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THE CLOSE CORPORATION AND THE NEW NORTH CAROLINA BUSINESS CORPORATION ACT

E. R. LATTY*

Capp and Skill have worked out a business idea that has prospects of paying off handsomely. Skill has the essential technical talent for the venture but little capital. Capp has the capital as well as considerable general business experience; he is also in a fairly high income tax bracket. The arrangement that Capp and Skill want between themselves is about as follows: Capp is to put in a designated amount of capital, considerably more than Skill; Skill is to give his full time to the business; Capp is to give substantially his full time, subject to such time as he needs to keep an eye on his other business interests; Capp is to be generally in charge of the routine of office personnel and outside contacts, while Skill similarly is to have jurisdiction over technology and production; no major policy decision is to be taken without their mutual agreement; in particular no salary can be fixed without the concurrence of both; each is to get a designated salary; net profits, over and above their salaries, are to be divided 60% for Capp and 40% for Skill; the arrangement is to last so long as both of them are able properly to perform their respective duties. Also, it is agreed that Capp's son will be employed by them at a designated salary and that Skill will teach Capp Jr. the inside know-how of the technology.

In a partnership, all these reasonable arrangements (as well as further details to round out the picture) can easily be worked out by an agreement of partnership which does not leave Skill to the mercy of dominant control by bigger partner Capp and which does not subject Skill to Capp's power to amend their basic mutual contract by virtue of Capp's majority interest. But Capp and Skill are very anxious to get limited liability; indeed, Capp will not go into the venture without it. The only feasible form of business organization to achieve this goal seems to be the corporation.¹

When they turn to the corporate form of organization, will they find the typical state corporation law well adapted to their arrangement?

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¹ Even in a limited partnership or "Massachusetts trust" the owner-management group will be personally liable except, in the case of the business trust at least, in so far as contract creditors agree to look only to the business assets for payment of their claims. UNIFORM LIMITED PARTNERSHIP ACT § 7; Anno., 156 A. L. R. 22, 165-169 (1945). As for alternatives like the "partnership association" in a few states, see *infra* p. 456.

What they will probably find is a corporation law that was drafted with the publicly held corporation in mind and which, unless they are extremely careful, automatically casts them into a mold wherein the minority shareholder is at the mercy of the dominant shareholder, who as a practical matter can swing both the board of directors and shareholders' action. The typical corporation law seems to prescribe a representative form of government, with administration of the affairs of state vested in a central policy board to be periodically elected (or rejuvenated) by the theoretically democratic process of majority vote, which board in turn must be free to choose the law-prescribed officers and to contract for the services of the executives to whom the active management and executive functions are delegated. In such a corporation, it would be unthinkable to let one shareholder (or worse still, the holder of one share) defeat the wishes of the rest (and, presumably, the best interest of the corporation) with respect even to fundamental changes like amendment of the basic contract, amalgamation, transformation, dissolution, liquidation. Accordingly corporation laws permit even such major changes in the enterprise to be accomplished by majority vote or by some percentage short of unanimity. Also, in such corporations, there is something perhaps to be said (but the point is open to argument) for reducing the shareholder's rights down to the point where about all he has left is a right to cast a ballot for directors, to vote on certain fundamental changes, to inspect certain records and to bring a stockholder's suit for maladministration; hence let the *law* prescribe the scope of management's powers, rather than leave it a matter of contract among the associates.

All this structure of representative government in the typical corporation law is about as appropriate for a two-man get-together as Robert's Rules of Order.

A quick look at a few judicial decisions from different jurisdictions will illustrate the point.

1. Benintendi and Dondero owned all the stock of a hotel corporation, Benintendi having the smaller portion. To give Benintendi a partner-like check on majority shareholder Dondero, they had the corporation adopt three by-laws which required respectively: (1) unanimity for all shareholders' resolutions, (2) unanimity for election of directors and (3) unanimity for all directors' actions. In an action by Benintendi to have the by-laws declared valid and to enjoin their violation it was held that the by-laws were *invalid*.² Unanimity for shareholders' resolutions was held to violate the "statutory scheme of stock corporation management" as exemplified by statutory requirements of a mere two-thirds vote or majority vote for matters like changing the capitalization, disso-

² Benintendi v. Kenton Hotel, 294 N. Y. 112, 60 N. E. 2d 829 (1945). Another by-law, requiring unanimity to amend the by-laws, was upheld.

lution upon deadlock,³ etc. Unanimity for election of directors was held to violate a statute for election of directors by plurality vote. Unanimity for directors' actions was denounced as unworkable. (*Query*: Is it substantially more unworkable in a close corporation than a unanimity agreement among partners? Was the court thinking too much, and unnecessarily, of publicly held corporations?)

2. In *Kaplan v. Block*,⁴ the associate who claimed to be the secretary-treasurer brought an action to compel his readmittance to that office on the ground that his removal therefrom by the directors was in violation of a charter provision that made directors' action binding only if ratified by all the shareholders. He failed; the court held that the charter provision was invalid. Besides pointing out that such a requirement taken literally would enable one of the associates to make away with the corporate assets without redress (an over-argument) and that if the provisions were upheld one shareholder could even prevent the corporation from going out of business (which, if not an over-argument, at least shows that there ought to be an appropriate dissolution provision in the corporation statutes if a minority is going to be given veto power), the court dropped a remark that makes dubious any veto arrangement between owners of an incorporated partnership: "Corporations were invented to circumvent the unity required in partnerships."^{4a} (An observation that shows the need of further legislative and judicial thinking about close corporations.)

3. Three associates want to open a restaurant. They need more capital and approach Nickolopoulos. He says that he will come in for one-fourth of the shares but that he is to have a 50% vote both at shareholders' meetings and at directors' meetings, despite his mere one-fourth ownership. This is agreeable to everybody and they so agree in writing, making it clear that this is what they want regardless of anything to the contrary in the charter. In a suit to declare the validity of the agreement, it was held invalid, because such a side agreement on the voting rights of shareholders was not according to the scheme of things in the corporation statutes, which contemplate that the charter or by-laws is the place for voting rights provisions; further, said the court, this secret arrangement might fool and hurt outsiders.⁵ (But this was a fight among the

³ The court could very well have adopted a different approach, *viz.*, that there are certain transactions for which the Legislature intended a bare majority to have power to act, as for example dissolution for deadlock (where there is a special reason for so construing the dissolution statute), leaving other matters to be fixed as the parties may desire, and that a judicial declaration of validity or invalidity of the unanimity by-law would have to turn on a consideration of the *specific act* of by-law violation.

⁴ 183 Va. 327, 31 S. E. 2d 893 (1944).

^{4a} *Id.* at 335, 31 S. E. 2d at 896 (1944).

⁵ *Nicholopoulos v. Sarantis*, 102 N. J. Eq. 585, 141 Atl. 722 (Ct. of Err. and App. 1928).

insiders; there was no occasion to determine the arrangement's effectiveness by considering its validity or invalidity as to *outsiders*.⁶)

In each of the three above cases, the arrangement between the parties was a perfectly reasonable one from a business point of view. Furthermore, it is submitted, they had a perfectly legitimate objective: through the corporate form to have essentially a partnership with limited liability. Why shouldn't they be allowed to get the benefits of a corporation and yet stick to partner-like arrangements among themselves? If one wants to make the point that limited liability should be granted only to attract capital from the public, and has no business in a close corporation, that is another matter. But there's no point in granting limited liability to a close corporation and yet require it to adopt the mechanisms of representative government. Just whom do you protect by holding that to get limited liability the two associates must conform their set-up to one more appropriate for General Motors? Not creditors, for the trappings of representative government do not perform the function of creditor protection. (Creditor protection lies in the rules about dividend restrictions, capital impairment, watered stock, etc., none of which protective features would be endangered by the quasi-partnership arrangements above illustrated.) Not the "outside world" dealing with the corporation, since they are protected by doctrines of apparent authority not effected by secret arrangements between the shareholders. Not the State who, be it conceded, as an interest in the success of business enterprises; one must not overlook that these associates whose pocket-books are most directly concerned are fully as interested in their own success as the State is. All you achieve by invalidating their incorporated-partnership arrangement is to enable the senior partner (or a combination of the majority-shares partners) to welch on the agreement and to replace the theoretical democratic ideal of representative government by a dictatorship of the 51 per cent shareholder. Absent a valid arrangement to the contrary, the "senior partner" in an incorporated partnership is in position to elect his own board and that board in turn is free (within the elastic limits of fiduciary duties) to choose the working personnel, fix the salaries, determine dividend policy, issue additional shares and fix the issue price thereof and, in general, substantively to affect the interests of the junior associate or associates. In a nutshell, Family A with 51% ownership of a close corporation can live in luxury off a profitable business while Family B starves with 49%.

