. ILL. REV. STAT. ch. 32, § 157.28 (1971).

6. 48 Ill. 2d at 483-84, 272 N.E.2d at 7. No supporting citation is given by the court.

7. ILL. REV. STAT. ch. 32, § 157.14(c) (1971).

reliance by the majority on the disjunctive "or" because it would then follow that a corporation could have non-voting stock—something clearly not permitted under statutory[8] and case law[9]; and third, they argued that the reliance on Delaware analogies[10] was misleading because Delaware permits non-voting stock.[11] Finally and most fundamentally, they contended that "ownership" is an economic concept and therefore you cannot own part of a corporation if you have no interest in the assets or earnings.

While the result reached by the majority has some support elsewhere,[12] it is difficult to quarrel with the dissent's view that an economic interest in the corporation is the essence of stock ownership. Strangely enough, the majority may have, in fact, accepted the dissent's economic argument. The final paragraph of the majority opinion opens with the statement "[w]e have assumed, *without deciding*, for the purpose of this decision only, that the Class B stock carried with it no rights to dividends, current or liquidating."[13] (emphasis added). Since there was no dispute over the lower court's finding that the shares had *no rights* to current or liquidating dividends, the meaning of this sentence is far from clear. The majority may have been suggesting that "voting only" shares have an inherent right to participate in current and liquidating dividends. This would not be inconsistent with the result reached. The majority had to determine whether the shares had the right to vote—not whether they could participate in dividends. Conceivably, they could subsequently hold that all shares must participate in current and liquidating dividends. However, if the majority really felt that there was an inherent right to receive dividends, it is difficult to understand why they failed to say so. Such a statement would have made most of the majority's discussion moot. It is indeed, as Justice Schaefer noted, "hard to understand"[14] the last paragraph of the majority opinion.

8. ILL. REV. STAT. ch. 32, § 157.28 (1971).

9. People *ex rel.* Watseka Telephone Co. v. Emmerson, 302 Ill. 300, 134 N.E. 707 (1922).

10. 48 Ill. 2d at 487-88, 272 N.E.2d at 9. The majority cited Lehrman v. Cohen, 43 Del. Ch. 222, 222 A.2d 800 (1966).

11. DEL. CODE ANN. tit. 8, § 151(a) (1953).

12. Lehrman v. Cohen, 43 Del. Ch. 222, 222 A.2d 800 (1966).

13. 48 Ill. 2d at 484, 272 N.E.2d at 7.

14. *Id.*

Even in light of *Blackhawk*, it is advisable for attorneys to avoid creating "voting only" stock because the dissent's argument may ultimately prevail. Where issuance of such stock seems necessary to achieve a desired voting balance, the safest course of action is to provide a miniscule dividend preference for the shares. For example, in the *Blackhawk* situation, the Class B stock could have been given the following characteristics: non-cumulative, non-participating with annual dividend preference of 1/10th of a mil per share, and upon liquidation 1/4 cent per share. This would have given the Class B shareholders the right to receive $500 yearly whenever the Class A shares were being paid dividends, and the right to a return of their nominal capital contribution in the event of dissolution. Even such a small economic interest presumably would have satisfied Justices Schaefer and Ward, and eliminated any possible challenge to the legality of the issuance of the stock.

The question of personal liability of shareholders for business debts was involved in three cases—two of which held the shareholders personally liable. In *Califf v. Coca-Cola Company,*[15] a products liability suit was filed against the Coca-Cola Company [CCC] and its wholly-owned subsidiary, Coca-Cola Bottling Company of Chicago [CCBC]. CCC manufactured and sold syrup to CCBC which, in turn, manufactured and bottled the final soft drink product which had exploded and injured plaintiff's eye. The court granted CCC's motion to dismiss and said "[m]ere stock ownership is insufficient to make a parent corporation liable for the tortious acts of its subsidiary."[16] The companies were independently operated, had separate facilities, separate boards of directors, and separate officers except for an assistant secretary and assistant treasurer. In view of this separation and the financial stability of CCBC, the result was quite predictable.

Liability was imposed on shareholders in *Kingsberry Homes v. Corey,*[17] who had operated their business as partners until November 1967, when they formed the corporation. Several months prior to incorporation, the partners began making purchases from plaintiff and had executed personal guarantees to obtain credit. Defendants

15. 326 F. Supp. 540 (N.D. Ill. 1971).

16. *Id.* at 541.

