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Cross Fire on the Close Corporation: Norms Versus Needs

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CROSS FIRE ON THE CLOSE CORPORATION: NORMS VERSUS NEEDS

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Suppose that Gator and Growl wish to start a business or to continue one which they have successfully developed as partners. Gator has the technical skill, and Growl has the capital and general business experience. Gator expects to give his full time and technical talent to the undertaking; Growl is to contribute the greater portion of the capital required and his general business ability. Growl is not solely dependent on income from this business for his livelihood, but Gator is. They wish to have an arrangement whereby no major policy decision is to be taken without unanimous agreement. Neither desires to put it in the power of the other to control unilaterally salaries, dividends, or tenure as an officer or employee. Gator is not willing to be placed in a position of being "frozen out" by Growl.[1] Growl must protect his larger capital contribution. This business situation is such a common type that further description is superfluous. All will recognize it.

Such a business arrangement would be simple to work out in a partnership agreement, and there would be no question about its validity. Gator would not be subject to complete control by Growl, even though Growl's financial contribution is much larger. But there are two defects in this solution: (1) Gator and Growl both desire the limited liability for their undertaking which the corporate form alone

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[1]This can be done by a majority stockholder through his control of the board of directors. By having himself and members of his family elected or appointed to high-salaried positions, by curtailing dividends, by discharging a minority stockholder-employee, and by other tactics which oppress the undesired minority, the latter's lot can be made extremely unpleasant and, consequently, untenable. If one could safely assume that the participants in such a close corporation would always act in harmony, there would be no problem. Numerous lawsuits evidence how unsafe that assumption is.

"A stockholder, in taking stock in the ordinary corporation, submits, within the charter limits, to a guidance of the corporate affairs according to the will of the owners of a majority of the stock and through the directors whom the majority choose." Stone v. Holly Hill Fruit Products, Inc., 56 F.2d 553, 554 (5th Cir. 1932).

provides; and (2) tax considerations may make the corporate form more desirable, particularly for Growl, who has other income.[2] The only type of business organization which offers any hope of achieving all these goals is the corporation. Not even the limited partnership will do it because there must be at least one general partner in a limited partnership,[3] and this general partner is subject to personal liability.[4] Also, the limited partner must refrain from taking part in the control of the business if he is to retain limited liability,[5] and *both* Gator and Growl desire to exercise managerial control. No existing form of partnership will accomplish the objective. Is it possible to utilize the corporate form for such a business venture?

Gator and Growl and their attorneys will find in most states a business corporation act which was enacted in contemplation of the corporation whose shares are widely held and which will automatically cast them into a mold wherein the minority shareholder may find himself at the mercy of the majority shareholder, who can, as a practical matter, dominate meetings of both shareholders and directors. The Florida Business Corporation Act,[6] like its counterparts in many other states, prescribes a representative form of government with majority rule. The affairs of the corporation are placed in the hands of a board of directors periodically elected by majority vote according to the number of shares held. The board of directors, acting

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[2]While there are several tax-saving possibilities provided by the corporate form of business organization, probably the best example is the opportunity afforded to the stockholder-officers of a close corporation to pay themselves salaries (deductible from corporate income) instead of dividends, building up the value of their interests by retention of earnings within the corporation, and then realizing this enhanced value by a distribution that is taxed at capital gain rates rather than at personal rates. The tax gatherer, of course, has devised some obstacles to such a plan. See Freeland and Stephens, *The Commissioner and the Corporation*, 11 U. FLA. L. REV. 509 (1958).

There have been suggestions that close corporations be taxed as are partnerships, thereby removing tax considerations from the partnership versus corporation dilemma. Lowndes, *Taxing the Income of the Close Corporation*, 18 LAW & CONTEMP. PROB. 558, 581 (1953); O'Neal, *Recent Legislation Affecting Close Corporations*, 23 LAW & CONTEMP. PROB. 341, 361-62 (1958). Congress has recently made such treatment elective. This may result in incorporation being more desirable than before for the corporation with no more than ten stockholders. See Freeland and Stephens, *supra* at 535.

[3]FLA. STAT. §620.01 (1957); UNIFORM LIMITED PARTNERSHIP ACT §1.

[4]FLA. STAT. §620.09 (1957); UNIFORM LIMITED PARTNERSHIP ACT §9.

[5]FLA. STAT. §620.07 (1957); UNIFORM LIMITED PARTNERSHIP ACT §7.

[6]FLA. STAT. c. 608 (1957).

by a majority of a quorum, may choose the officers of the corporation, exercise its powers, and manage its ordinary business free from any interference from minority shareholders or minority directors. Such an arrangement is about as appropriate for a close corporation such as Gator and Growl wish to form as the United Nations Charter would be for a small town. Unless ingenuity is present, Gator will probably be placed at the mercy of Growl, who will own more shares than Gator because he contributed more capital.

In the United States the concept of the close corporation has developed with very little statutory basis in an area in which the legislature has provided most of the law. This type of business organization, displaying many of the characteristics of a corporation while at the same time partaking of the nature of a partnership in some respects, is seeking legal recognition. This is in response to a growing demand from the business community. Yet the legal status of this type of business organization is still unclear, and uncertainties surround it in many states, including Florida. The evolution of this hybrid form of business association is another example of the dynamic quality of the common law. As the needs of the business world change, the forms of business organization change also to accomodate the new needs.

