

Capano v. Wilmington Country Club, 2001 WL 1359254 (Del.Ch. 2001)

The Wilmington Country Club, a private country club located in Greenville, Delaware (the “WCC” or the “Club”) has had from its inception a by-law authorizing its board of directors to expel a member for cause (the “expulsion by-law”). The WCC also has a separate by-law that requires a new member, as a condition of membership, to purchase shares of WCC stock that are restricted in terms of their transferability. One such restriction, which is contained in a separate by-law provision, requires that if a member dies or is expelled, his or her shares of stock are forfeited unless the shares are transferred to the member's spouse (the “compulsory stock transfer by-law”).

The plaintiff, Louis J. Capano, Jr. (“Capano”), became a member of the Club in 1981. In so doing, he contracted to be bound by those by-law provisions. In 1999, the WCC's board of directors voted to expel Capano for cause, in that he gave false testimony to a grand jury in a highly publicized criminal proceeding. Capano elected to challenge the expulsion by invoking the arbitration procedure provided for in the expulsion by-law, but he did not prevail in the arbitration.

In this action Capano challenges both the expulsion by-law and the compulsory stock transfer by-law, contending that both are facially invalid under Delaware corporate law principles. In his complaint Capano seeks, among other things, an order directing the WCC: (1) to permit his wife to transfer back to him the shares of WCC stock that he transferred to her after his expulsion, and (2) to reinstate Capano as a Club member.

Pending before the Court are cross motions for summary judgment. Those motions present two purely legal issues, namely, whether (1) the Club's expulsion by-law and (2) the compulsory transfer by-law are valid under Delaware corporate statutory and case law. I conclude that both provisions are valid and that consequently, Capano's motion for summary judgment must be denied and the Club's cross motion must be granted.

I. FACTS

The material facts are undisputed. On April 24, 1901, the WCC was formed as a stock corporation under the Delaware General Corporation Law (“DGCL”) for the “maintenance of an association for social, intellectual, and recreative purposes.”

The Club's certificate of incorporation provides that the Board of Directors will conduct the affairs of the corporation and are authorized “to make by-laws for the government of the corporation, and to alter, change or amend the same at any meeting.”

From its inception, the Club had in effect a by-law (the expulsion by-law) which provided that, “[a]ny member may be suspended or expelled for cause, by the vote of three-fourths of the Directors present at any meeting”. The expulsion by-law initially provided for one week's notice before expulsion, but later was amended to require two weeks' notice.

In 1992, the expulsion by-law was again amended, this time to provide a definition of “cause” for expulsion.⁵ The amended by-law further provided that an expelled member could challenge the expulsion for the Club's procedural non-compliance with the by-law by means of an arbitration procedure spelled out in the by-law.

In its current form, the expulsion by-law states that:

“Any member may be suspended or expelled for cause by the vote of three-fourths of the directors present at any meeting. ... Challenges to a determination by the Board alleging the Club's procedural noncompliance with this Section ... shall be submitted to private arbitration.”

The Club also had in effect a separate by-law (the compulsory stock transfer by-law) which provided that “[a]ny stockholder ceasing to become a member of the Club by death or otherwise, shall forfeit his or her shares of stock to the Club except as provided in sub-paragraphs (b), (d) or (f) of this section.” Subsection (b), which is one of the exceptions to the forfeiture provision, provides that “[n]o stockholder is permitted to sell or assign any of his or her shares ... except shares may be voluntarily transferred once between spouses to qualify either one for membership.” In obedience to this by-law, this transfer restriction appears as a legend on each of the certificates representing the Club's shares.

Capano became a stockholder member of the WCC in 1981, at which time he purchased one share of WCC stock. He later paid for, and was issued, three additional shares of WCC stock.

