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NORTH CAROLINA LAW REVIEW

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Volume 34 | Number 4

Article 4

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6-1-1956

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## Recommended Citation

E. R. Latty, *A Conceptualistic Tangle and the One- or Two-Man Corporation*, 34 N.C. L. REV. 471 (1956).

Available at: <http://scholarship.law.unc.edu/nclr/vol34/iss4/4>

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# A CONCEPTUALISTIC TANGLE AND THE ONE- OR TWO-MAN CORPORATION

E. R. LATTY\*

The judicial opinions in the *Park Terrace* litigation<sup>1</sup> have generated so much concern among lawyers and businessmen in North Carolina that they merit a special commentary. The case could and should have been disposed of quite easily on the ground that a release of a corporate cause of action by the sole stockholder precludes the corporation from enforcing that cause of action, at least in absence of special circumstances not present in this case. Instead, in its twisting course which finally managed to leave the way open to preclude the corporation's recovery, the North Carolina Supreme Court has shaken the very foundation of the one-man corporation (including wholly owned subsidiaries of a parent corporation) and the two-man corporation. It is instructive to see how this came about.

The defendant, Park Builders, had constructed an apartment housing project for the plaintiff corporation under a contract with that corporation. Subsequently, the four persons owning all the corporation's common stock sold all their stock to McLean. Some of the sellers also owned shares in the defendant, Park Builders, for which reason the stock purchase agreement between the purchaser and three of the sellers contained a provision substantially to the effect that: McLean accepts and has by this contract accepted the real estate and improvements in the property owned by the corporation in their present condition and agrees that no claim shall be made against Park Builders (or the sellers of the stock) because of improper workmanship or use of defective materials. Eighteen months after McLean had so acquired all the common stock, and while he still held it, the corporation brought an action against Park Builder's surety (to which action Park Builders was made a defendant) to recover damages for alleged improper workmanship and use of defective material. Park Builders in its answer, properly viewing itself as third party beneficiary under the above contract of release, pleaded sole stockholder McLean's above agreement as a defense and moved to make McLean a party defendant.

One theory on which the pleaded agreement could be a defense is that even if viewed as the agreement of McLean himself and not as an agreement made *for* the corporation, still it was enough to preclude the cor-

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<sup>1</sup> *Park Terrace, Inc. v. Phoenix Indemnity Co.*, 241 N. C. 473, 85 S. E. 2d 677 (1955); on rehearing, 243 N. C. 595, 91 S. E. 2d 584 (1956).

poration's suit. The Court, it is submitted, should have sustained this defense on this theory, as well as on other theories discussed later. In refusing to do so in the first hearing it seems (although the Court does not spell this out) that the Court overemphasized the sanctity of the corporate entity—the concept of the corporation as a separate entity distinct from the shareholders. Now, the separate entity concept should be viewed only as a shorthand formula for summarizing the attributes of a corporation for a fairly long list of legal issues in the solution of which the corporation is to be viewed *as if* it were a person distinct from the shareholders. (The list would include such important issues as liability for corporate debts.) It should not be used as the dogmatic premise from which, by sheer logic, one drives to the seemingly inescapable conclusion that, whatever be the issue, the corporation is something completely separate and apart from the shareholders, let the chips fall where they may.

In this areas of corporate entity doctrine the courts find readily available completely antithetical formulae. On the one hand it is stated time and again in judicial opinions that a corporation is ordinarily an entity distinct from the shareholders; on the other hand, judicial statements abound to the effect that the corporate entity will be disregarded when justice so requires. One is reminded of competing proverbs: absence makes the heart grow fonder; out of sight is out of mind. The task of choosing which of these competing entity rules to apply is a most delicate operation. The *Park Terrace* case was one where the sole stockholder was exercising his dominant control over his wholly owned corporation<sup>2</sup> to have it bring suit on a cause of action upon which he had agreed "no claim" would be made and under which, if corporate recovery were allowed, the recovery would benefit the very person who had agreed to release the claim. This is the perfect case for disregarding the corporate entity or, if you prefer, for lifting the cloak of corporate entity and taking a peek to see who is there underneath, getting the benefits of the corporate action. Certainly there is no dearth of decisions and formulae for disregarding the corporate entity in a "proper case."<sup>3</sup> Putting aside any question of fraud by the stock sellers in the instance case, it would be about as shocking to let the sole stockholder profit by his breach of contract here as to see the beneficiary of a life insurance policy get the

<sup>2</sup> The preferred stock in the instant case, all held by the FHA, was only nominal in amount and existed solely to give FHA voting control in the event of the default under the mortgage on the housing project.