17. 457 F.2d 181 (7th Cir. 1972).

argued that the personal guarantees applied to purchases made prior to incorporation *(i.e.,* by the partnership) and not to purchases made by the corporation. The court rejected this argument and said defendants were estopped from denying personal liability because of their failure to formally notify plaintiff of the fact of incorporation. In a sharp dissent,[18] Judge Stevens argued that plaintiff in fact had knowledge of the incorporation, both through its regional sales manager and because all invoices after the date of incorporation had been paid by corporate check.

In *Anzalone v. Durchslag,*[19] liability was imposed on Durchslag, a former shareholder, for money due plaintiff for goods delivered to the business. In April 1963, Durchslag, a major shareholder in Chicago Camcorp, Inc., approached Anzalone, an old friend, and requested that Anzalone sell painting supplies to the corporation on credit. The request was granted. In April 1964, Durchslag told Anzalone that a new employee was being hired, that they were going into painting in a big way, and that General Painting Contractors was the name that was going to be used because it was more descriptive. Anzalone said that he expressed reservations about Durchslag's new employee, but "as long as Mr. Durchslag was behind the whole situation and I had known him for so many years and his family and doing business with them, and always been paid, I went, just went along with them [sic]."[20] Anzalone further testified that he was told "they were changing the name from Chicago Camp Corp [sic] to General Painting Contractors, a division of that or whatever . . . I am positive that is what he termed it as in forming a new company."[21]

From April to September 1964, supplies were purchased and bills were paid by Chicago Camcorp checks. In September, Durchslag told Anzalone he was no longer associated with General Painting Contractors. When Anzalone asked whom he should see for money, Durchslag replied, "You will have to chase Jack Richards."[22]

Because the court found that Durchslag had represented that he

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18. *Id.* at 183-84 (dissenting opinion).
19. 1 Ill. App. 3d 125, 273 N.E.2d 752 (1971).
20. *Id.* at 127, 273 N.E.2d at 753.
21. *Id.* at 127, 273 N.E.2d at 754.
22. *Id.*

was acting for General Painting Contractors, a new corporation which in fact did not exist, Durchslag and his "co-shareholder" were held liable as partners.[23] Having decided that Durchslag was acting for a nonexistent corporation, the court had to dispose of one final argument—that Anzalone should not be permitted to recover from Durchslag personally because credit was extended to a "business" rather than to Durchslag personally. The court rejected this "estoppel" argument because the trial court had found as a fact that Anzalone had relied on Durchslag's personal credit.

Finally, the opinion contains confusing dicta regarding the right of a corporation to use another name. The court suggests that it would have been improper for Chicago Camcorp to have done business as "General Painting Contractors, a division of Chicago Camcorp."[24] It says that such a designation would *not* inform creditors that the two companies were one and the same. No authority for this view is cited and it seems questionable on its face.[25]

Anzalone and *Kingsberry* both illustrate the continuing difficulties encountered by shareholders of close corporations in trying to insulate themselves from personal liability for contractual debts of the business. A small businessman who wishes to avoid personal liability when making purchases for the corporation must make it absolutely clear to the seller that he is acting on behalf of the corporation. Any ambiguity will be resolved against the individual purchaser and he will be held personally liable.

In *Somers v. AAA Temporary Services, Inc.*,[26] the issue was the effectiveness of a bylaw amendment enacted by the corporation's only two shareholders. The amendment purported to reduce the number of directors on the board from three to two. In a questionable decision, the First District Appellate Court held the amendment

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23. *Id.* at 130, 273 N.E.2d at 756.

24. *Id.* at 129, 273 N.E.2d at 754.

25. It is hard to believe that the average person would be confused by such a designation. It is common for large corporations to use "division" designations. *See e.g.*, Kingsberry Homes v. Corey, 457 F.2d 181 (7th Cir. 1972), where suit was brought by "Kingsberry Homes, a division of Boise Cascade Corporation." It is unclear whether the use of a "division" designation when soliciting business violates ILL. REV. STAT. ch. 32, § 211.1 (1971), which prohibits "assuming any other or different name," or ILL. REV. STAT. ch. 96, §§ 4-8 (1971), which prohibits a corporation using a name other than its "real name."