On March 27, 1999, the Board of Directors of the WCC notified Capano in writing that it would hold a meeting to consider whether he should be expelled for cause from the Club on the ground that he had made false statements to a grand jury in the case of a highly publicized criminal proceeding. Capano attended that hearing, and was assisted by counsel who advanced the contention that Capano should not be expelled. The directors voted to expel Capano, however, and gave him formal, written notice of the expulsion on April 28, 1999. That notice also stated that, in accordance with the compulsory transfer by-law, Capano could transfer his WCC shares to his wife rather than forfeit them to the Club. Capano accordingly transferred his shares to his wife, thereby enabling her to become a member without purchasing stock.

Shortly thereafter, Capano invoked Article II, Section III(c) of the WCC by-laws, requesting arbitration of the Board's decision to expel him from the Club. After a hearing at which Capano appeared with counsel, the arbitrator upheld the expulsion, having concluded that the Club had complied with its by-laws in all material respects.

⁵ The amended provision states that a “[p]roper cause for dismissal will include any conduct which, in the opinion of the Board, is disorderly or injurious to the Club's interests or reputation. The offender's conduct will be judged by the Board in accordance with the Club's purposes: the promotion of fellowship, sportsmanship, and the preservation of the highest standards of personal conduct.”

II. THE CONTENTIONS AND ISSUES

The pending motions implicate three membership requirements, all contained in the WCC by-laws. The first is that members of the Club must, as a condition of membership, own WCC stock. The second is that the club's directors are authorized to expel a member "for cause." The third is that if a member dies or is expelled, his or her shares are forfeited, unless they are transferred to the member's spouse.

A careful analysis of Capano's invalidity claim reveals that it challenges only the third of these requirements, namely, the compulsory stock transfer provision. Capano's argument, simply put, is that as a matter of Delaware corporation law that provision must be contained in the Club's certificate of incorporation. The argument is odd, because even if it were found to be valid, the relief that would flow to Capano would be of little utility to him: Capano's status as an expelled member would continue unaffected, and the only consequence of a ruling in his favor would be to allow him to retain his four WCC shares.

That result flows logically from the narrow scope of Capano's claim. Capano does not dispute that as a general matter a private club may enact governance procedures allowing the expulsion of a member for cause. Where the club is organized as a non-stock corporation, the expulsion provision may be contained in the certificate of incorporation or the by-laws. Where the club is a corporation authorized to issue stock, and there is no linkage between expulsion and stock ownership (*i.e.* there is no compulsory stock transfer provision), the expulsion provision could appear in either the certificate of incorporation or the by-laws.¹¹ In both circumstances the expulsion provisions would affect the club member only *qua* member, not *qua* stockholder. Thus, if the WCC had no compulsory stock transfer requirement, Capano would have no claim, because the board voted to expel him for cause and Capano unsuccessfully challenged that expulsion in an arbitration-all in accordance with the procedure prescribed in the Club's by-laws to which Capano voluntarily agreed when he joined the Club.

Capano does, (because he must) attack the expulsion by-law. The basis for his attack is not that the by-laws must appear in the WCC certificate of incorporation, but rather, that Delaware corporate law forbids the directors of a corporation from expelling a stockholder. But that argument, even granting its correctness, is a non-starter, because its factual premise is irrelevant in this case. The WCC's Board expelled Capano only as a member, not as a stockholder, because the expulsion by-law operates only against members in that capacity, not in their capacity as stockholders. The only by-law provision that operates against an (expelled) member in his or her capacity as a stockholder is the compulsory stock transfer by-law. Accordingly, that is the only provision Capano may validly challenge on the basis that it must appear in the corporate charter. Thus, the only genuine corporate law issue presented on these cross motions for summary judgment is whether the compulsory stock transfer by-law provision must, as a matter of Delaware statutory law, be contained in the WCC certificate of incorporation.