<sup>3</sup> In *FLETCHER, CORPORATIONS* (perm. ed. 1931) in the sections to the effect that a corporation ordinarily is viewed as a separate entity, literally hundreds of cases are cited, true. See citations to § 25 *et seq.*, in cum. supp. 1955. But an equally impressive number of cases are also cited under §§ 41 and 42, especially in cum. supp. 1955, for disregarding the corporate entity "when necessary to the justice of the case."

proceeds when he murders the insured. For analogy, consider what should be the result where *A* buys from *B* all the stock of a corporation, after full investigation of its assets and business,<sup>4</sup> and then, having paid the price upon in the arm's length bargain, has the corporation bring an action against *B* to recover for, say, *B*'s having sometime in pre-sale days taken "corporate opportunities" for himself. In such a case even the corporation itself would probably be barred from recovering;<sup>5</sup> *a fortiori* would the corporation be barred, it is submitted, if purchaser *A* had expressly agreed with seller *B* that no claim would be made against *B* arising out of *B*'s former management of the corporation.

To make its "entity treatment" still more confusing, the Supreme Court in the original *Park Terrace* hearing, after having treated the corporation as a separate entity, added at the very end of the majority opinion the ominous remark: "Query: Since McLean has now acquired all the stock of plaintiff, is it now a corporation? The question is not presented by the record." But since the record did show that McLean was the sole stockholder (except for preferred stockholder, whose holdings here could be disregarded), if that feature makes a corporation *not* a corporation (about which more later) why did not this clearly pre- the question whether there was now *no* corporation and whether, accordingly, the sole stockholder was the *true* plaintiff (under another name) and hence barred from enforcing a claim which he had released?

A further theory upon which a defense arising out of the sole stockholder's release might be based is that the release was not simply the personal release of the sole stockholder but was a *corporate* act, in which the sole stockholder either was empowered automatically to act for the corporation by virtue of his acquisition of all of the shares (plus also getting the contemporaneous written resignation of all of the officers and directors) or had for other reasons become authorized to act for the corporation. For this line of reasoning it could even be conceded that the corporation is viewed as a separated entity. It is submitted that here again the court took too narrow a view in finding that this was not a corporate act. The Court opined that, for one thing, the sole stockholder, in his purchase agreement, did not purport to act for the corporation. What does a sole stockholder have to do to *purport* to act for the corporation? Does he have to state *expressly* that he is so acting? When this sole stockholder, with all the corporate control that sole ownership carried with it, agreed that "no claim" would be made against Park

<sup>4</sup> On stock purchaser McLean's inspection of the properties here involved, see companion case, *Lester v. McLean*, 242 N. C. 390, 87 S. E. 2d 886 (1955).

<sup>5</sup> See *Capital Wine & Spirit Corp. v. Pokrass*, 302 N. Y. 734, 98 N. E. 2d 704 (1951), *aff'g* 277 App. Div. 184, 98 N. Y. S. 2d 291 (1st Dept. 1950). See also *Home Fire Ins. Co., v. Barber*, 67 Neb. 644, 93 N. W. 1 1024 (1903), quite properly cited by Bobbitt, J. dissenting in the *Park Terrace* case, *supra* note 1, on original hearing.

Builders, then, since the only one who might have any claim was the corporation, cannot the part of the agreement that relates to the "no claim" aspect be viewed as being made on behalf of the corporation, even though the main subject matter of the contract was one to which the corporation was not a signatory party? One must bear in mind that the sole stockholder is often likely to overlook formalities incident to corporate action as mere red tape; in the resulting failure to identify clearly the capacity in which the sole shareholder acts the court has the opportunity to put that interpretation upon the actor's capacity which most comports with the just solution.