⁶ Compare the sounder approach in *Kantzler v. Benzinger*, 214 Ill. 589, 73 N. E. 874 (1905), upholding an agreement among *all* the shareholders that the plaintiffs should have the offices of president, secretary and treasurer for five years at a specified salary and should have certain controls as officers, wherein the court met the argument about invalidity as against outsiders by saying: "It will be time enough to consider the rights of subsequent stockholders and creditors of the corporation when they are before us complaining." *Id.* at 600, 73 N. E. at 878.

True, under the corporation law of almost any state a protective veto arrangement freezing the status quo can be worked out in a 2-man corporation as follows: have the charter classify the stock into two classes, each class regardless of size to elect one-half of the directors and to vote by class on all matters submitted to shareholders' vote; have the by-laws require a majority of the full board of directors for a quorum; then be sure not to attend a meeting of directors unless the full number of directors elected by your class of shares are to be there. (Perhaps the statutes or decisions of a particular state reveal that other possible vetoes can be worked out, *e.g.*, high vote requirements for shareholders' and directors' action, etc.)⁷ Yet a mere freeze of the status quo may not be what the partners want; at the beginning of their venture, while all is yet harmony, they may want to agree on positive action, such as disbursement of a designated percentage of net profits unless periodically waived. But the moment they venture into the area of making such positive managerial decisions by pre-arrangement (or, indeed even in making veto arrangements merely by agreement and not left-handedly by classification of shares and quorum-blocking by-laws) they are skating on thin ice.⁸ They never know when a court is going to say: "Our statutes contemplate that the affairs of a corporation shall be managed by a board of directors and you have no business invading their jurisdiction." True, in some states you can cut into the directors' managerial province a bit if you don't go too far⁹—if you don't go so far as to create a "sterilized board of directors."¹⁰ So, it is always safer to specify certain matters as to which the rights of the parties are as provided by agreement rather than to rely on a sweeping "sterilization" of the board by requiring (whether by charter, by-law or otherwise) unanimous board action for *all* matters or that *all* board actions must be approved by *all* of the shareholders.¹¹ Even so, you can't be sure; in one case even as specific a matter, in a unanimous agreement among the shareholders, as the continued employment of the plaintiff shareholder as treasurer at a speci-

⁷ *Query*: would the numerically smaller class be able to block action by the numerically bigger class of shares under a statute like the present N. C. GEN. STAT. § 55-165 relating to mergers, which permits a merger upon vote of "a majority of the outstanding shares entitled to vote"? Arguably, that means to throw all outstanding shares into one class for *this* voting purpose, regardless of what the charter says. (Although this writer believes otherwise.) At any rate, a veto power on the board of directors (say, by giving each of two classes of shares the right to elect one half of the directors) would apparently enable one class to block a merger under present N. C. GEN. STAT. § 55-165.

⁸ See O'Neal, *Giving Shareholders Power to Veto Corporate Decisions: Use of Special Charter and By-law Provisions*, 18 LAW & CONT. PROB. 451 (1953).

⁹ *Clark v. Dodge*, 269 N. Y. 199 N. E. 641 (1936).

¹⁰ *Manson v. Curtis*, 223 N. Y. 313, 119 N. E. 559 (1918); *McQuade v. Stoneham*, 263 N. Y. 323, 189 N. E. 234 (1934); *Kaplan v. Block*, 183 Va. 327, 31 S. E. 2d 893 (1944).

¹¹ Compare the cases cited *supra* notes 2, 9, 10.

fied salary per year was held invalid;¹² in another case, a unanimous agreement among the shareholders that one of them was to be general manager removable only by unanimous consent was held invalid.¹³

It is submitted that there is little force in the argument, popularized by the oft-cited New Jersey case of *Jackson v. Hooper*,¹⁴ that the associates (two, in that case) in an incorporated partnership forego all the rights, duties and obligations of partners when they form a corporation and become its shareholders and "cannot be partners inter sese and a corporation to the rest of the world."¹⁵ There is a certain verbal plausibility and superficial attractiveness in such a pronouncement, but nothing more.^{15a} Indeed, that philosophy is apparently now rejected even in the home state of *Jackson v. Hooper*.¹⁶ Further, insofar as the *Benintendi*¹⁷ case in New York may have reflected such philosophy, the Legislature promptly responded with a statute that legalized the very kind of unanimity requirement, for shareholders' votes and directors' action, which the New York court had invalidated.¹⁸

¹² *McQuade v. Stoneham*, 263 N. Y. 323, 189 N. E. 234 (1934). Except for the fact that the agreed employment of the shareholder in question was perhaps unlawful by statute because of his position as a city magistrate, the case is not easy to reconcile with the same court's decision a few years later in *Clark v. Dodge*, 269 N. Y. 410, 199 N. E. 641 (1936), *supra* note 9.

¹³ *People v. Pyle*, 235 Ill. App. 532 (1924). Cf. *Fitzgerald v. Christy*, 242 Ill. App. 343 (1926), granting temporary injunction against breach of an agreement among all the shareholders which gave the complaining shareholder a veto power over changes in officers or salaries and over any proposal to declare dividends or to incur expenses.

¹⁴ 76 N. J. Eq. 592, 75 Atl. 568 (1910).

¹⁵ *Id.* at 598, 75 Atl. at 571. As a result, despite the equal ownership of the corporation between *A* and *B* and their agreement for equal control and their conduct of the corporate business for years without regard to corporate forms virtually as partners, *A* was squeezed out of control when the dummy directors (into whose names *A* and *B* had put a few shares to qualify them as directors, with the understanding that the dummies were to vote as directly by *A* and *B* jointly) sided with *B*; the court would not grant *A* a dissolution for his wrongful exclusion from joint control and participation in the business as co-owner—a remedy that would be entirely appropriate in a partnership situation.

^{15a} For a more realistic view; see the healthy attitude of the court in *De Boy v. Harris*, 207 Md. 212, 113 A. 2d 903 (1955) and cases there cited. The case is noted in 69 HARV. L. REV. 565 (1956).

¹⁶ See *Katcher v. Ohsman*, 26 N. J. Super. 28, 97 A. 2d 180 (1953), where in effect a requirement of unanimous consent by all of the three owners of the close corporation for any binding act of the corporation was upheld as against the majority's attempt to increase their salaries and exclude the minority shareholder from management. The court stated that there is no public policy which requires close corporations to stick to the "statutory scheme of majority control" that is obligatory as to public issue corporations. But for the continuation of the old attitude in New York see *Manacher v. Central Coal Co.*, 284 App. Div. 380, 131 N. Y. S. 2d 671 (1st Dept. 1954) *aff'd* in a memorandum decision, 308 N. Y. 784, 125 N. E. 2d 431 (1955).

¹⁷ See *supra* note 2 and text thereto.

¹⁸ N. Y. STOCK CORP. LAW, § 9. This statute does not expressly mention unanimity; it authorizes charter provisions prescribing a greater number than a majority to effectuate corporate action. Presumably, a unanimity requirement is valid. Also, the greater-than-majority provision must be in the charter. The court's invalidation of the *Benintendi* by-laws had been based upon reasoning equally applicable to charter provisions.

THE BASIC PHILOSOPHY OF THE NEW CORPORATION LAW WITH
RESPECT TO CLOSE CORPORATIONS

North Carolina's prospective Business Corporation Act, enacted May 26, 1955 but not to become effective until July 1, 1957¹⁹ (hereafter referred to as the New Business Corporation Act or the new Act)²⁰ rejects the philosophy, exemplified by the New Jersey case of *Jackson v. Hooper*,²¹ that there is something reprehensible about adopting a corporate form for an incorporated partnership and yet retaining a quasi-partner relationship among the co-owners of the close corporation. This rejection not only appears here and there in various sections but, perhaps even more significantly, is reflected in what may be called the basic philosophy provision relating to close corporations that are virtually incorporated partnerships, *viz.*, section 55-73(b) of the new Business Corporation Act, which is as follows:

"Except in cases where the shares of the corporation are at the time or subsequently become generally traded in the markets maintained by securities dealers or brokers, no written agreement to which all of the shareholders have actually assented, whether embodied in the charter or bylaws or in any side agreement in writing and signed by all the parties thereto, and which relates to any phase of the affairs of the corporation, whether to the management of its business or division of its profits or otherwise, shall be invalid as between the parties thereto, on the ground that it is an attempt by the parties thereto to treat the corporation as if it were a partnership or to arrange their relationships in a manner that would be appropriate only between partners. . . . A transferee of shares covered by such agreement who acquires them with knowledge thereof is bound by its provisions."