¹¹ See 8 Del. C. § 202 ("A restriction on the transfer ... of securities of a corporation may be imposed either by the certificate of incorporation or by the by-laws")

Capano's by-law challenge rests upon 8 *Del. C.* §§ 102(a)(4) and 151, which (to paraphrase) provide that any rights, preferences, restrictions and limitations relating to any class or series of stock must be set forth in the certificate of incorporation. Thus, the implicit premise of Capano's argument is that the compulsory stock transfer by-law constitutes a "limitation" with respect to the WCC stock. That premise, however, is flawed because the compulsory transfer requirement is not a characteristic or attribute-such as a voting right, dividend right, or dividend or liquidation preference-that affects each individual WCC share. Rather, that provision operates only against the *holder* of the stock (in the event of that member's death or expulsion), not against the *stock* itself. Put in statutory terms, the compulsory stock transfer provision is not a limitation "with respect to" the WCC shares, and is therefore not statutorily required to be set forth in the Club's charter. The reasons for that conclusion are discussed in the analysis that next follows.

III. ANALYSIS

Two separate by-laws are challenged in this litigation: the expulsion by-law and the compulsory stock transfer by-law. [...] The validity of the expulsion by-law is addressed in Part III(A) of this Opinion; the validity of the compulsory stock transfer by-law is analyzed in Part III(B).

A. Validity Of The Expulsion By-Law

The first issue is whether the WCC expulsion by-law, standing alone, is legally valid. More specifically, the issue is whether the WCC may enact a by-law that authorizes the expulsion of a member from the Club for cause, by a vote of the three-fourths of its directors. The answer is clearly yes. As earlier noted, Capano does not dispute that as a general matter, a private club may enact governance procedures that authorize the expulsion of a member for cause.

The WCC is a private club organized as a stock corporation.¹³ As a general matter, a private organization is given wide latitude to enact rules to achieve the club's purposes and to discipline its members. Membership in voluntary associations is generally viewed as a privilege that may be withheld, not as a right that may be independently enforced. In rare cases where courts have scrutinized a private club's expulsion by-laws, it was only to determine if the club complied with its own by-law procedures, or whether the by-laws violated general public policy, or if bad faith motivated the enforcement of the by-laws against the affected members. In this case, there is no claim that the WCC failed to comply with its own by-laws when it expelled Capano. Nor does Capano contend that his expulsion was motivated by bad faith on the part of the Club's Board of Directors, or that the expulsion by-law violates public policy.

Most important, Capano does not contest that the WCC has the power to exclude him as a *member* of the WCC at all. What he contends is that he cannot be removed as a *stockholder*. That argument, however, implicates the compulsory stock transfer by-law, not the expulsion by-law.

¹³ If the WCC were organized as non-stock corporation, the membership requirements would have to be stated in the certificate of incorporation or (if provided by the certificate of incorporation) in the by-laws. 8 *Del. C.* § 102(a)(4).

[...] Capano argues that a board of directors of a Delaware corporation can never be empowered to remove any of the corporation's shareholders. But [...] the argument proceeds from a false premise. The expulsion by-law does not result in the “removal” of a Club-member *qua* shareholder. It operates against a member only in his or her membership capacity.

Only because the WCC is organized as a stock corporation is Capano positioned to advance his “shareholder removal” argument. Even then, in order to make that argument Capano must resort to conflating the expulsion by-law and the compulsory stock transfer by-law provisions. But, as a legal matter those two by-laws are separate, and their requirements and operation are independent of each other. The very nature of Capano's argument (that a corporation's directors cannot legally remove the equity investors) only underscores that Capano's challenge, properly understood, is directed against the compulsory stock transfer-and not the expulsion-by-law. If any demonstration of that were needed, it is that even if Capano's challenge were to prevail, he would not gain reinstatement as a member, but only as a shareholder without membership privileges. The pyrrhic nature of such a legal victory is apparently what drives Capano's effort to conflate the expulsion and the compulsory transfer by-laws, and to treat them as if they were a single, unified, integrated, and non-severable requirement. [...]

B. The Validity Of The Compulsory Stock Transfer By-law

[...]

