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## Joint Adventure Agreement Survives Incorporation

### *DeBoy v. Harris*<sup>1</sup>

In 1948 A, B and C orally agreed to associate themselves as joint adventurers in a business of furnishing warehouse facilities. They formed a corporation as an instrumentality to carry out the joint enterprise. It was agreed that each venturer was to have a fixed proportionate interest in the assets and to receive a fixed percentage of the profits. Shares in the corporation were issued according to the agreed interests of the parties: A, 28%, B, 52%, and C, 20%.

By 1952 the venture had become quite successful, and it would appear that the net worth of the enterprise far exceeded the par value of the shares held by the joint adventurers. B and C removed A as an officer and director in the corporation. By resolution of the board of directors, they recommended an increase in the authorized capital stock of the corporation, and as stockholders, approved the necessary charter amendment. New shares were later issued to B and his nominees. A's pre-emptive right to purchase a proportionate share of the new issue, however, was not denied. A alleged that B's and C's purpose in causing this additional issue of stock was to destroy his interest in the enterprise since they knew that by offering such a large number of shares A would be financially unable to purchase enough of the shares to maintain his agreed proportionate interest.

A brought suit at law for the breach of the joint adventure agreement to recover the damages he sustained by the watering down of the interest allotted to him in the agreement. The lower court sustained a demurrer, and

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<sup>1</sup> 207 Md. 212, 113 A. 2d 903 (1955).

judgment was entered for B and C. *Held*, judgment reversed, with costs, and the case remanded to equity for an accounting.<sup>2</sup>

The Court of Appeals held that where a corporation is the mere *instrumentality* for carrying out a joint adventure, incorporation does not terminate the agreement of the co-adventurers. Therefore, B and C could not use the corporate entity as a shield against personal liability for the breach of their antecedent agreement.

There is a conflict of authority on whether or not partners or joint adventurers may use the corporate entity as a tool of their enterprise. Several cases, including the instant one, follow *Wabash Ry. Co. v. American Refrigerator Transit Co.*<sup>3</sup> in giving effect to the real intent of the parties. On the other hand, the New York courts and others follow *Jackson v. Hooper*<sup>4</sup> in holding that public policy does not permit a partnership to masquerade as a corporation because the partners should not get the advantages of both limited liability and partnership control.

In *Manacher v. Central Coal Co.*<sup>5</sup> the New York Appellate Division expressed the *Jackson v. Hooper* rule as follows:

“Individuals may enter into partnership agreements or joint ventures independent of the corporate form but they may not organize a corporation for the purpose of carrying on a joint venture. Thereby they would become joint venturers *inter sese* and a corporation to the rest of the world with the privilege of changing from coadventurer to stockholder as the situation might require.”<sup>6</sup>

The rationale underlying the *Jackson v. Hooper* view would appear particularly inappropriate in the situation presented by the *DeBoy* case. The policy against infringing on the discretion of corporate directors is an important

\* A joint adventure may be defined as a “partnership for a single transaction or for a limited number of transactions”, *Hobday v. Wilkinson*, 201 Md. 517, 526, 94 A. 2d 625 (1953). Were the parties actually “joint adventurers” as distinguished from “partners”? See Mullen, *Joint Adventures*, 8 Md. L. Rev. 22 (1943).

<sup>2</sup> 7 F. 2d 335 (8th Cir., 1925), *cert. den.* 270 U. S. 643 (1926). This is the majority view according to BALLANTINE, CORPORATIONS (Rev. ed., 1946), Sec. 183(6).

<sup>3</sup> 76 N. J. Eq. 592, 75 A. 568 (1910).

<sup>4</sup> 284 App. Div. 380, 131 N. Y. S. 2d 671 (1954), *aff'd.* 308 N. Y. 784, 125 N. E. 2d 431 (1955), noted 55 Col. L. Rev. 419 (1955).

<sup>5</sup> *Ibid.*, 131 N. Y. S. 2d 671, 677. *Cf.* *LaVarre v. Hall*, 42 F. 2d 65 (5th Cir., 1930), where it was held that a partnership may acquire shares and thereby control corporations.

element in the *Jackson v. Hooper* line of cases. Here, however, the joint venture agreement merely sought to preserve a fixed proportional interest in the enterprise and did not purport to affect the directors' control over business decisions. Moreover, here, all the present shareholders had agreed to the arrangement — a fact which ordinarily forecloses an attack on this ground.