It was believed, in the drafting of the New Business Corporation Act, that in addition to the flexibility in specific matters permitted by other sections (later discussed herein), it was advisable to set a friendly tone for incorporated partnership arrangements, inasmuch as in situations not anticipated in the drafting, the judicial decision in often largely determined by the court's basic tolerance or intolerance toward partner-like arrangements between the co-owners of the incorporated business.

It will be noted that the quoted provision takes as its standard of the close corporation (although that term is not used and no attempt was

¹⁹ N. C. Sess. Laws 1955, C. 1371; N. C. GEN. STAT. § 55-1 to 55-175, incl. (Vol. 2B, 1955 Cum. Supp. pp. 40-126).

²⁰ The law now in effect as to ordinary business corporations is N. C. GEN. STAT. §§ 55-1 to 55-183, incl., and will be referred to hereafter as the "present corporation law."

²¹ *Supra* note 15. Cf. the attitude of the Maryland court in the *De Boy* case, *supra* note 15a.

made to define such a concept) the absence of trading in its shares in the securities markets. A significant characteristic of the close corporation is that its shares are not the subject of general trading; this factor is more significant than, say, its size (the Ford Motor Company was until recently a close corporation despite its size) or the number of its shareholders (although if they become numerous, trading in the over-the-counter markets will inevitably follow). Someone may object to the lack of certainty in the phrase about the shares being "generally traded" in the markets; it is believed that the problem is largely academic, particularly in view of the fact that in the numerous litigated cases in which the co-owners of a business have made partner-like arrangement the "generally traded" test would have given no trouble. Furthermore, the partners have it within their power to forestall general trading in the shares by transfer restrictions. (See discussion *infra*.)

Perhaps the most important aspect of the above quoted provision is that it is phrased in the negative and that, accordingly, flexibility in judicial treatment is preserved. That is to say, the basic approach is: no arrangement set out in the charter and by-laws agreed to by all the co-owners or set out in a writing signed by all of them is invalid *just because* it is a partner-like arrangement. A court may pronounce it bad for other reasons, although presumably it would have to be something pretty serious since it was agreed to by everyone. Conversely, the provision does not limit validation of arrangements to those that meet the language of this statutory provision. So, unless the court goes out of its way to read in a negative implication the court might still validate, at least as against certain parties, a side agreement that has *not* been signed by all, or that is *not* in writing, etc., as the circumstances of the case may appear to the court to require. What the provision was meant to do was to suggest to the counsellor a legal framework within which partner-like arrangements having a reasonable business purpose could be worked out with a substantial assurance of legal validity.²² Finally, it was hoped that section 55-73(b) would be the safety valve for close corporations in case other sections of the Act should seem to indicate, as is almost inevitable in corporate statutes, that they were drafted with the publicly held corporation primarily in mind and consequently in terms not happily chosen for application to close corporations.

²² It may not be an irrelevant digression at this point to suggest that in the typical two-man, three-man (and other few-men) arrangements for an incorporated partnership, each party should be represented by *his* attorney in negotiating and drafting the terms of the agreement. No matter how harmonious everything is in the early honeymoon stage, it must not be overlooked that the interests of the parties are diverse at many points and that each requires, before the arrangement is finally cleared, a full consideration and clarification of his interests in anticipation of future events.

SPECIFIC PROVISIONS WITH AN EYE TO CLOSE CORPORATIONS

It might be urged that the drafting of the new Business Corporation Act could have rested with the above discussed section 55-73(b) as the basis for judicial acceptance of any reasonable arrangement in a close corporation, however out of line that arrangement may be with the traditional forms, structures and mechanisms of publicly held corporations. It was feared, however, that uncertainty might arise out of a potential conflict between the generality of that provision and such other sections on specific matters as might seem to prescribe the rigors of representative form of government, including the inviolability of majority rule and of the sphere of directors' management. Further assurance was believed advisable, as appears in provisions about to be discussed.

Director's Management of Corporate Affairs

Unlike the present corporation law²³ and that of New York,²⁴ New Jersey²⁵ and others which provide simply that "the business of every corporation shall be managed by its directors," the New Business Corporation Act provides in section 55-24(a) :

"Subject to the provisions of the charter, the by-laws or agreement between the shareholders otherwise lawful, the business and affairs of a corporation shall be managed by a board of directors."
(Emphasis added.)

The italicized words were deliberately added to make it clear that, particularly (but not solely) in close corporations, there is no such thing as an inviolate sphere of directors' jurisdiction into which no arrangement can infringe. Under a statute without the italicized words, some New York decisions indicate that an arrangement for a specific dividend program is invalid, on the ground that decision about dividends is directors' business.²⁶ (Query whether under this view a charter clause requiring a certain percentage of the net profits to be paid out in dividends might be invalid; yet if that is the arrangement that the associates want, why not let them have it?²⁷) In the same vein, an agreement among all the shareholders of a close theatre corporation, to which the corporation itself was also a party, that provided for the management of the corporation's theatres by one of the parties to the agreement for a period of nineteen years was held invalid as too deep an invasion of directors' power and amounted to a violation of the above mentioned New York

²³ Present N. C. GEN. STAT. § 55-48.

²⁴ N. Y. GEN. CORP. LAW § 27.

²⁵ N. J. GEN. CORP. LAW § 14:7-1.

²⁶ See *Lindgrove v. Schluter & Co.*, 256 N. Y. 439, 176 N. E. 832 (1931); cf., *Dejonge v. Zentgraf*, 181 App. Div. 43, 169 N. Y. S. 377 (2d Dept. 1918).

²⁷ See *Wabash Ry. Co. v. American Refrigerator Transit Co.*, 7 F. 2d 335 (8th Cir. 1925).

statute:²⁸ (Again one asks: if that was what the parties contracted for, why not hold them to it? Particularly since the same end could presumably have been achieved by a long-term lease.) For similar reasons, another New York decision held invalid a contract which contained a provision that the management of the corporation should be in the holder of the Class B stock and that holders of Class A stock should not interfere in management either as individuals, stockholders or directors.²⁹ Yet even in that state, as in most others, a charter can make Class A shares non-voting and Class B shares voting, whereupon the one man or few men who hold Class B quite obviously are in position to manage without effective interference from Class A even if some Class A holders are put on the board. All that a "directors must manage" type of statute does is to put a premium on evasive techniques for close corporations.

Although the provision of the new Business Corporation Act under discussion is not limited to close corporations, two observations may be made: (1) it is unlikely that publicly held corporations ever feel a strong business need for departing from the usual directors' management set-up; (2) if a publicly held corporation should attempt to use an unorthodox management set-up which does or might operate to the detriment of shareholders, in violation of traditional ideas we have about majority rule and representative form of government for such corporations, the arrangement could be held invalid by a court. After all, the provision under discussion does not say that every provision about management of corporate affairs in charters, by-laws or side agreements *shall be* valid; furthermore, let us not overlook the term "otherwise lawful" in the new provision, which (a court could say) was apparently meant to afford just such a safety valve.

The One-man Corporation

In a 1955 decision of the North Carolina Supreme Court Judge Barnhill dropped a remark which cast a bit of a cloud upon that rather common variety of the close corporation, viz, the one-man corporation. His remark was: "Query: since McLean has acquired all of the stock of the plaintiff, is it now a corporation?"³⁰ The remark was dropped quite *obiter*, at the very end of the opinion. When the opinion came out, the General Statutes Commission was putting the finishing touches to the new Business Corporation Act which had been introduced at the 1955 session of the General Assembly. In view of the fact that one-man and the two-man corporations have become a common phenomenon of the

²⁸ Long Park v. Trenton-New Brunswick Theatres Co., 297 N. Y. 174, 77 N. E. 2d 633 (1948). The case arose out of an action for a declaratory judgment to determine the validity of the agreement.

²⁹ Abbey v. Meyerson, 274 App. Div. 389, 83 N. Y. S. 2d 503 (2d Dept. 1948).

