Indiana Law Journal

Volume 4 | Issue 9 Article 3

6-1929

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VOTING TRUSTS

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A decided conflict among the authorities exists as to whether or not stockholders may surrender their voting power and irrevocably vest it in others, either permanently or for a stated period of time. A number of methods have been employed by groups seeking to tie up a majority of the voting stock of a corporation, the voting trust seemingly being the best of the group in spite of the existing conflict.[1] The paucity of decisions on this point, however, makes the law hard to define.

What then is a voting trust? A voting trust may be comprehensively defined as one created by an agreement between a group of the stockholders of a corporation and a trustee, or by a group of identical agreements between individual stockholders and a common trustee, whereby it is provided that for a term of years, or for a period contingent upon a certain event, or until the agreement is terminated, control over the stock owned by such stockholders, either for certain purposes or for all, shall be lodged in the trustee, either with or without a reservation to the owners or persons designated by them of the powers to direct how such control shall be used. It is essential, however, that the ownership of the stock and the voting power be separated in order to have a voting trust.[2]

Although the past forty years have seen voting trusts used with greater frequency, the question as their enforcibility, in the absence of a governing statute, has given considerable cause for argument. Needless to say, different courts have reached opposite conclusions and many writers today hold that the weight of authority regards voting trusts illegal per se; while others state the law otherwise. Hence, disregarding the weight of authority, which ever way it may be, the purpose of this article is to determine whether or not voting trusts should be

* See p. 608 for biographical note.

[1] (1) Use of holding companies which hold a majority of the shares of the subsidiary. (2) Sometimes by agreement between stockholders to vote together. (3) Classification of stock, voting rights being had in only a small class. (4) Sometimes by an agreement whereby proxies were given to trustees with power to vote as they may be directed or may determine.

[2] Fletcher's Cyclopedia Corporations—Vol. III, p. 2871.

upheld; an attempt being made to present the arguments on both sides in an unbiased manner.

What are the arguments then against enforcing voting trusts? As one court has said:

"The duty which each stockholder owes his fellow stockholder, is to so use such power and means as the law and his ownership of stock give him, that the general interests of stockholders shall be protected, and the general welfare of the corporation sustained, and its business conducted by its agents, managers and officers, so far as may be, upon prudent and honest business principles, and with just as little temptation to and opportunity for fraud, and the seeking of individual gains at the sacrifice of the general welfare as possible. * * * He may shirk it perhaps by refusing to attend stockholders' meetings, or by declining to vote when called upon, but the law will not allow him to strip himself of the power to perform his duty."[3]

This objection, then, is merely that a stockholder is entitled to the benefit of the deliberation and judgment of all the other stockholders. However, since one stockholder has no legal right to the deliberation of another stockholder, is not this a fallacious objection? Furthermore, in our present day corporation with its widely diversified group of stockholders, is it not a practical impossibility for many such stockholders to take an active part in the affairs of the corporation?

Another argument often raised against voting trusts is that public policy is opposed to a separation of the power to vote and the beneficial ownership, otherwise than where a revocable proxy or agreement is had. Those urging this objection feel that public policy frowns on the management of a corporation by those without direct pecuniary interest. Seemingly, they regard the voting power as a protection of the beneficial ownership of the stock; a divorce of such power permitting the trustees to act oppressively or fraudulently. Then again, others urge that all combinations among members of a class, which exclude some of the members of that class, does violence to public policy in that such a discrimination is abhorred by the common law. Perhaps a reply can be had in citing a quotation from Mr. Justice Holmes in which, in discussing the public policy of a voting trust, he says:

"* * * although it is impossible to view such an agreement without suspicion" still "it is also impossible to let suspicion take the place of

[3] *Bostwick v. Chapman*, (1890) 60 Conn. 553. *Luthy v. Ream*, (1915) 270 Ill. 170.

proof. We know nothing of the policy of our law to prevent a majority of stockholders from transferring their stock to a trustee with unrestricted power to vote upon it."[4]

A further argument made against voting trusts is that they are nothing more than a proxy, hence, since a statute is necessary to authorize an ordinary revocable proxy, the absence of a statute authorizing an irrevocable separation of the voting power from the beneficial ownership of the stock, condemns such an agreement. Those making this objection regard the "trustee" merely as an agent and the agreement as a collective revocable proxy. How, then, can this objection be answered, if at all? Perhaps the fact that the voting trust does not create an agency relationship, but a trust relationship, makes it distinguishable from a proxy. Further, a voting trust is in the nature of a power coupled with an interest. In reality, it is a real trust; the power to vote not alone being delegated, but the legal title, which carries the power to vote, being the thing transferred. While it is probably true that the agreement would only constitute a revocable power if it were a dry trust, still, since it is really an active trust, both by reason of the power and duty to vote and by the interest each stockholder has in the participation of the others in the agreement, it does not fail on that ground. Hence, although the Legislature could express the intention of permitting the voting power and beneficial ownership of stock to be separated, the mere fact that it has not done so is no argument against such a voting trust agreement.

