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O'Neal: Close Corporations: Law and Practice.

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BOOK REVIEWS

Close Corporations: *Law and Practice*. By F. Hodge O'Neal.¹ Chicago: Callaghan & Company, 1958, 2 Vols., Pp. xx 369; vii, 437. \$30.00.

Professor O'Neal has produced a much needed work, which should be welcomed by the practitioner. There is no other published treatise dealing with the subject of "Close Corporations." And yet the corporate law problems of the close corporation, as Professor O'Neal defines it, are predominant in the practice of most lawyers, including the practice of those who specialize in corporate law.

In Chapter I, the author explains what he means by the term "close corporation"; describes, broadly, the unique needs of its shareholders; and correctly points out that there has been a general failure on the part of both legislatures and courts to provide satisfactorily for those needs.

The author gives a good working definition, even if somewhat arbitrary, of the close corporation. After rejecting, as not sufficiently comprehensive, the commonly used definition, namely, that of a corporation in which there is a "substantial integration of ownership and management", the author defines the close corporation as one whose shares are "not generally traded in the securities market", thus emphasizing the closer than normal personal relationship of the participants to one another and to the enterprise.

Actually, the close corporation is not a specific type of business entity; rather it is an enterprise the owners of which have need for special legal treatment because of this closer than normal personal relationship. As it is sometimes put, a close corporation is a business undertaking corporate in form but in which certain important partnership characteristics are desired. Thus, as the author soundly points out, participants in this kind of business venture commonly desire, because of their personal involvement in the enterprise, both (1) a control over management beyond that afforded by a mere voice in the selection of directors and (2) a power to exclude new entrants from the enterprise. Because they usually expect to turn over a substantial part of their assets and frequently to devote a substantial portion, if not all, of their working time to the enterprise, participants commonly wish assurance of continued employment. Further, because of the difficulty of finding a market for their stock in the enterprise should dissension arise and because of the normal legal barriers to obtaining corporate dissolution, these participants often seek a means for the resolution of dissension and for termination of the enterprise if dissension cannot be resolved. Additionally, because of the close relationship of participants to the enterprise and to one another, relief from the formalities of calling, holding and recording the minutes of stockholder and directorate meetings is from time to time sought to be achieved.

The basic problems of the "close corporation" are problems of how, if at all, to satisfy these desires, and the balance of the treatise is devoted in greater part to a consideration of possible techniques to this end.

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Before proceeding to a consideration of such techniques, however, Professor O'Neal devotes a chapter (Chapter II) to a good discussion of such elementary but essential questions facing the practitioner as whether to advise use of the corporate or partnership form, what proportion of debt to equity to recommend in capitalization, the classes of stock which should be issued, the advantages and disadvantages of tax-free incorporation and the desirability of a formal pre-incorporation agreement.

In treating of possible techniques for satisfying shareholder needs, consideration is first given to the matter of the commonly desired control by participants over management beyond that afforded by a mere voice in the selection of directors. Three chapters are devoted to this subject (Chapters III through V). It is hardly necessary to point out that corporation statutes of the various states almost universally contemplate that shareholders shall elect directors and that the latter shall manage the business, fundamental changes in the corporate structure being customarily left for shareholder determination by a majority or greater than a majority vote. For participants in a close corporation to have control over policy or day-to-day decisions, they must normally first achieve representation on the directorate, and to guard against undesired fundamental changes in the corporate structure, minority stockholders must have, in some form or other, a power of veto. How to attain representation on the board of directors when there is only one class of stock (as through cumulative voting) is first considered, and then the use for the purpose of obtaining such representation of charter clauses providing for more than one class of stock, each with the right to elect a fixed number of directors to the board, is next treated. The use of high voting requirements to protect against undesired fundamental changes at the stockholder level and to afford at least a veto power on policy and day-to-day decisions at the directorate level is extensively discussed.

Additionally, attempts to fulfill the desire of shareholders for such control through shareholder agreements, voting trusts and irrevocable proxies are explored, and the limitations upon the usefulness of each of these devices are carefully pointed out. Thus, it is noted that no general assurance can be given as to the effectiveness of shareholder agreements, the conclusion depending largely, it is said, on their purpose. Here, more help might have been given the reader. It is believed that shareholder agreements can play a more effective part in achieving the objectives of the shareholders of close corporations than the author appears to recognize, provided, of course, that the agreements make use of statutory corporate machinery and are not in conflict with statutory mandates. With respect to voting trusts, it is correctly pointed out that such trusts may prove cumbersome and, even more importantly, that statutes authorizing and regulating such trusts commonly limit their life to ten years and thus weaken their usefulness for the purpose at hand. The author then refers to the common law doctrine of revocable powers (except where "coupled with an interest") and says that this doctrine, together with statutes limiting the period for which proxies may be given, impairs the general usefulness of irrevocable proxies as a control device.