³⁰ Park Terrace Inc. v. Phoenix Indemnity Co., 241 N. C. 473, 478, 85 S. E. 2d 677, 580 (1955).

twentieth century business world,³¹ the Commission and the drafting committee did not take the remark too seriously. They did not, however, disregard it entirely. Accordingly, there was incorporated in the new Act a sentence in new Section 55-8 that "Corporate existence is not impaired by the acquisition of all the shares by one person." To make the point doubly sure, with specific respect to limited liability, new Section 55-53(e) makes it clear that a shareholder's otherwise limited liability is not lost "even if all the shares are owned by one person." It was believed that this statutory language, coupled with the dispensation (again with one-man and two-man corporations primarily in mind) in the new Act of any requirement that the directors be shareholders³² was sufficient to meet the seemingly mild threat in the *Park Terrace* case.

On a rehearing of the *Park Terrace* case, however, the North Carolina Supreme Court in 1956 expanded its 1955 dictum into a considered rationale which has caused considerable consternation in close corporation circles in North Carolina. From the present statutory provisions prescribing three or more incorporators, requiring three or more directors and two or more officers and authorizing meetings to be called by three shareholders and dissolution to be effected by a majority of the shares, the court drew the conclusion that the legislative scheme does not contemplate a one-man corporation and that when one person acquires all the shares the corporation becomes "dormant" and "can no longer act as a corporation."³³ This is not the place for an extended critique of the court's rationale;³⁴ however, it should be noted that (1) since the rationale is equally applicable under the statutes of nearly all other states, if valid it would throw a serious monkey wrench into machinery long accepted throughout the country, (2) the rationale would, if logically

³¹ In a recent interview between the writer and a practicing attorney in Durham, N. C., who represents some 150 corporate clients, the attorney stated that about 25 of these are one-man corporations and that another 30% are two-man corporations; he also stated that in his opinion his experience with these proportions is fairly typical of that of other attorneys in North Carolina. Sometimes a few shares are spread around the family "just for looks," but the real beneficial interest is still in one man or two men.

One can hardly pick up the advance sheets of judicial decisions around the country without seeing the one-man and two-man corporation in the picture. As these lines are being written, for example, the federal advance sheets alone on the desk show one-man (including wholly owned subsidiaries) or two-man corporations in: *Hoss v. Purington*, 229 F. 2d 104 (9th Cir. 1956); *American Trans-Ocean N. Corp. v. Commissioner of Internal Revenue*, 229 F. 2d 97 (2d Cir. 1956); *Lidgerwood Mfg. Co. v. Commissioner of Internal Revenue*, 229 F. 2d 241 (2d Cir. 1956); *R. F. C. v. Unted Distillers Products Corp.*, 229 F. 2d 665 (2d Cir. 1956); *Love v. Irwin*, 228 F. 2d 501 (5th Cir. 1956); *Insurance Co. of North America v. Putney*, 136 F. Supp. 894 (E. D. Va. 1955); *Fayes, Inc. v. Kline*, 136 F. Supp. 871 (S. D. N. Y. 1955) and others.

³² New Section 55-24(c).

³³ *Park Terrace v. Phoenix Indemnity Co.*, 243 N. C. 595, 597, 91 S. E. 2d 584, 586 (1956).

³⁴ For discussion of the case see comments in this issue, pp. 471 and 531.

pursued, throw doubts on even the 2-man corporation,³⁵ (3) all you achieve by this rationale is to induce resort to dummy nominee holders of one or two shares, (4) the rationale, in those rare instances in which it has been used in this century³⁶ (mostly in Kentucky)³⁷ has been pure dictum or at least a clumsy device for reaching a decision amply supportable on other grounds;³⁸ and (5) even more disconcerting than application of the rationale to future transactions (avoidable by proper planning) is the retroactive effect of the rationale. Suffice it to say that the attitude which the court has displayed will now make it necessary to incorporate clearer and stronger provisions in the new Act, including those of a curative nature with respect to corporate activities of one-man and two-man corporations which have occurred before the new Act goes into effect, so as to assure the legitimacy of such corporations, old and new, and of their otherwise valid activities. Efforts along that line are now under way.

Perhaps these efforts should even include reexamining the propriety of the new Act's requirement of three or more persons to form³⁹ a corporation, as well as of three or more directors.⁴⁰ There is actually no good reason for these requirements,⁴¹ and they represent no conscious

³⁵ Indeed, the Court said in the *Park Terrace* rehearing, *supra* note 33:

"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."

243 N. C. at 597, 91 S. E. 2d at 586.

³⁶ In general, one has to go back to the 1890's and 80's (or earlier) to find suggestions that corporate existence is "suspended" or is "in abeyance" upon acquisition of all of the shares of one person. See *First Nat. Bank v. Winchester*, 119 Ala. 168, 24 So. 351 (1898); *Louisville Banking Co. v. Eisenman*, 94 Ky. 83, 21 S. W. 531 (1893); *Geo. T. Staggs Co. v. Taylor*, 95 Ky. 651, 27 S. W. 247 (1894); *Swift v. Smith*, 65 Md. 428, 5 Atl. 534 (1886). Cf. *Newton Mfg. Co. v. White*, 42 Ga. 148 (1871); *Russell v. McClellan*, 14 Pick. 63 (Mass. 1833). See also *Montgomery v. Forbes*, 148 Mass. 249 19 N. E. 342 (1889). See next footnote for twentieth century Kentucky cases.

³⁷ *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).

³⁸ Thus, in the *Russell* case, *supra*, note 37, where the sole shareholder allowed another concern to use the corporate name and led the plaintiff to believe that notes executed in that name were authorized notes of the corporation, the corporation was, justly enough, held liable on those notes. For a court to resort to "merging the identity" of the shareholder and the corporation because of "suspended animation" (the court's language) serves only to befuddle the law. In the *Hawley* case, *supra*, note 37, despite the Court's repetition of the "suspension" formula, what was actually held was that the corporation's properties could not be seized to satisfy the debts of the sole shareholder.

³⁹ New Section 55-6.

⁴⁰ New Section 55-25(a).

⁴¹ Compare the answer of Mr. Paul Carrington, one of the draftsmen of the new Texas Business Corporation Act, when asked this question in the panel discussion on corporation law at the Legal Institute held at the University of Arkansas School of Law, September 29-October 1, 1955: "Why didn't Texas permit one man to incorporate like Wisconsin?" Mr. Carrington's answer:

"We debated it and personally I would say that from the standpoint of corporate law I don't see any real objection why we could not permit it. We

policy against one-man or two-man corporations. There was discussion in the General Statutes Commission about permitting a corporation to be formed by one person (or more) and to have less than three directors but it was felt that (1) while we have all come to accept one-man ownership of the shares some persons (including some in the Legislature!) might shake their heads out of sheer tradition over actually forming a corporation with just one man signing all the papers; (2) no real difficulty seems to be encountered in getting persons to act as incorporators or directors and (3) other safeguards exist for not letting the dummy directors run wild. Thus, one such safeguard was worked out by a new provision which permits the majority shareholders (unless the charter or by-laws otherwise provide) to remove the entire board or any individual director, with or without cause.⁴² So, if the sole shareholder has put in himself, his wife and son-in-law as directors, he is fairly protected against the possibility that the wife and son-in-law will gang up on him and have a field day at his expense until the next annual meeting. (Ordinarily majority shareholders have to take such removal action at a *meeting* but there again the new Business Corporation Act, anticipating the concentration of shareholdings, provides that shareholders' action ordinarily required to be taken at a meeting can be taken by simply filing with the secretary of the corporation a writing signed by all the shareholders setting forth the shareholders' action.⁴³ Presumably all the the sole shareholder need do is to sign and deliver a written statement to the Secretary to the effect that "*A and B are hereby removed as directors.*" Or, if he *is* the Secretary, presumably he need merely inform the interested parties of his action.)

Permission of High Vote and High Quorum Requirements; Herein of Unanimity.

Among the devices which have been used in incorporated partnerships to avoid the unsuitability of plain majority rule are charter or by-law provisions requiring more than a majority of directors or shares to be present to form a quorum for a valid meeting or requiring more than a bare majority to take action at a meeting—even to the point of requiring unanimity.⁴⁴ Under the corporation statutes of many states, drafted

decided that it was an innovation that had not been tested, that the general historical idea of having at least three people was pretty well embedded in everyone's minds. We raised the question at institutes and found most everybody willing to go along with the minimum of three incorporators and a minimum of three directors."

Panel on Arkansas Corporation Law, 10 ARK. L. REV. 46, 47 (1956).

⁴² New Section 55-27(f).

⁴³ New Section 55-63(c).