The Court, instead, seemed to reason that McLean's release did not bind the corporation because he was not *authorized* to act for it. At the time he signed the contract, said the Court in the first decision, McLean was not a stockholder, director or officer. But, for one thing, one does not have to be actually registered on the books to be a stockholder. More important, the Court's reasoning overlooks that the very contract by which he became the controlling stockholder was the contract in which he agreed that no claim would be made against Park Builders and that at the time of the contract all the shareholders involved in the sale of stock (whether you view the sellers as still the shareholders or the buyer as now the shareholder) intended that all claims against Park Builders would be released by the sale of all the shares. Finally, if it be conceded that, despite the Court's view above discussed, McLean intended to act for the corporation but that he then was not yet the sole stockholder and hence without authority, his immediate acquisition of the status of sole stockholder, combined with corporate passivity (with, obviously, "corporate" knowledge of the act), amounted to ratification by the corporation, if the crucial point be granted that the act of a sole stockholder *can* "bind" the corporation without further corporate formalities.<sup>6</sup> Here, again, the Court took a position that is questionable. It seemed to view the problem as one to be solved by resort to the hornbook black letter rule that corporate action by shareholders and directors requires them to act as a body, in regular meeting. But that is only the rule *ordinarily*—a rule for the protection of stockholders and accordingly to be applied where some or all of the co-owners of the corporation would be deprived of the benefits of the appropriate corporate organs of discussion. The case of *Duke v. Markham*,<sup>7</sup> cited by the Court, is a perfect example of the ordinary application of the orthodox rule: the alleged assent to a corporate mortgage by a number of shareholders holding a majority of

<sup>6</sup> That the act of the sole stockholder can bind the corporation, see Fuller, *The Incorporated Individual; A Study of the One Man Company*, 51 HARV. L. REV. 1373, 1387-89 (1938); LATTY, *SUBSIDIARIES AND AFFILIATED CORPORATIONS* (1936) 70-72.

<sup>7</sup> 105 N. C. 131, 10 S. E. 1017 (1890).

the stock was obtained by an officer who contacted the stockholders separately, and not all of them at that. The rule obviously has no application where there are only two stockholders, one of whom gets the consent of the other; *a fortiori* where there is only *one* stockholder.<sup>8</sup> In such a close corporation, the basic reason for the general rule fails. *Cessante ratione, cessat lex*. In corporation law, one must always re-examine the validity with respect to close corporations of those rules that grew up against the background of the publicly held corporation.

The upshot of the original *Park Terrace* hearing in the Supreme Court was, accordingly, that those paragraphs in the defendant's answer based on the sole-stockholder's release of the defendant were stricken from the pleading and that the sole stockholder was held not to be a necessary party defendant.

On rehearing, the majority of the Court managed to work out a technique that had the effect of making the sole stockholder's release preclude recovery by his corporation. The technique was to hold that the sole stockholder was a necessary *party plaintiff*. (The Court's power, it said, over lower court orders, judgment and decrees was adequate, in order to promote justice in a proper case, to make the stockholder a *plaintiff* even though the motion had been to make him a defendant. It is interesting to note that "proper cases" and "promotion of justice" are also the very factors that empower courts to disregard the corporate entity.) This technique of making the sole stockholder a necessary party plaintiff, will cause his release to preclude recovery whatever he does: if he files a pleading the defendant's plea of release will succeed; and if he files no pleadings, then said the court, the "defendants may file an amended answer alleging the facts which make McLean the real—and a necessary—party plaintiff and plead their contract with him"<sup>9</sup>—which will presumably be a good defense to the action.