The author's discussion of the meaning of the phrase "proxies coupled

with an interest" is somewhat disappointing from the standpoint of analysis; actually, the only valid barrier to the creation of irrevocable proxies, in situations such as the author is considering, lies in the common statutory provisions limiting their duration and not in a so-called common law requirement that such proxies be "coupled with an interest." It seems to this reviewer that it is only because of the fiduciary relationship involved that agencies are held to be revocable despite a valid contract not to revoke them. If, under the circumstances, the agency gives rise to no fiduciary relationship, as where the agent may properly act wholly without regard to the interests of the principal and solely in his own interests or in the interest of a third person, there is no sound reason why a contract not to revoke should not be specifically enforceable or why the law should not give a short cut to specific performance and treat the agency as irrevocable. An irrevocable proxy given to achieve objectives desired by participants in a close corporation will commonly be of this latter type involving no fiduciary relationship between the giver and the receiver of the proxy. Accordingly, such a proxy should be held irrevocable unless violative of a statute fixing its term, and this probably explains, and certainly justifies, decisions upholding such proxies which the author refers to as decisions which "have broadened the 'interest' concept."²

The author does not, it seems to this reviewer, adequately warn against the practical dangers underlying the use of the control devices he discusses, particularly the use of veto powers through high stock or directorate vote requirements. He mentions more than once that they create the risk of deadlock and consequent frustration, but the author is highly critical of courts and legislatures which stand in the way of giving effect to these devices and thus inevitably fosters an impression that he is sympathetic to their use. Yet their use is far from an unmixed blessing, although it may in particular instances be a necessary evil. In any event, the non-specialist organizers of a "close corporation" should be fully apprised of the risks underlying the adoption of such devices in instances in which they may lawfully be adopted.

Chapter VI deals with ways in which participants in a "close corporation" may assure themselves of employment. It has been noted that such participants frequently transfer substantial portions of their assets to the business and expect to devote to it their full business time. Having determined to devote themselves to the business, they are vitally concerned with assurance that they have security in their employment. The effectiveness of arrangements to this end through long term employment contracts is the principal subject considered in this chapter. Reference is made to the inhospitability which some courts have manifested toward long term employment contracts, allegedly because of statutory provisions placing the powers of management in the directors (an inhospitability clearly not warranted). Also considered is the not uncommon form of statute authorizing the directors to remove at will officers and employees and the influence of such

² *Op. cit. supra* Vol. 1, p. 321.

statutes on judicial decisions (in this instance, perhaps sounder) which hold such employment contracts unenforceable. The fact is also noted that specific performance of employment contracts will not normally be granted. A highlight of the chapter is a good practical check list for use in drafting corporate employment contracts.

One of the best discussions in the book is in Chapter VII. There, stock transfer restrictions generally, including buy and sell arrangements in the event of death, are considered at length. The legality of various types of restrictions is considered, and it is correctly stated that first options and buy-outs are the easiest to sustain, and that they are generally held valid. Excellent suggestions are made as to matters to include in drafting options. The discussion of how best to arrive at a purchase price and of how to provide in advance for funds for its payment in the event of a participant's death is treated well and at length. Insurance possibilities are considered, as are helpful techniques to employ with respect to payment for shares of non-insurable participants.

The author wisely urges that consideration be given to the importance, if feasible, of compulsory buy-out provisions in the event of death. The position of the widow of a once active participant may be most unfortunate in the event of his death unless there be provision for purchase of his interest by his fellow shareholders or the corporation. The widow may have a stock certificate increasing her tax burden but of little, if any, practical value to her.

Chapter VIII deals with so-called "Problems of Operation." Among other matters, this chapter contains a good discussion of attempts by majority participants to freeze out minority shareholders through withholding dividends and through dilution of the interests of the minority by the issue below fair value of additional stock. The difficulty of obtaining adequate protection through litigation is pointed out. No really practical suggestion is advanced as a protection against the withholding of dividends, but charter provision against additional stock issues without unanimous consent of shareholders is recommended to protect against dilution. A good, but elementary, discussion with respect to compensation problems is included, and the author touches briefly on the desire, hard, if not impossible, to satisfy, which participants have of being free from the formalities commonly required by corporate statutes. His wise advice is to conform, except when the legislature explicitly affords relief (which is rare), to the formalities required and avoid the risk otherwise present of invalidity of corporate action or personal liability of participants consequent upon court disregard of the corporate entity.

The need of participants for a technique to resolve dissension and to effect dissolution if the dissension cannot be resolved is competently discussed in Chapter IX. A partner who is unhappy with a partnership arrangement may, unless he has agreed otherwise, terminate the arrangement at will. A shareholder in a corporation is rarely, if ever, in this position. His stock is commonly subject to a restriction on transfer, and, even apart from such a restriction, the market for his stock is commonly quite limited.