⁴⁴ See in general O'Neal, *Giving Shareholders Power to Veto Corporate Decisions: Use of Special Charter and By-Law Provisions*, 18 LAW AND CONT. PROB. 451 (1953).

with an eye to publicly held corporations, these requirements have sometimes been upset by courts who saw, or professed to see, in the statutes in question a policy against such requirements. The unanimity requirements in particular have had rough sledding.⁴⁵ True, one finds in corporation laws generally a provision to the effect that the charter may contain, in addition to prescribed items, any provision for the regulation of the affairs and the conduct of the business of the corporation;⁴⁶ but that provision cannot be relied upon to validate the challenged high-majority or unanimity requirements.⁴⁷ Presumably, a similar statute seemingly giving wide scope for insertion of any desired provisions in *by-laws* would be no more effective. Conceivably, in the cases where unanimity requirements were invalidated, the junior associate holding, say, 40% of the voting shares, might have fared better, at least so far as a veto power over shareholders' action is concerned, under a provision, in charter or by-laws, requiring a 65% vote to take shareholders' action. But one cannot be sure.⁴⁸ Likewise, the junior might have succeeded in achieving veto power over directors' action by an arrangement (perhaps by cumulative voting or by division of shares into classes with the right of each class to elect directors) whereby he would have, say, two men on a five-man board under a charter or by-law requiring board action to be taken by four directors out of the five-man board. One finds no cases that actually invalidate a high-voting requirement for directors although the language in some of the cases adverse to *unanimity* requirements in charters or by-laws suggests that the court might not have taken kindly even to a mere high-vote requirement, wholly aside from the fact that some statutes might be viewed as forbidding requirements that set a higher vote than that prescribed by statute.⁴⁹

The new Business Corporation Act, not content with the broad quasi-partnership tolerance expressed in new Sec. 55-73(b) previously discussed (and which per se might support a unanimity requirement in a close corporation), would provide with respect to directors' action, that a majority can act "unless the act of a greater number is required by the

⁴⁵ See cases *supra* notes 2, 4, 14.

⁴⁶ *E.g.*, the present N. C. GEN. STAT. § 55-2.

⁴⁷ The corporation statutes of Virginia have long contained such a provision (very much like North Carolina's present G. S. § 55-2) but nevertheless the unanimity requirement was stricken down, without even mentioning this statutory provision, in *Kaplan v. Block*, 183 Va. 327, 31 S. E. 2d 893 (1944).

⁴⁸ In *Eisenstadt Bros. v. Eisenstadt*, 89 N. Y. S. 2d 12 (Sup. Ct., Spec. T., Queens Co. 1949), where each of the three shareholders held one-third of the shares, the court nvalidated a by-law requiring a 90% vote for shareholders' action, saying that such a by-law is just as objectionable as the one requiring 100% in the *Benintendi* case, *supra* n. 2. But cf. *Kronenberg v. Sullivan County Steam Laundry Co.*, 91 N. Y. S. 2d 144 (Sup. Ct. Sullivan Co., 1949).

⁴⁹ For example, it is by no means clear that the statutory requirements for directors' action or shareholders' action under present N. C. G. S. 55-165 for consolidation or merger could be increased by charter or by-law provisions. See *supra* note 7.

charter or the by-laws."⁵⁰ It is not believed that a court would construe this to mean that the greater number must still be less than the full board. Similarly with respect to shareholder action the new Act would permit the *charter* to require (except in situations where the new Act expressly makes this statutory provision inapplicable) the "concurrence of a greater proportion of the votes" than otherwise would be required.⁵¹ One doubts that a court would see in this a prohibition against a unanimity requirement, particularly in light of the quasi-partnership provision, new Section 55-73(b), previously discussed. Likewise with respect to *quorum* requirements, the new Act would permit the charter or the by-laws to require "a greater number" than the majority of the directors,⁵² and as to shareholders' meetings, a majority of the voting shares would constitute a quorum "unless otherwise provided in this chapter or in the charter or in the by-laws."⁵³ With the latter provision compare the present law, which apparently forbids the by-laws to require more than a majority of the shares for a quorum.⁵⁴ As a practical matter, it is preferable to resort to a high vote requirement than to a high-quorum.⁵⁵

High vote requirements for shareholders and directors may need to be buttressed by appropriate charter or by-law provisions that protect against increases in the number of shares or of directors that would circumvent the high vote requirement. The new Act lends itself readily to such protective provisions by its express recognition of the validity of restrictions that in turn require a high vote to amend the charter⁵⁶ or the by-laws;⁵⁷ it also affords a mechanism for filling vacancies on the board, from death or other causes, by those interests in the corporation who were represented by the erstwhile director.⁵⁸ The issuance of shares for property or services without pre-emptive rights can be forbidden or qualified by appropriate charter provisions.^{58a} Further buttressing all this stands Section 55-73(b), previously discussed, relating to quasi-partnership arrangements in close corporations.

It may be asked: is it wise to permit high quorum or voting require-

⁵⁰ New Section 55-28(d).

⁵¹ New Section 55-66(b).

⁵² New Section 55-28(d).

⁵³ New Section 55-65(a).

⁵⁴ N. C. GEN. STAT. § 55-27. Query: would the court see in this section of the present law a policy against a high quorum requirement set forth in the *charter*?

⁵⁵ See O'Neal, *Giving Shareholders Power to Veto Corporate Decisions: Use of Special Charter and By-Law Provisions*, 18 LAW & CONT. PROB. 451, 464 (1953).

⁵⁶ New Section 55-100(b) (3) states that the charter may require more than the usual majority vote "either for all amendments or for a specific amendment."

⁵⁷ New Section 55-16(b) permits charter or by-law provisions that require more than the usual majorities (or directors or shareholders, as the case may be) for amending the by-laws.

⁵⁸ New Section 55-27 not only permits the charter or the by-laws to prescribe the filling of vacancies but also contemplates, in subsection (d), that vacancies of directors elected by a particular class shall be filled by the remaining directors elected by that class. Subsection (f) carries on with this idea by preventing one class of shareholders from removing directors elected by another class.

^{58a} New Section 55-56(c).

ments for corporations without specifically limiting that device to close corporations? In publicly held corporations these devices, if available, might be used to perpetuate the management or otherwise defeat the will of the majority shareholders. The new Business Corporation Act does not expressly restrict the use of high vote and high quorum to close corporations; to have worked out a set of distinctions and restrictions appropriate to those distinctions would have been a hazardous task of drafting. Accordingly, the language used *appears* to be applicable to all corporations,⁵⁹ but this was done in the belief that (1) publicly held corporations typically do not resort to high vote or high quorum provisions and (2) if a publicly held corporation should adopt such a provision that violates traditional ideas of what is appropriate for such corporations, our courts would go behind the literal language of the Act and find reasons for not giving effect to the charter or by-law provision in question under the special circumstances of the case before the court.

Deadlock and Dissolution

One of the safety valves in a partnership is that when things get to an impasse, a partner can always bring about a dissolution; even if the partnership term has not expired, application for dissolution may be made to a court "when a partner so conducts himself in matters relating to the partnership business that it is not reasonably practicable to carry on the business in partnership with him,"⁶⁰ or even when "other circumstances render a dissolution equitable."⁶¹ If worse comes to worse, a partner even has the *power* wrongfully to dissolve if he wishes to take the chance of paying damages for his breach of the partnership contract and, under the Uniform Partnership Act, of being bought off by the aggrieved partner at an amount found by the court to be the fair value of his interest, minus the damages caused by his wrongful dissolution.⁶² In a partnership, then, even the junior partner has it within his power to cut the Gordian knot of friction, dissension, suspicion and deadlock.

It would be a serious matter to give to associates in close corporations a partner-like veto through statutory tolerance of unanimity requirements, high vote and high quorum requirements and other partner-like co-control features and yet, despite the deadlocks thereby arising, to pro-

⁵⁹ As in the Model Business Corporation Act prepared by the Committee on Corporate Laws of the American Bar Association. See American Law Institute, Model Business Corporation Act (revised 1953) § 30 (quorum of shareholders), § 136 (vote of shareholders), § 37 (quorum of directors).

⁶⁰ UNIFORM PARTNERSHIP ACT, § 32(1) (d). Strife, mutual lack of confidence and constant friction over not only serious matters but even minor matters which in the aggregate make co-operation impossible would seem to make partnership dissolution available. See *Owen v. Cohen*, 19 Cal. 2d 147, 119 P. 2d 713 (1941); *Ferrick v. Barry*, 320 Mass. 217, 68 N. E. 2d 690 (1946).