In *Shore v. Union Drug Co.*<sup>7</sup> the pre-incorporation agreement of the parties provided for the formation of a corporation with ownership in fixed proportions. One of the parties took control of the corporation initially, and acting under resolution of the board of directors cut out the others by refusing to issue them stock. The Delaware Court held that specific performance of the pre-incorporation agreement could be had. Just as in the present case, the defendant contended that the plaintiffs must be relegated to their stockholder's remedies, if any. Various other "freeze out" cases are in accord with the view that the corporation is incidental to the contract between the parties, and that the individual contract rights survive incorporation.<sup>8</sup>

It should be pointed out that the decisions, both in the instant case and in the *Union Drug Co.* case appear to be predicated on the basis that the rights of third parties are not adversely affected.<sup>9</sup> Thus as a practical matter the scope of the instant case may be limited to close corporations. In other situations the rights of third parties are likely to be adversely affected.<sup>10</sup> It is also well to note that the Maryland Corporation Law will allow charter provisions to require unanimous board or shareholder action.<sup>11</sup> Hence,

<sup>7</sup> 18 Del. Ch. 74, 156 A. 204 (1931).

<sup>8</sup> *Rogers v. Penobscot Mining Co.*, 154 F. 606 (8th Cir., 1907); *Wallace v. Eclipse Pocahontas Coal Co.*, 83 W. Va. 321, 98 S. E. 293 (1919); *Bailey v. Interstate Airmotive*, 358 Mo. 1121, 219 S. W. 2d 333, 8 A. L. R. 2d 710 (1949).

<sup>9</sup> This limitation seems well established, at least by *dictum*; *Bailey v. Interstate Airmotive*, *ibid.* *Elsbach v. Mulligan*, 58 Cal. App. 2d 354, 136 P. 2d 651 (1943), apparently relies upon the fact that third parties have not been adversely affected. The *dicta* of *Wabash Railroad Co. v. American Refrigerator Transit Co.*, *supra*, n. 3, is quoted by the Maryland Court of Appeals to this effect in the instant case, *supra*, n. 1, 219.

<sup>10</sup> In an analogous problem to that of the incorporated partnership, agreements which provide that one party is to have permanent employment with the corporation restricts the future action of the board of directors, and have been held invalid for that reason, *West v. Camden*, 135 U. S. 507 (1890); *In re Petrol Terminal Corp.*, 120 F. Supp. 867 (D. Md., 1954). However, where all the shareholders agree, such an agreement has been held valid, *Clark v. Dodge*, 269 N. Y. 410, 199 N. E. 641 (1936).

See BALLANTINE, *op. cit.*, *supra*, n. 3, Sec. 183(4) and (5), and ISRAELS, *The Close Corporation and the Law*, 33 Cornell L. Q. 488 (1948).

<sup>11</sup> Md. Code (1951), Art. 23, Sec. 38(b) and 52(d), authorize a quorum of greater than a majority. In *Roland Pk. Shop. Center v. Hendler*, 206 Md.

it appears that the present plaintiff could have protected his proportionate ownership and control by appropriate charter provision.

In the *DeBoy* case the hardship of the plaintiff is in the foreground. The pre-emptive right to purchase shares<sup>12</sup> is of relatively little solace to one whose financial circumstances will not permit buying new shares. If the financially embarrassed adventurer is held to a shareholder's derivative action, he must overcome a strong presumption that the board of directors acted in the best interests of the corporation, and a breach of fiduciary duty on the part of majority shareholders is hard to find where pre-emptive stock rights have been accorded the minority.

It therefore appears that the *Jackson v. Hooper* view, holding the Proteus-like "incorporated partnership" void *per se*, is a rather severe penalty for failure to insert the appropriate clause in the charter, such as a provision that all shareholders must agree to any additional issue of stock. In the light of the widespread use of the close corporation, and the various ownership and control arrangements sanctioned by modern corporation law, there appears to be no logical reason for such a harsh result, which would seem to be turning on form rather than substance. The approach of the Maryland courts would seem preferable.

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10, 109 A. 2d 753 (1954), the court said that a requirement for unanimous board or shareholder action is valid both under pre-existing law and under the current statute.

<sup>12</sup> See Md. Code (1951), Art. 23, Sec. 26, on pre-emptive rights.