Why was he a necessary party plaintiff? The reason (said the Court) is that he was "the real party in interest";<sup>10</sup> and the reason that he was the real party in interest (and here comes the bombshell which has caused consternation in close corporation circles in this state) is, the Court opined, that a one-man corporation is not within the statutory scheme of things for corporations as gathered from the framework of the North Carolina corporation law. Specifically, the Court said:

"It requires three or more persons to obtain a certificate of incorporation, G. S. § 55-2, and the certificate of incorporation must be signed by a majority of the applicants. If one dies before

<sup>8</sup> See BALLENTINE, CORPORATIONS (rev. ed. 1946) 125-27, 390-91.

<sup>9</sup> *Park Terrace v. Phoenix Indemnity Co.*, 243 N. C. 595, 599, 91 S. E. 2d 584, 588 (1956).

<sup>10</sup> *Id.* at 597, 91 S. E. at 586.

the organization of the corporation, some other person must be designated in his place and stead. G. S. § 55-7. The corporation must have at least three directors who manage the affairs of the corporation, G. S. § 55-48, and three officers, provided any two offices may be held by one person. So there must be at least two officers. G. S. § 55-49. Real estate of the corporation may be conveyed by its president and two stockholders or by the president, attested by the secretary. G. S. 55-40. Three stockholders may call a meeting of the corporation, G. S. §55-6, and a majority of stockholders may dissolve the corporation, G. S. § 55-121.

“Thus the concept that a corporation is a combination of three or more persons who may operate as a legal entity when chartered so to do threads its way through the cited and practically every other section of our law on corporations. General Statutes, Ch. 55. No lesser number will suffice.”<sup>11</sup>

The Court then posed this question: “When one person acquires all the stock of a corporation, what then is the status of the corporation and the property held in its name?”

To which the Court then made the following answer:

“We are of the opinion and so hold that the corporation becomes dormant or inactive and exists only for the purpose of holding legal title of the property for the use and benefit of the single stockholder who becomes seized of the beneficial title to the property. Not possessing the managerial agencies—stockholders, directors, or officers,—contemplated by statute, it can no longer act as a corporation. Its decisions are the decisions of the single stockholder, and its action is his action.”<sup>11a</sup>

No previous judicial decisions of the Court would have led one to anticipate this rationale. One ventures that nowhere in American decisions of the 20th century has a court for the first time cast so dark a cloud on a form of business organization so commonly accepted, so entrenched in the business mores of the business world, as the one-man and two-man corporation and the wholly owned subsidiary of a parent corporation. Literally thousands of such corporations exist in this state,<sup>12</sup> as well as in other states.

True, the inner structure of the North Carolina corporation law reveals that it was framed with the publicly held corporation primarily in mind. That law was enacted over 50 years ago, close to the turn of

<sup>11</sup> *Id.* at 597, 91 S. E. 2d at 586.

<sup>11a</sup> *Ibid.*

<sup>12</sup> One Durham, North Carolina, lawyer alone tells me he has nearly 100 one-man or two-man corporations as clients.

the century. In that day, the close corporation had not yet become the familiar phenomenon that it now is. Since then, in this state as well as over the country generally, the historical idea of the corporation as a legally personified body of numerous subscribers to its public offering of stock has undergone sharp evolution, as have many other business practices and their legal bases. We have come to look upon corporation laws as affording a machinery which, although originally devised for numerous associates is, after all, adaptable also for the few, and to view requirements of three incorporators, three directors, etc., as mere formalities—almost legal idiosyncrasies—which are to be complied with, as are other formalities in the law, but which carry no implication of a mandatory public policy, and by no means carrying an implication of requiring three stockholders at all times. There is no magic in numbers and there is no public policy which says that three men may limit their liability and acquire a legal personality different (for some purposes) from their individual personality, but that one man or two men cannot. For example, in so far as limited liability is concerned, as Lord Herschell said in a famous English case: "How does it concern the creditor whether the capital of the company is owned by seven persons . . . or almost entirely owned by one person."<sup>13</sup> (He could well have left out even the word "almost.") If one wants to argue that this is a contention that should be addressed to the legislature, the argument *assumes* that the present corporation law contains a clear command against less-than-three-man corporations. It is submitted that the law is not that rigid. True, it contemplates a structure more appropriate to representative form of government (three directors, etc.) than to one-man and two-man corporations, but even the prescribed structure is not impossible for the latter. It is to be noted that in 1949 the Legislature abolished the requirement that directors must be shareholders; this can be taken as some indication of legislative acceptance of less than three stockholders. Other states also have the same inner structure as does the North Carolina corporation law, yet nowhere else in this century is so strong a judicial denunciation of such corporations to be found.<sup>14</sup> It is fair to say that

<sup>13</sup> See *Salomon v. Salomon* [1897] A. C. 22, 44-45.