⁶¹ UNIFORM PARTNERSHIP ACT, § 32(1) (f).

⁶² UNIFORM PARTNERSHIP ACT, § 38(2) (b). See *Vangel v. Vangel*, 116 Cal. App. 2d 615, 254 P. 2d 919 (1953).

vide no "out," by dissolution or otherwise. Here again, traditionally state corporation laws, drafted with the publicly held corporation in mind, have until relatively recent years overlooked the close corporation's dissolution problem. In the publicly held corporation, there is no problem of friction leading to deadlock; even with cumulative voting, a majority of the directors are elected periodically by majority vote of the shares voting, and if a particular director turns out to be a friction maker, he is simply dropped from the slate for reelection—and that's that unless he wants to start a proxy fight. Small wonder, then, that many state corporation laws in their dissolution provisions have gone no further than to set forth a procedure of "voluntary" dissolution (usually, by directors' recommendation of dissolution followed by shareholders' majority vote⁶³ or procedures of "involuntary" dissolution for insolvency or abuse of corporate powers, occasionally with power in a prescribed percentage of the shares to apply for a dissolution for some degree or other of unprofitableness and non-payment of dividends.⁶⁴ Under such a statutory scheme, the traditional view perhaps is that a court (perhaps even when faced with an incorporated partnership which presents that friction, strife and deadlock which would justify a partnership dissolution) lacks power to decree a dissolution except upon statutory grounds.⁶⁵ True, this view is losing ground,⁶⁶ and some courts have granted dissolution for deadlock without aid of statute.⁶⁷ State statutes have increasingly tended to include deadlock as one of the grounds of dissolution, although, as one writer points out, some courts have even under those statutes tended towards conservative interpretation and to view corporate existence as a "sacred cow" to which homage must be rendered.⁶⁸

The new Business Corporation Act does not view corporate existence as a sacred cow—at least it does not so view its going-concern operation. Besides enacting a catch-all provision to the effect that the superior court has power to liquidate the assets and business of a corporation when liquidation "is reasonably necessary for the protection of the rights or

⁶³ See present N. C. GEN. STAT. § 55-121.

⁶⁴ See present N. C. GEN. STAT. § 55-125.

⁶⁵ See Note, 28 N. C. L. REV. 313, 315-6 (1950) pointing out that although there are no North Carolina holdings on the question, there is a lone statement in a dissenting opinion, in keeping with the old tradition, that "in the absence of statutory provision to the contrary, only the State which created the corporation can sue to dissolve it." Clarkson J., in *Kistler v. Caldwell Cotton Mills Co.*, 205 N. C. 809, 814, 172 S. E. 373, 375 (1933). The thought is, apparently, that only the Legislature can prescribe how to create a corporation, hence only the Legislature can prescribe how to put an end to it.

⁶⁶ See note cited *supra* note 65.

⁶⁷ *Guaranty Laundry Co. v. Pullam*, 200 Okla. 185, 191 P. 2d 975 (1948), and see cases there cited; *BALLENTINE, CORPORATIONS* (rev. ed. 1946) 715; *STEVENS, CORPORATIONS* (2d ed. 1949) 956-6.

⁶⁸ *Israels, The Sacred Cow of Corporate Existence*, 19 U. OF CHIC. L. REV. 778 (1952).

interests of the complaining shareholder,"⁶⁹ the new Act has its eye on close corporations when it provides for liquidation in an action by a shareholder when a deadlock among directors cannot be broken by shareholders (which may be the case not only in even-split situations but also under high vote or unanimity requirements in charter and by-laws) and business can no longer be conducted advantageously to all or when shareholders are deadlocked and therefore unable to elect successor directors.⁷⁰ It should be pointed out, however, that these new provisions merely give the court power to liquidate; whether it exercises that power will be determined by how badly the situation calls for that rather drastic remedy.⁷¹ Indeed, the inability of shareholders to muster enough votes to change the existing directorate may have been exactly what the incorporated partners sought to achieve by the particular set of charter or by-law provisions or distribution of shares among them; that deadlock in electing new and different directors does not per se call for liquidation.

Besides the foregoing liquidation-for-deadlock provisions, which follow the Model Business Corporation Act,⁷² the new Act, again with its eye on the close corporation, goes a step further and authorizes the associates to write their own ticket with respect to liquidation of the business by inserting either in the charter or in other written agreement the terms upon which the complaining shareholder is entitled to dissolution, which may be either at will or upon the occurrence of same designated event.⁷³ In the absence of such a statute there seems to be a question whether a court will give effect to dissolution agreements even if all the shareholders are parties to it,⁷⁴ although here again the new Act's quasi-partnership Section 55-73(b) previously discussed, might per se uphold such an agreement. Under the new Act, then, the parties in a close corporation can work out, if they so wish, a right of liquidation upon death of *A* or *B*, upon failure to elect the persons selected by *A* to two posts on the board of directors, etc. Just as partners can beforehand agree on an event of dissolution, so can incorporated partners so agree for liquidation under the new Act.

There would seem, then, to be no reason under the new Act for a court to approach the problem of liquidation of the business of a close

⁶⁹ New Section 55-125(a) (4).

⁷⁰ New Section 55-125(a) (1) and (2).

⁷¹ See Application of Cantelmo, 275 App. Div. 231, 88 N. Y. S. 2d 604 (1st Dept. 1949) under a dissolution-for-deadlock statute. (Relief denied; although the situation literally met the statutory deadlock conditions, the business was not seriously affected.)

⁷² MODEL BUS. CORP. ACT, *supra* note 59, § 90(a) (1) and (3).

⁷³ New Section 55-125(a) (3).

⁷⁴ Cf. views of Hornstein, *Stockholders' Agreements in Closely Held Corporations*, 59 YALE L. J. 1040, 1047 (1950) with Israels, *The Sacred Cow of Corporate Existence*, 19 U. CHIC. L. REV. 778, 792 (1952). A few years later, Hornstein viewed the problem as unsettled. Hornstein, *Judicial Tolerance of the Incorporated Partnership*, 18 LAW & CONT. PROB. 435, 448 (1953).

corporation with substantially more conservatism than it would show in dissolving a partnership, free from any carry-over of the "sacred cow" tradition of corporate existence.

There is one further aspect of this problem which the new Act might have gone into but which it avoids: it makes no attempt to confer a right upon the majority shareholder or shareholders to buy out a shareholder seeking a liquidation and to establish a mechanism for appraisal of shares in such event. The matter is not an easy one to work out, although two states have statutes to that effect,⁷⁵ which statutes, unlike the Uniform Partnership Act, are not aimed simply at buying out the associate who brings about a *wrongful* dissolution. It is not easy to draft an appropriate buy-out provision in an equal-ownership case or one which does not lend itself to being used as a pressure device. Since the effective date of the new Act was deliberately postponed to July 1, 1957, in order to get ideas for improvement of the Act, someone may yet come up with a suggestion on this point for the 1957 General Assembly.

Keeping the Close Corporation Closed; Share Transfer Restrictions.

The owner-managers of an incorporated partnership are as much concerned with the *delectus personae* as are out-and-out partners and hence are likely to make arrangements to restrict share holdings to acceptable persons. Despite its awareness of the problems of the close corporation, the new Business Corporation Act has no section specially devoted to restrictions on the transferability of shares. Primarily, the reason for this seeming neglect is that North Carolina case law on this matter furnishes a solid basis for the adoption by incorporated partners of the kind of reasonable restriction for which they have any good business reason. In the leading case of *Wright v. Iredell Telephone Co.*,⁷⁶ the court upheld a charter provision to the effect that shares could not be sold or transferred until the sale or transfer was reported to the directors and approved by them; accordingly, a purchaser who bought under a non-complying sale was held not entitled to be registered as a shareholder and to have a stock certificate issued to him in his name. The court demonstrated a commendable liberality in two respects. In the first place, it upheld a restriction that went beyond the customary "first refusal" condition that requires the shares first to be offered to the corporation or to the other shareholders before being sold to outsiders. A number of courts, however tolerant they might be of a "first refusal" type of restriction, would balk at a "directors' consent" type,⁷⁷ on the

⁷⁵ CALIF. CORP. CODE §§ 4658, 4659; W. VA. CODE ANN. § 3093 (1949).

⁷⁶ 182 N. C. 305, 108 S. E. 744 (1921).