Then there is the argument that such an agreement constitutes a restraint on alienation. As a necessary incident to the creation of an ordinary voting trust, certain evidences of title known as voting trust certificates are issued. The exact legal status of these certificates, like the enforcibility of the agreement at all, is, as yet, far from settled. However, since the trust certificates may be bought and sold, subject, of course, to the trust agreement, the restraint against alienation argument does not seem tenable.

"It is true that, as a rule, those who have the largest interests in a corporation are entitled to control its affairs; and where a combination to effect such a result is entered into for a fixed, definite, and reasonable

[4] *Brightman v. Bates*, (1900) 175 Mass. 105.

time, * * * it is not necessarily obnoxious to the rule which condemns as illegal all contracts in restraint of alienation."[5]

A further argument that is sometimes advanced is that a voting trust is contrary to the idea of corporate management in that it makes for the possibility of having the minority control the majority. This may occur where sixty per cent of the stockholders have placed their stock with the trustee and only thirty per cent of this group are in favor of some action by the trustee as regards corporate management. One reply to this objection is that since a majority of the stockholders were in favor of vesting control in a trustee, the action by the trustee is the action by the majority.

Then there is the ever present objection that no one but the stockholders can have as strong an interest in the prosperity of the corporation, since they are the actual beneficial owners of the stock. Those raising this argument contend that a trustee who does not receive dividends can not be vitally interested in the corporation's success. This statement may be seen to be false where the corporation was in trouble before the trust agreement was entered into; the agreement being the only basis for creditors increasing loans to the corporation. With prosperity ensuing to the corporation and stockholders, management having been vested in a trustee, the answer to this objection seems complete.

Having briefly stated some of the main objections advanced against voting trusts, what may be said in favor of such agreements? Certainly the repeated efforts of lawyers, business men, and others to make use of such agreements must be deemed indicative of the fact that in certain cases such an arrangement seems necessary to protect investing interests. It is obvious that a voting trust agreement provides one way for a continuous business policy.

"There are few moneyed corporations, the management of which is not liable to change hands, every year, by the requirement of law or charter that the board of directors shall be chosen annually. Where the stock is held but by a few persons and as a permanent investment, no inconvenience results, because the annual election is usually a re-election; but in a case of new enterprises, or corporations with a widely distributed capital, unless some one man or family holds an interest so large as to be practically controlling, changes will not be infrequent. Under such circumstances a vacillating policy often results. Plans of direction may be abandoned, when but half tried, for others which meet no better fate. This

is a real evil, and the 'voting trust' is the remedy, to which, of late years, there has been frequent resort."[6]

Further, just what rights does a creditor have in regard to the internal management of a solvent corporation? Practically none. On the other hand, there are numerous cases where a voting trust agreement has been used to a great advantage as an arrangement to secure the interests of creditors of a corporation in distress. Many instances can be cited where, instead of forcing the corporation into insolvency, creditors have given an extension of credit, provided management and control of the corporation is transferred to them as security for additional loans. Certainly a great economic evil is avoided by such a votting trust agreement.

It may be safely said that the courts which take the practical, economic view realize that, in the reorganization of a corporation, often times banking interests may be willing to invest only if continuity of an approved and satisfactory business policy is absolutely assured. As has been seen, where large corporations are concerned, it is practically impossible for the average shareholder to vote intelligently on business questions. Hence, would it not be better for a competent trustee to be used to carry on the corporate work?

In practice the voting trust is used, not to injure the shareholders, but to protect their interests. Especially is this true where a reorganization is necessary.