<sup>14</sup> One finds Kentucky cases in the 20th century that still *talk* about "suspension" of the corporation when all the stock is acquired by one person. *Russell Lumber & Supply Co. v. First Nat. Bank*, 262 Ky. 388, 90 S. W. 2d 372 (1936); *Hawley Coal Co. v. Bruce*, 252 Ky. 455, 67, S. W. 2d 703 (1934). But in Kentucky this is merely a survival of a rationale announced in the 19th century. Moreover, "the suspension" rationale generally appears as a make-weight and is referred to only in passing, as it were, in cases where the court reaches the decision without resting primarily on that reasoning.

What one is more apt to find in judicial language now-a-days in the case of the one-man corporation is not "suspension" or "dormancy" talk but unguarded overstatement, *e.g.*, *Lindstrom v. Sauer*, 166 So. 636 (La. App. 1936), to the effect that the one-man stockholder "may not use the screen of corporate entity to absolve him from responsibility." (All that this meant was that the corpora-

no disturbance comparable to that produced by the *Park Terrace* rehearing has been caused in close corporation circles by a judicial decision since the English Court of Appeals in 1895 held that Mr. Salomon was obligated to pay the creditors of his insolvent corporation, Salomon & Co., because although there were six other shareholders who each had a share (viz., his wife, daughter and four sons), apparently making up the required seven, the real beneficial owner of all the outstanding shares was really one person, a situation which (said that court) the Companies Act scheme of things did not contemplate.<sup>15</sup> The great shock<sup>16</sup> that this decision was to English business no doubt was a factor in its categorical reversal by the House of Lords.<sup>17</sup>

There is a further difficulty in the *Park Terrace* rehearing: in order to "come out right" the Court was forced to make still another false turn. After stating that the corporation became "dormant" for reasons stated in the excerpt previously quoted, the Court went on to say that the sole stockholder "could not later, and cannot now, evade the consequences of his act merely by transferring some of the stock to third parties so as to comply with the statute." If it be granted that sole stockholder McLean's release of the defendant should have precluded the corporation from recovery (for reasons hereinbefore stated), then the corporation would of course be barred from recovery even if at the time of bringing the action it has acquired three or more stockholders, at least unless they are bona fide purchasers of shares who would be unjustly aggrieved if their corporation were to be deprived of this asset—which is doubtful. But, on the "party plaintiff" rationale, if the corporation is *not* dormant at the time the motion is made to make the shareholder a party, on the

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tion's sale of its business and good will precludes the sole stockholder from continuing the same line of business at the same location and making frequent use of the old name. Even this proper disregard of the corporate entity does not mean that the sole stockholder loses limited liability.)

<sup>15</sup> Broderip v. Solomon [1895] 2 Ch. Div. 323.

<sup>16</sup> Here are some of the comments that the Court of Appeals decision evoked in contemporary literature:

"Opposed to the settled practice of recent years and . . . a source of danger to the multitude of private companies which have been established . . ." 41 SOL. J. 61 (1896).

"Shaken the stability of half of the private companies in existence." 31 L. J. 631 (1896).

"A novel and startling doctrine." Sweet, *The Bona Fide Incorporator's Case*, 7 JUR. REV. 314, 323 (1895).

"The giant growth of joint stock enterprise is one of the marvels of our age. Whatever may be said of it, it has conferred very great benefits on the community. It has given enormous impulse to trade; it has unlocked by the magic key of limited liability vast sums for useful industrial undertakings. . . . Let us beware lest in gathering the tares we root up the wheat also." Manson, *One Man Companies*, 11 L. QU. REV. 185, 188 (1895).