⁷⁷ *Morris v. Hussong Dyeing Machine Co.*, 81 N. J. Eq. 256, 86 Atl. 1026 (1913); *Feckheimer v. National Exchange Bank of Norfolk*, 79 Va. 80 (1884); BALLANTINE, CORPORATIONS (rev. ed. 1946) 778 and cases there cited; Cataldo, *Stock Transfer Restrictions and the Close Corporations*, 37 VA. L. REV. 229 (1951).

ground that this puts the transfer of one man's property at the mercy of another man's veto, and one that might be exercised arbitrarily at that.⁷⁸ (However, the actual facts in the *Wright* case were that the directors did not simply withhold their consent to the the transfer; rather, they came up with approved persons who were willing to buy the shares at the price that the shareholder was getting from the unapproved purchaser. To be on the safe side, then, the transfer restriction in a North Carolina corporation should be phrased in terms of a "first refusal" or, if not, the persons having the veto power should produce a standby purchaser.) In the second place, the corporation in the *Wright* case was not merely an incorporated partnership; apparently the shares in the corporation (a local telephone company) were rather widely held in the community; still, the purpose of the restriction was reasonable enough: the local citizens did not want to run the risk that the shares would be bought up by a telephone "system" which (experience had led them to believe) would result in higher rates. It would seem, then, that in an incorporated partnership the North Carolina courts would be even more tolerant of transfer restraints and would be inclined to accept a restraint (at least a "first refusal" restraint) without further inquiry into the purpose of the restraint, reserving inquiry into proper purpose for corporations that are something more than an incorporated partnership, as in the *Wright* case. (As a practical matter, a "first refusal" restraint, with rights of purchase in the case of transfer by operation of law, is all that the incorporated partners really need.)

Perhaps in view of the fact that the restraint in the *Wright* case was found in the *charter*, the new Act should have taken the occasion to clarify the point, not clear at common law, whether an otherwise tolerable restraint can be stated in the by-laws if not stated in the charter, since at least the old cases seemed to be more tolerant of restrictions placed in the charter than of those placed in the by-laws.⁷⁹ In a mild sort of way, however, the new Act contains language which indicates that the by-laws are a proper repository for matters relating to transfer of shares; new Section 55-16(c) states that the by-laws "may contain any provisions for the regulation and management of the affairs of the corporation, *including the transfer of its shares*, not inconsistent with the law or the charter." (Emphasis added.) Similar language has on occasion been held a sufficient basis for a by-law restricting transfers,⁸⁰ and in those cases where such a statute was held not to authorize the by-law restriction, the decision seems to reveal rather an antipathy to-

⁷⁸ However, O'Neal, *Restrictions on Transfer of Stock in Closely Held Corporations: Planning and Drafting*, 65 HARV. L. REV. 773 (1952) makes the point (p. 780) that the recent cases tend to uphold even "consent" restrictions.

⁷⁹ See cases and writers cited *supra* notes 77, 78.

⁸⁰ Nickelson v. Franklin Brewery Co., 82 Ohio 94, 91 N. E. 991 (1910).

ward the restraint (unlike the North Carolina court's attitude) than an objection to placing the restrictions in the by-laws.⁸¹ Any argument based on lack of notoriety of the by-laws, as distinguished from the fiction of "constructive notice" of the charter, would seem to lack force in view of the fact that purchasers without notice of the restriction would get the benefit under the new Act, as they do under the present law,⁸² of the Uniform Stock Transfer Act provision requiring the restriction to be stated on the share certificate. Incidentally, the very fact that this provision of the Uniform Stock Transfer Act refers to transfer restrictions "by virtue of any by-laws of such corporation, or otherwise," is a further indication that if there is anything wrong with a transfer restraint it is not because the restraint is in the by-laws. Still, the careful lawyer will probably prefer to put the restriction in the charter. Perhaps it may be advisable to suggest an amendment that would insert in above-quoted Section 55-16(c) of the new Act, after the words "including the transfer of its shares," the words "and restrictions thereon"; it is hard to see how that could do any harm, even if the foregoing discussion suggests that this is unnecessary.

There is a technical point on which the new Act, while adequate for the really close corporation (the incorporated partnership) could perhaps be improved with respect to facilitating the operation of stock transfer restrictions. That is, it should perhaps be made clear that a corporation may properly acquire its own stock under a first refusal restriction. The new Act's approach (Section 55-52) to the problem of a corporation acquiring its own stock is to enumerate the kinds of cases in which that can be done. The enumeration does not specifically mention acquisitions pursuant to transfer restrictions. In a really close corporation, this presents no great problem since new Section 55-52(c) (3) expressly permits a corporation to buy shares (out of surplus) from any shareholder upon the vote of the majority of the other shares. (And if the holders of all the other shares consent in writing, no meeting is necessary under new Section 55-63(c) relating to shareholders' actions without meetings.) Those provisions seem adequate to take care of the few-man corporations, even aside from the quasi-partnership section, Section 55-73(b), previously discussed. But for the more widely held corporation it would appear that there should be added in the appropriate place (say, in an additional paragraph in subsection (c) of Section 55-52), an express provision permitting a corporation to purchase its own shares

⁸¹ See *Kretzer v. Cole Brothers Lightning Rod Co.*, 193 Mo. App. 99, 181 S. W. 1066 (1916); *Steele v. Farmers & Merchants Mutual Telephone Ass'n*, 95 Kan. 580, 148 Pac. 661 (1915).

⁸² N. C. GEN. STAT. § 55-95, being Section 15 of the Uniform Stock Transfer Act.

"from any shareholder in the exercise of the corporation's right to purchase the shares pursuant to restrictions upon the transfer thereof."

Intramural Informality in Close Corporations

The really close corporation, particularly the "incorporated hot dog stand," is notorious for its persistent flaunting of all those formalities and ceremonials dear to the heart of the true corporation lawyer.⁸³ Now, the law maker (be he legislator or judge) can do one of two things when faced with this stubborn fact of life within the close corporation family: (1) he can threaten and beat the perpetrators of this corporate informality with laws designed primarily for publicly held corporations, on the theory that what is good for General Motors is good for Hot Dog, Inc., hoping that the threat or the beating or both will serve as a warning to all corporate parties in the future to show good corporate manners, even if in the course of the beating some innocent by-standers catch some of the stray blows; (2) he can recognize this fact as one of the personality traits of the close corporation and try to live with it (chastizing the culprit when his disregard of proprieties goes beyond lack of good corporate manners and becomes anti-social conduct to the detriment of insiders or outsiders). The General Statutes Commission, after a lively discussion, decided to adopt the second of the above positions. This is reflected by Section 55-29 of the new Act relating to "informal or irregular actions by directors or committees." Subsection (a) of that section would, for example, view as board action the action taken by a majority of the directors even without a formal meeting (or any "meeting") if either written consent to the action is signed by all directors and filed in the minute books or if all shareholders know of the action and make no prompt objection or if the directors have, to the knowledge of the shareholders, been accustomed to take action informally. (It is even arguable that the requirement of shareholders' knowledge of the directors informal habits should be eliminated.) Subsection (b) of that same section provides that if a meeting of directors otherwise valid is held without proper call or notice, action taken at such meeting is deemed ratified by non-attending directors unless they file an objection promptly after knowing about it. Some misgiving was voiced over the possibility

⁸³ To quote from Prentice-Hall, *Lawyers Weekly Report: Corporation News* (Jan. 24, 1955):

"Owners of small 'family' corporations, or 'incorporated partnerships' are notoriously negligent in observing the legal requirements and formalities of doing business in the corporate form. Often they are little interested in such things as minutes, meetings and resolutions, and know nothing about such legal rules as 'interested directors' and 'corporate opportunity'—until the day of reckoning comes, when the 'partnership' breaks up in dispute or creditors decide to assert their claims. Acts done informally and in complete good faith are then tested against strict legal requirements that the parties knew nothing about or ignored. An unhappy education results."

that the stamp of approval would thereby be put upon laxness, leading to even greater laxness. It was preponderantly believed, however, that actual practices would be little affected and that the big corporations would continue showing patrician corporate manners while the little ones would continue in their uncouth plebian ways, but without getting worse.

The General Statutes Commission's attitude was similarly reflected in new Section 55-63 relating to irregular meetings of shareholders and shareholders' action without a meeting. Accordingly, subsections (a) and (b) thereof are to the effect that a meeting of shareholders, even if held without proper call and notice, can act as validly as if proper call and notice were had so long as all the shareholders attend and make no objection (and silence of the minutes *prima facie* establishes that no objection was made) or if those who did not attend (there having been, however, a quorum present) sign, before or after the meeting, a waiver or approval of the action taken. Subsection (c) provides that written consent to shareholders' action signed by all the shareholders is the equivalent of action taken at a meeting.