1. 8 Del. C. §§ 102(a)(4) and 151 Do Not Require The WCC Restriction To Be In The WCC Certificate

Sections 102(a)(4) and 151 of the DGCL define the universe of provisions, relating to a corporation's stock, that must be contained in the corporation's certificate of incorporation. Section 102(a)(4) pertinently states that:

The certificate of incorporation shall ... set forth a statement of the designations and the powers, preferences and rights, and the qualifications, *limitations or restrictions thereof*, which are permitted by § 151 of this title in respect of *any class or classes of stock*.... (emphasis added).

And Section 151(a) provides that:

Every corporation may issue *one or more classes of stock*... [with] such designations, preferences and relative, participating, optional or other special rights, and qualifications, limitations or restrictions thereof, as shall be stated and expressed in the certificate of incorporation (emphasis added).

The central concept embodied in these statutory provisions is that rights or restrictions that attach to (*i.e.*, are attributes of) a *class* of stock must be in the certificate of incorporation. For example, if a class of stock possesses no voting rights, or has special rights with respect to dividends, those

restrictions are attributes of the stock and must therefore be in the certificate of incorporation. In terms of this case, if the compulsory stock transfer by-law imposes conditions that legally constitute a “limitation” or “restriction” with respect to the WCC stock, then that limitation or restriction must be in the WCC certificate. In that event, because those limitations are set forth only in the WCC by-laws, they would be invalid.

To say that, however, is to reveal the flaw in Capano's position. The WCC compulsory stock transfer by-law does not impose restrictions on the WCC *stock*, but only against certain *holders* of the stock. To own WCC stock one must be a member of the Club, and if a holder ceases to be a WCC member (by reason of expulsion), then that person must either transfer the stock to his or her spouse or forfeit the stock. Because the compulsory stock transfer by-law operates against the *stockholder*, not against the *stock*, the WCC by-law and the concomitant stock certificate legend do not constitute a “restriction ... in respect to any class of stock” within the meaning of Section 102(a)(4). Therefore, Sections 102(a)(4) and 151 do not require that restriction to be in the certificate of incorporation.

2. The WCC Restriction Is Valid Under 8 Del. C. § 202 As A Restriction On The Transfer of Stock

Properly viewed, the compulsory transfer by-law is a restriction on the *transfer* of stock that is governed by 8 Del. C. § 202. Section 202 sets forth the requirements for a valid restriction on the transfer of securities. The first two of those requirements are that the restriction must be conspicuously noted on the stock certificate, and that the restriction may be imposed either in the corporation's certificate of incorporation or in its by-laws. Here, it is undisputed that the WCC conspicuously placed a legend on its stock certificate noting the restriction. It is also undisputed that the restriction is contained in the WCC by-laws. Therefore, the issue becomes whether the other (substantive) features of the compulsory stock transfer by-law satisfy the remaining statutory criteria of Section 202 for a legally permissible restriction upon the transfer of a corporation's stock.

It is noteworthy that Section 202 was amended shortly after Capano was expelled from the WCC. As amended, that statute now expressly permits a by-law provision of the kind challenged here. The current Section 202(c)(4) authorizes a restriction on the transfer of stock that:

[o]bligates the holder of the restricted securities to sell or transfer an amount of restricted securities to the corporation or to any other holders of securities of the corporation or to any other person or to any combination of the foregoing, or causes or results in the automatic sale or transfer of an amount of restricted securities to the corporation or to any other holders of securities of the corporation or to any other person or to any combination of the foregoing.

In its present form, Section 202 would permit the WCC compulsory transfer by-law, because it “results in the automatic ... transfer of an amount of restricted [WCC stock] to the corporation ... or to any other person [(Capano's wife)].” Because Section 202 was amended after Capano was compelled to transfer his stock to his wife, however, the compulsory transfer by-law must be analyzed under Section 202 as it existed before the 1999 amendments.

[Court analyzes the old Section 202 and finds that the key question is whether Delaware case law views the WCC bylaw as a lawful restriction on transfer of securities, so that it would be allowed under Section 202(e).]