26. 5 Ill.App.3d 931, 284 N.E.2d 462 (1972).

invalid because it had not been approved by the directors as required by the Business Corporation Act.[27]

One would have assumed that under the principles enunciated by the Illinois Supreme Court in *Galler v. Galler*[28] that a different result would have been reached. In *Somers*, the court quoted what it thought was the *Galler* holding:

> There is no reason why mature men should not be able to adapt the statutory form to the structure they want, so long as they do not endanger other stockholders, creditors, or the public, or violate a clearly mandatory provision of the corporation laws.[29]

Since no one in *Somers* thought that the shareholders' amendment of the bylaws endangered the shareholders, creditors or the public, the court had to find that the B.C.A.-prescribed amendment procedures were mandatory. They said:

> The *Galler* court did not say that the Illinois Business Corporation Act may be disregarded in the case of a close corporation. Slight deviations from corporate norms may be permitted. However, action by the shareholders which is in direct contravention of the statute cannot be allowed.[30]

Galler did not indicate which provisions of the B.C.A. were to be considered mandatory. However, it is hard to believe that the *Somers* situation falls within this category. After all, *Galler* approved a shareholders' agreement that specified dividend payments and salaries—two things that are normally within the exclusive province of the board of directors. Surely, determination of the number of directors is of less significance than dividend payments and salaries. The practical consequences of the court's decision are particularly unfortunate. The plaintiff in the case was the ousted third director who owned no stock in the corporation. In all likelihood, he was acting on behalf of Kay, one of the two shareholders. This would indicate that Kay and Raimer, the other shareholder, had a falling out and that the suit was designed to allow Kay and the plaintiff

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27. ILL. REV. STAT. ch. 32, § 157.25 (1971).

28. 32 Ill. 2d 16, 203 N.E.2d 577 (1964).

29. *Id.* at 30, 203 N.E.2d at 585. The language cited is actually from a Yale Law Review article by George Hornstein which the court introduced with this comment: "Numerous helpful textual statements and law review articles dealing with the judicial treatment of the close corporation have been pointed out by counsel. One article concludes . . . ." While the Hornstein language does not represent the precise holding of *Galler*, it is hard to argue with the proposition that a mandatory provision must be obeyed. The problem is determining what is mandatory.

30. 5 Ill.App.3d at 935, 284 N.E.2d at 465.

to gain control of the board and the business.[31] The court's decision goes a long way toward helping Kay reach that objective. It is doubtful that such a result will promote an equitable settlement of the shareholders' differences.

LEGISLATION

On July 1, 1972, the new short form merger statute became effective.[32] This statute governs mergers of subsidiaries into their parent corporations where the parent owns at least 99% of each class of the subsidiary's outstanding stock. The statute substantially simplifies the normal merger procedure[33] by eliminating the need for approval by the board of directors and shareholders of the subsidiary and the need for approval by the shareholders of the parent.

In addition to simplifying procedure, the statute eliminates the right of shareholders of the parent to dissent from the merger, *i.e.*, to be paid the fair value of their shares in cash. However, this does not impose a hardship on the parent's shareholders, since the traditional reason for providing "dissenters' rights" does not exist, *i.e.*, there is no significant change in the economic entity from the viewpoint of the parent's shareholders.

From the viewpoint of the shareholders of the subsidiary corporation, the new corporation, in which they may be asked to accept stock, is a substantially changed economic entity. Since they also are given no voice in determining the plan of merger, it is not surprising that their right to dissent has been preserved. To exercise this right the shareholder must notify the corporation in writing within 30 days after the plan of merger has been mailed. Within 10 days after receiving the written objection, the corporation must make the shareholder an offer to purchase his shares at "fair value." If no agreement is reached, the shareholder may file suit within 90 days after receiving the corporation's offer. The Act provides for the

31. The effect of the court's decision would be to reinstate Somers as a director because ILL. REV. STAT. ch. 32, § 157.34 (1971) provides that "[e]ach director shall hold office . . . until his successor shall have been elected and qualified." He would continue in office until the two shareholders would agree on a replacement—something that Kay obviously would not do so long as Somers continued to support her.

32. ILL. REV. STAT. ch. 32, § 157.66(a) (1971).

33. ILL. REV. STAT. ch. 32, §§ 157.61-69 (1971).

assessment of costs, including appraisers' fees, against the corporation if the court finds that the fair value of the shares "materially exceeds" the amount which the corporation offered to pay.

However, there is no provision for the payment of attorneys' fees to the prevailing party in the litigation. While it may be argued that this will tend to reduce litigation, it should be remembered that the statute, in effect, gives the corporation the right to force out the minority shareholder. Under such circumstances, the cost of an undervaluation of the stock by the corporation would seem to be more properly borne by the corporation.[34]

34. There are no states that provide for attorneys' fees under these circumstances. See Model Business Corporation Act Ann. 2d § 81 (1971).