Moreover (although this is not expressly stated), nothing in the mentioned sections should discourage a court from validating corporate action on the bases of such doctrines of ratification by acquiescence, disinterest or passivity as the court may deem appropriate for the protection of whoever needs to be so protected. Actually, courts have frequently tolerated departure from strict formality, particularly by close corporations, and it is doubtful that the new Act here is really making any radical innovation.⁸⁴ This is not to say, however, that anything in the new Act condones the conduct of these who view their managerial post as simply the occasion for running the corporate business solely for their own benefit, in disregard of the rights of creditors or other shareholders and who, resentful of the very existence of other interests, tend to lapse into the frame of mind (particularly if their management has been skillful and successful) of Louis XIV: *L'état c'est moi*.⁸⁵

⁸⁴ See BALLENTINE, *CORPORATIONS* (rev. ed. 1946) 123-126, 129-30, 390; STEVENS, *CORPORATIONS* (2d ed. 1949) 657-662.

⁸⁵ For example, it is by no means clear that in the case to which the Prentice-Hall letter, *supra*, note 83, was addressed, what was involved was merely a lack of formality; we further quote from that letter:

"Robert organized and managed a family real estate development corporation. A dispute arose and Robert was held to account for these transactions (although the court stated that Robert made a 'dream come true' and that much could be said in his defense, practically if not legally):

"(1) Stock was issued to Robert without *legal* consideration (apparently, it was felt that Robert was entitled to the stock for past and future services). He had to choose whether to pay for the stock or have it cancelled.

"(2) Robert borrowed \$40,000 from the corporation at 4½%. He didn't know it, but the loan was illegal and he—and the other directors—were jointly and severally liable to repay it at 6%.

"(3) The corporation conveyed some vacant lots to Robert. He built on the lots and sold them at a profit to *himself*. Because he 'diverted a cor-

Miscellaneous

There are other points with respect to which the new Act recognizes that the mechanisms of publicly held corporations need some flexibility or dispensation for close corporations. For example, by new Section 55-64(d) a voting list need not be prepared for a shareholders' meeting where, as in a close corporation, the stock records present readily show who the shareholders are. In a similar spirit, Section 55-70 permits the charter or the by-laws to dispense with voting inspectors at shareholders' meetings.

A simple procedure for dissolution is provided in Section 55-117, of practical utility to close corporations where all the shareholders are ready to sign the written consent to dissolution. Although no similar provision for a short form of merger was specifically provided for, as a practical matter two or more close corporations could readily merge or consolidate without going through the procedure of shareholders' meetings by virtue of Section 55-63(c), under which the written consent of all of the shareholders of the merging or consolidating corporation can take the place of voting at a formal meeting.

Also, it must not be overlooked that the wide freedom of dividing shares into classes and of giving each class such voting or participating right as may be desired (in which respect the new Act is not at all novel) furnishes a mechanism that can be of great utility in an incorporated partnership.

WHY NOT A SEPARATE CLOSE CORPORATION ACT?

One finds in legal writings from time to time the suggestion that there be a separate statute for close corporations. It is pointed out that the continental Europeans have such a system⁸⁶ and so do the English⁸⁷ with their special provisions in the Company Act for "private companies." In drafting the new Business Corporation Act, however, the General Statutes Commission felt that a single piece of legislation could embody the essential needs and safeguards with respect to both the closely held and the publicly held corporation. To attempt to define generally a category of close corporations is no easy matter. To define such a corporation by numerical standard (say, less than 50 shareholders) is not without difficulties, such as those raised by evasive dispersion or groupings of shares, repurchases of shares, etc. Moreover, even these foreign systems are not designed to take care of that common

porate opportunity,' he had to pay the profit over to the corporation. [Mac-lary v. Pleasant Hills, Inc., Del. Ch. Ct., No. 305, 12/6/54]."

The case has since been reported in 109 A. 2d 830 (1954).

⁸⁶ See Treillard, *The Close Corporation in French and Continental Law*, 18 LAW & CONT. PROB. 546 (1953).

⁸⁷ See Gower, *The English Private Company*, 18 LAW & CONT. PROB. 535 (1953).

American phenomenon, the one-man corporation.⁸⁸ Furthermore, the proliferation of close corporations under the usual American legislative set-up for corporations and the experience of close corporations under that set-up, even on those occasions when their experience before the courts has been a sad one, suggest that what is needed is not so much a special statute for close corporations as a general awareness throughout the corporation law of the peculiarities of the close corporation. Moreover, experience in those few states that have what might be called a special statute for close corporations, such as the "partnership association" (with limited liability) in Pennsylvania,⁸⁹ Michigan, New Jersey and Ohio, indicate that little use is made of those statutes by co-owners of a business who desire limited liability; instead, they consistently use the corporation law, leaving it to counsel to work out within the corporation law something that fits their needs.⁹⁰ Perhaps the reason is that those limited liability statutes, aside from the corporation law, are ancient, skimpy and more awkward to operate under than the corporation law; perhaps a good close corporation law would have had a different experience. Still, the very fact that nobody in those states has started a strong movement to modernize and perfect these other statutes for use of incorporated partnerships is suggestive in and of itself. It is also interesting to note that the New York Law Revision Commission, faced with the discontent that arose as a result of the *Benintendi* case,⁹¹ also considered and rejected the idea of defining the close corporation and of having either a separate act for such corporations or a set of provisions applicable solely to close corporations.⁹² Instead they came up with a section expressly granting authority to include high-vote and high quorum requirements

⁸⁸ Under the English Companies Act, 1948, for instance, if the shareholders even in a "private company" fall below two in number, the sole shareholder loses limited liability. 11 & 12 Geo. 6, c. 38, § 31 (1948). By Italian law, in the case of insolvency the sole shareholder of a stock corporation (of the *società per azioni* type) is liable for corporate debts incurred while he was sole shareholder. Civ. CODE, art. 2362. And as to what may be called the close corporation (in Italy, the *società a responsabilità limitata*, with "quotas" instead of shares), the very notion of a "società" as well as the general legislative scheme seems to preclude a one-man "society."

⁸⁹ PA. STAT. ANN. tit. 59, §§ 341-461 (1930). Pennsylvania also has a form of association known as the "registered partnership," wherein all the partners have limited liability. PA. STAT. ANN. tit. 59, §§ 241-321. See also the "partnership association" in Michigan, MICH. COMP. LAWS §§ 449.301 *et seq.* (1948); the "limited partnership association" in New Jersey, N. J. STAT. ANN. §§ 42:3-1 *et seq.* (1940); the "limited partnership association" in Ohio, OHIO REV. CODE, §§ 1783.01-08 (1954), all of which have limited liability.

⁹⁰ In 1952 the writer sent an inquiry to all of the graduates of the Duke University Law School practicing law in Pennsylvania and New Jersey to find out whether extensive use was made of the statutes in question, in their experience. Without exception, the answers received were to the effect that, in their experience, resort was had always to the corporation law, never to these other statutes.

⁹¹ *Supra*, note 2.

⁹² See N. Y. LAW REV. COMM., REPORT (1948) 385, 386. See also Israel's, *The Close Corporation and the Law*, 33 CORN. L. Q. 488, 491 (1948).

in corporate charters.⁹³ Apparently a similar attitude prevailed in the Committee on Corporate Laws of the American Bar Association which drafted the Model Business Corporation Act.⁹⁴ The European distinction between ordinary corporations and what might be called close corporation (as well as the English scheme for companies, "private" or otherwise)⁹⁵ is addressed less to the problems of intracorporate control and management with which American close corporations have been greatly concerned than to the problem of protection of the investing public—a problem which with us is met by Blue Sky Laws and, more emphatically, by the legislation under the administration of the Securities and Exchange Commission.⁹⁶ All in all, it was believed that a single North Carolina Act could meet the need of both the close and publicly held corporation.

⁹³ N. Y. STOCK CORP. LAW § 9.

⁹⁴ See 8 *Bus. Lawyer* 33-37 (Jan. 1953).

⁹⁵ See N. Y. LAW REV. COMM., REPORT 418-422 (1948). It is to be noted that the English provisions relative to "private companies" are to be found not in a separate Act for such companies but in a few provisions within the Companies Act itself.

⁹⁶ See N. Y. LAW REV. COMM., REPORT 416 (1948).