<sup>17</sup> Salomon v. Salomon [1897] A. C. 22. In turn, the House of Lords went too far the other way in permitting sole stockholder Salomon to stand as a £20,000 secured creditor of his corporation which had an equity capital of only £10,000. It is easy in these corporation cases to aim either too high or too low.

hypothesis that he has theretofore transferred a share to each of two other persons so that the coporation now has three stockholders, then the real-party-in-interest status of the now-dominant-but-not-sole stockholder would seem to have disappeared. Obviously, the Court cannot mean that a corporation once dormant for lack of three shareholders cannot later be revived by acquiring the requisite number.

All in all, it would be much better just to forget about this "dormancy" theory of one-man corporations.

One cannot help wondering whether a Pandora's box has now been opened by this "dormancy" rationale, and a mass of potential troubles let loose. Will sole stockholders lose limited liability? Will the federal income tax authorities question, or even reopen, tax solutions which so often involve one-man or two-man corporations? Will the income of the sole stockholder now include that of the corporation, all at individual rates? Can the Court's rationale be circumvented by one real stockholder and two dummies who appear on the books as stockholders but whose stock certificate, blank endorsed, is held by the real stockholder? (If not, are we wisely discouraging one source of venture capital?) In all corporate litigation, must the sole stockholder (or the two if only two) be made a party for being the "real party in interest"? Must he sign the deeds conveying corporate property? (Will the title insurance companies now insist on this, and make investigation into the actual as well as registered holding of shares?) What about past deeds executed by corporations in the "normal" way? (Will title insurance companies and institutional lenders now refuse to approve titles under such past deeds?) Granted that the next General Assembly will react with vigor to the doctrine announced in the *Park Terrace* litigation (which can be predicted with confidence, whatever else the 1957 Legislature may do on the general subject of corporation law revision), what about past transactions of one-man and two-man corporations? Will even the most curative of curative statutes really cure?

The best hope, in addition to legislation, is that the Court will whittle away *Park Terrace* to where there is nothing left of it. If it is willing to close its eyes just a bit, the way is open—the Court itself left it open. The Court said of the corporation in *Park Terrace*: "Not possessing the managerial agencies—stockholders, directors, or officers,—contemplated by statute, it can no longer act as a corporation."<sup>18</sup> Now, even one-man corporations (and *a fortiori* two-man ones) will normally have directors and officers, even if they are only old hold-overs. Accordingly, the Court can well say of the next case that comes along: this case is distinguishable; in the case before us it appears that the corporation had officers and

<sup>18</sup> *Park Terrace v. Phoenix Indemnity Co.*, 243 N. C. 595, 597, 91 S. E. 2d 584, 586 (1956).

director and hence it did not lack the essential managerial agencies during the periods pertinent to the litigation; hence, although some of the language in the *Park Terrace* case taken literally might indicate the contrary, the existence of the corporation now before us has not been effectively impaired.

True, although the opinion does not so indicate, one suspects that the requisite directors and officers existed even in the *Park Terrace* case, and that's why we say the Court may have to close an eye for a bit. This feat should not be difficult for a court which displayed the ingenuity to make the Park Terrace sole stockholder a necessary party plaintiff so as to make the case before.

Of course, if the significance of a judicial decision lies only in what is actually *held*, and not in the announced reasoning that accompanies the holding, there is nothing to get excited about over the *Park Terrace* case. One view of what the court held is this: where the sole stockholder, even though not acting "authorizedly for" the corporation, gives a release on a cause of action which his corporation has against a third party, that release (in the absence of special circumstances) will be a defense even against the corporation itself; and one device by which that defense is made effective is to require the said stockholder to be a party plaintiff in any suit by the corporation to enforce that cause of action. But even if this be the proper theory of the "authority" of judicial decisions under our common law system of *stare decisis*, we must not overlook the fact that the power of the written word in a judicial decision often overshadows the nub of the decision itself.