Before Section 202 was enacted, the Delaware cases held that restrictions imposed by a corporation upon the transfer of its stock would be upheld if those restrictions were reasonable. A restriction was valid if it was reasonably necessary to advance the corporation's welfare or attain the objectives set forth in the corporate charter. A determination of the validity of those restrictions required balancing the policies served by the restrictions against the traditional judicial policy favoring the free transfer of securities.

In *Lawson v. Household Financial Corp.*, the Court held that a corporation could require any stockholder who wished to sell his or her stock to offer it first to the corporation.³⁴ The Court upheld that restriction as reasonable, because it furthered what the Court found was a commendable plan to retain the stock ownership of a finance company among its employees.

On the other hand, our courts have found a transfer restriction to be “unreasonable” if it completely prevents the sale of stock of a corporation, and is not related to the corporation's successful operation. In *Greene v. E.H. Rollins & Sons*, this Court indicated that a corporate charter provision authorizing the corporation to buy a shareholder's stock at any time at its net asset value, even from an unwilling seller, might be an invalid restriction on transfer. The apparent purpose for the restriction was to perpetuate a company consisting of shareholders who were “agreeable” to the Board. The Court concluded that the power to redeem stock is “highly questionable if its avowed purpose was to get rid of certain stockholders of a given class solely because their presence in the stockholding group was undesirable to the rest.”³⁸

Under the applicable common law test, the Court must decide if the WCC stock transfer restriction at issue here is reasonably “related to the corporation's successful operation.” I conclude that it is.

The WCC certificate of incorporation provides that the Club's “object to be promoted is the maintenance of an association for social, intellectual, and recreative purposes.” The purpose of being a club member is for recreative, intellectual and social purposes, and not to achieve traditional investment purposes. It is self-evident that people do not join a country club for the reasons that they would buy shares in a for-profit-corporation, such as General Motors or Du Pont. The corporate form is merely a structure for organizing the Club, and the stock ownership requirement is a means to evidence membership in the Club. To say it differently, being a

³⁴ [...] The restriction at issue in *Lawson* is now expressly allowed by Section 202(c)(1).

³⁸ Based on the facts before it, however, the Court was unable to determine whether the restriction at issue served a valid purpose for the corporation. It concluded that a full hearing was needed to determine whether “the ends and purposes of the restraint complained against so related to the corporation's successful operation [] as to warrant the conclusion that the restraint is reasonable.”

stockholder of the WCC is not the desired end. The desired end is being a Club member. Owning shares of the Club is a requirement that must be satisfied to achieve that end.⁴¹

It is reasonable to conclude the Club's purposes would not be achieved if these shares (memberships) were freely transferable. Indeed, membership in a country club would be less attractive to potential and current members if the shares could be freely transferred to anyone (*i.e.*, if the Club were not exclusive). It follows that where a member is expelled from the Club, no purpose would be served by allowing the expelled member to retain his or her shares in the Club. Those shares have worth only as a requirement for (and as evidence of) membership. They have no independent economic value except (possibly) if the club were to dissolve and liquidate its assets. Requiring Capano (a member) either to transfer his shares to his spouse or to forfeit them after being expelled from the Club is, therefore, a reasonable restriction upon the transferability of the WCC stock under former 8 *Del. C.* § 202(e).

[...]

⁴¹ Capano devotes much rhetorical force to his argument that he is “forfeiting” his stock to the WCC without compensation. Because the WCC agreed to allow Capano to transfer his shares to his wife, his stock was not forfeited. Moreover, the money he paid for his membership was never intended as an investment that would one day be recovered. By the plain terms of the contract to which Capano agreed, the investment would never be recovered unless he died or resigned from the Club (due to a change of residency) within five years of becoming a member. This is clearly stated on the stock certificate and in the by-laws, both of which Capano assented to. Capano became a member in 1981, and more than five years have lapsed since then. From that point forward, Capano had no reasonable expectation of ever recovering his membership fee in the corporation.