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His stock, by hypothesis, is not traded on a securities exchange, and it may, in any event, be difficult to find one willing to purchase when there is a background of dissension. Dissolution statutes rarely give needed relief. Even statutes permitting dissolution on deadlock generally are construed not to permit dissolution when deadlock is due to veto, presumably for fear of frustrating the objective underlying the provision of a veto. The author explores the possibilities of arbitration but recognizes the many difficulties in effective use of this technique. Thus, for example, he refers to the fact that problems of management, involving as they often do difficult business judgments, may not lend themselves to solution by arbitration and that to make the arbitration award mandatory may violate the management prerogatives conferred by statute upon directors. Also explored in this chapter is the possibility of contractual provisions for dissolution. It is suggested that participants ought to be able to "waive" statutory dissolution provisions. Actually, however, a right of waiver would not seem to be in issue. Dissolution may only be had if and to the extent the State, through legislation, permits it. That the parties can properly be permitted to substitute their criteria for the legislative criteria as to the appropriate conditions for dissolution seems to be highly doubtful and not to present a question as to the right of waiver.

Professor O'Neal's work is basically for the non-specialist practitioner, and, being for the non-specialist, it is subject to the defect of encouraging such a practitioner to believe that more can be accomplished to meet the needs of participants than can in fact be assured. It is true that the author warns that "legislatures and courts have seldom attempted to formulate rules and concepts to solve the problems of close corporations," and he has also wisely added that, "Before drafting the charter, the draftsman . . . should try to find clear statutory or judicial support for each clause he uses"; that he "must search the statutes and decisions of the state of incorporation," and that "great caution must be exercised in departing from customary corporate procedures." Yet, these warnings become almost lost in the missionary spirit which pervades the volumes. The reader is time and again told about what the "modern court" is doing to free the close corporation of its shackles and to validate action which ought, in the author's view, to be validated. Nothing, however, warrants the author's pervasive optimism. Basically corporate law is statutory law. And, wise as courts should be, they still are obligated to apply statutes when the legislature has enacted them. This excellent work suffers somewhat from this crusading spirit and from efforts better directed to corrective legislation than toward judicial deviation. The danger in the author's approach, particularly in a work addressed basically to the non-specialist, is that the reader may well be led to believe that the law is more favorable to techniques of the kind discussed than it can fairly be said to be. Many of the devices suggested have little chance of being sustained in many jurisdictions or at least their validity is in grave doubt and cannot safely be predicted. And this is not because the courts are not "modern." Nor is it because the courts are unwilling to adapt themselves to human needs. It is because corporate law

is essentially statutory law, and statutory law, soundly or unsoundly, often stands in the way.

One reviewer has said that these volumes use a "how to do it approach."³ This is not literally true. The teaching of these volumes can be said to be "how to do it" only if it can lawfully be done in the state whose law is controlling. The value of the volumes is not in teaching "how to do it" but in pointing out avenues of approach; in indicating what the possible solutions may be. And, in this respect, the work affords a most valuable contribution by providing in effect a comprehensive check list. Whether particular techniques suggested for consideration are usable, the reader must determine for himself.

Your reviewer would have preferred a shorter or a longer study than that reflected in the present work.

The present work is too long for what it achieves. It is too repetitive even for use by a non-specialist. The Note "Statutory Assistance for Closely Held Corporations" published in the June, 1958 issue of the Harvard Law Review seems to this reviewer to give a clearer statement with respect to a large part of the problems elaborated upon in Professor O'Neal's work than does his work itself. Moreover, the latter work is marred by such statements as "Apart from limitations imposed by statute or public policy, parties may adopt whatever provisions they desire," which, although true, make no contribution to the subject.

On the other hand, a longer work could have been justified. But such a work should not only stress that the problem is basically statutory; it should relate its analysis more closely to the relevant statutes of particular states and the decisions interpreting them.

Be this as it may, admittedly no work is perfect, and certainly Professor O'Neal's work should be far from condemned. Whether or not we would like a fuller contribution to the subject, Professor O'Neal has made the most valuable contribution yet made to the subject "Close Corporations."

One word in conclusion. Volume 2 ends with a collection of forms suggested for consideration. The forms constitute, as the author has stated, "invaluable assistance to draftsmen if used cautiously and only as idea guides." They are worthy of careful attention.

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Modern Corporation Law. By Howard L. Oleck. Indianapolis: The Bobbs-Merrill Company, Inc. 1958, Vol. 1, Pp. vii, 968, \$20.00; 1959, Vol. 2, Pp. iv, 913, \$20.00; 1959, Vol. 3, Pp. iv, 846, \$20.00.

The post-war period has been one of unprecedented growth and development in the area of corporation law. Many states have thoroughly revised their corporation statutes and others are in the process of doing so; the close

³ *Israels, Book Review, 72 Harv. L. Rev. 1187 (1959).*