"We think we are safe in saying that experience has shown that, so far from exercising an injurious influence on trade, voting trusts have added efficiency, economy, and stability to the administration of corporate affairs."[7]

Having stated the arguments above, may the few decisions which we have as to the enforcibility of such agreements be classified? One writer has held that in three cases the courts seem to justify the creation of such a trust; namely: (1) Where the trust is coupled with an interest, or to protect an interest; and (2) where the voting trust is a mere means of carrying out a fixed and binding plan or policy; and (3) in those states where pooling contracts are sustained, a voting trust which is a mere instrument for carrying out a pooling agreement will be upheld.[8]

[5] *Brown v. Britton*, (1899) 58 N. Y. Supp. 353.

[6] Baldwin, Voting Trusts, 1 Yale Law Journal 1.

[7] *Carnegie Trust Co. v. Security Life Insurance Co.*, (1900) 111 Va. 1.

[8] Marion Smith, 22 Columbia Law Review 627-37.

Ballantine, however, states that "it is believed that this is an unsound and unwarranted generalization."[9]

Since a conflict does exist, just what should be considered in determining whether or not such an agreement should be upheld? Seemingly, the purpose of the agreement alone is the one thing which determines its validity or invalidity. Of course, where held illegal per se, the purpose is of no importance; but where such agreements are sustained, even though not necessarily favored, if formed for a lawful purpose, not in conflict with public policy, with execution provided for in a proper manner, such should be upheld. As one text writer says, "the touchstone of the validity of voting trust agreements is primarily the purpose for which the agreement is formed. If its object is to advance in a lawful manner the interests of all of the stockholders, usually the agreement is held valid. If its purpose is to benefit the stockholders forming it at the expense of the other stockholders or of the corporation, or if it is in the furtherance of an unlawful or fraudulent design, it will not be sustained.[10] Again, if the purpose of the voting trust is in accordance with the views as to commercial rectitude entertained by the Court of Chancery, the voting trust is generally held valid, otherwise it is held absolutely void.[11]

A study of the decisions indicates that the early hostility and denouncement of voting trust agreements has been gradually disappearing, a clearer understanding tending to uphold such an agreement where a valid purpose exists. In support of this change may be mentioned the passage of statutes by various states authorizing the voting trust agreement. The proposed Uniform Business Corporation Act provides, in part, that "two or more stockholders of any domestic corporation may, pursuant to an agreement in writing, transfer their shares to any person or persons, or to a corporation having authority to act as a trustee, for the purpose of vesting in such person, or persons, or corporations, as trustee or trustees, all voting or other rights pertaining to such shares for a period not exceeding ten years, and upon the terms and conditions stated in the agreement." However, in spite of the fact that hostility has decreased, it must be recognized that there are two lines of decisions, one sustaining and the other denying the validity of these trusts.

[9] Ballentine, Private Corporations, note, p. 585.

[10] *Supra*, note 2.

[11] *Frost v. Carse*, (1919) 91 N. J. Eq. 124.

In drafting a voting trust agreement, what should appear therein? One eminent writer has contributed the following suggestions:

(1) The purpose should appear to be for the benefit of the corporation and the whole body of stockholders.

(2) The trustees should be selected from among the stockholders.

(3) The substitution and appointment of new trustees for the original trustees should be provided for.

(4) The agreement should recite valuable consideration other than mutual promises.

(5) The arrangement should be open to any stockholders who wish to join in and deposit their stock.

(6) The duration should be reasonable.

Provided the agreement is drawn as set out above, there is seemingly no reason to attack it or hold it void.[12]

While there may be some basis for a split of opinion where the corporation is not in distress, still, where the corporation is in trouble, business necessity demands a voting trust, such to be based upon a valid consideration, with a reasonable time limit fixed for its continuance. Many states have neither statute nor judicial decisions as to the enforcibility of voting trusts. Indiana, apparently, is one of these states. Certainly it is high time that Indiana expresses herself on such an important feature of present day private corporation law.

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[12] Ballentine, Private Corporations, p. 588.

INDIANA LAW JOURNAL

Published Monthly, October to June, inclusive, by The Indiana State Bar Association

EXECUTIVE OFFICE, 106 CITY HALL, INDIANAPOLIS, INDIANA
EDITORIAL OFFICE, BLOOMINGTON, INDIANA

SUBSCRIPTION PRICE, $3.00 A YEAR **SINGLE COPIES, 50 CENTS**
Canadian Subscription Price is $3.50; Foreign, $4.00

Subscription price to individuals, not members of the Indiana State Bar Association, $3.00 a year; to those who are members of the association the price is $1.50, and is included in their annual dues, $5.00.

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