There are several characteristics of a close corporation. The stock usually will not be listed on any public exchange, nor will it even be handled in over-the-counter markets; there are usually restrictions on the transfer of the shares; and the stockholders themselves are usually the directors and officers of the corporation. This closing of the corporation to outsiders as far as stock ownership is concerned and the emphasis upon direct management by the shareholders, as directors and officers, are features that resemble a partnership rather than a corporation.[7] The really distinctive characteristic of the close corporation is this identity between the ownership and the management — ownership and management are united in the shareholders. This basic characteristic is traditionally associated with partnerships rather than corporations. Since the creators of a close corporation usually want to keep it closed, this results in the close corporation being one wherein all of the issued stock is often owned by a small group of persons. One-man corporations and family corporations are close corporations, but there are many close corporations that do not have this kind of unity. Not all of them are small; the Ford

[7]Kramer, *Foreword,* 18 LAW & CONTEMP. PROB. 433 (1953).

Motor Company was until recently a conspicuous example of a large close corporation. These characteristics are, of course, interrelated and will vary greatly in relative importance when different close corporations are compared.

Returning to the problem of Gator and Growl, can they protect themselves by setting up a business organization with many partnership characteristics, and still enjoy the limited liability and tax status of stockholders in a corporation? With the objectives desired by Gator and Growl in mind, the first step is to examine the business corporation act of the state in which the corporation is to incorporate, along with the decisions construing the act. There is much variation among the states as to the legal status of the "incorporated partnership," even where the statutory law is very similar. It will probably not be overlooked, in this connection, that it is possible to incorporate under the law of a state that has a business corporation act favorable to close corporations such as New York or North Carolina and to operate as a foreign corporation in Florida and other states. The internal affairs of a corporation are controlled by the law of the state in which it is incorporated. The legal doubts about the close corporation arise out of these internal relations among the participants themselves rather than out of relations between the corporation and those outside the corporation.

It is very strange that the law generally has been more favorable to the one-man corporation than the close corporation that has more than one shareholder. Actually, analysis reveals that the legal considerations ought to be similar and that the one-man corporation is merely one type of close corporation. In the one-man corporation there is a combination of proprietorship with the corporate form so as to have the complete control of the former and the limited liability of the latter.[8] It, too, is a hybrid. Similarly, the wholly-owned subsidiary corporation is merely one type of one-man corporation, achieving limited liability within the limited liability of the parent

[8]Most states, including Florida, require as incorporators "three or more persons." FLA. STAT. §608.03 (1) (a) (1957). A corporation becomes a one-man type when, after incorporation, one person acquires all the shares, often according to a preconceived plan. Most courts have approved this practice, disregarding the corporate personality only when improper or dishonest purposes are present. Advertects, Inc. v. Sawyer Industries, 84 So.2d 21 (Fla. 1955); see Cataldo, *Limited Liability with One-Man Companies and Subsidiary Corporations,* 18 LAW & CONTEMP. PROB. 473 (1953); Trau, *Florida's Corporate Code: Draftsmanship and Practice,* 12 U. MIAMI L. REV. 63 (1957).

corporation, the latter having complete control of the subsidiary corporation, as would a proprietor. Both kinds of one-man corporations incorporate under general business corporation acts and have received the kiss of judicial approval, though not unanimously.[9] One might expect to find a similar reception when two or three shareholders try to achieve similar ends through amalgamation of partnership and corporation. The courts have not, however, received the close corporation with that cordiality.

A need for some clarification of the legal status of the close corporation is apparent. The average attorney probably spends more time working on the problems of close corporations than on the problems of corporations with stock widely held. Also, a recent development is the use of the close corporation in order to carry out joint ventures too burdensome for one of the participating corporations alone. Usually several corporations combine to carry out some specific project or bid on some particular contract. Naturally, each desires partnership control and protection against outsiders. Yet, at the same time, they all desire limited liability because of the great risks involved.[10]

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[9]Park Terrace, Inc. v. Phoenix Indemnity Co., 241 N.C. 473, 85 S.E.2d 677 (1955), *modified on rehearing*, 243 N.C. 595, 91 S.E.2d 584 (1946), 34 N.C.L. REV. 531; Latty, *A Conceptualistic Tangle and the One- or Two-Man Corporation*, 34 N.C.L. REV. 471 (1956). The opinion in the case cited stated that a corporation with less than three stockholders was "dormant" and that the corporate entity could be disregarded. The North Carolina Legislature has enacted amendments to the North Carolina Business Corporation Act designed to neutralize this dictum. N.C. Sess. Laws 1957, c. 550.

[10]"It would be a mistake, however, to assume that close corporations are limited in use to small business. In recent years it has become commonplace for two or more large corporations to join in a common enterprise through the instrumentality of a close corporation, the stock of which is owned equally or in agreed proportions by each of the sponsoring companies. The mushroom growth, both in size and numbers, of such close corporations makes it a reasonable prophecy that the peculiar problems of this form of business organization will receive more adequate consideration and attention in the future." Scott, *Developments in Corporate Laws*, 12 BUS. LAW. 438 (1957).

The Wall Street Journal, Aug. 18, 1958, p. 1, col. 6:

"The growing size and complexity of some of the research and development jobs now being parceled out by Uncle Sam's Defense Department are breeding what almost amounts to a new form of business enterprise — team contracting.

"It's a method that permits companies with a variety of capabilities to put their heads together for the sake of submitting a single bid on a big contract.

"This type of corporate cooperation has advantages for both big and small firms. It permits a small company, with one particular skill, to get in on the

The growing utilization of the close corporation, however, does not necessarily mean that its legal status is no longer doubtful or that the participants have the business arrangements they desire for their protection. It is not until the corporate honeymoon is over and the majority stockholder begins to exercise control in an area in which his and minority interests diverge that the minority participant realizes his mistake and, perhaps, the mistake of his attorney.

It might be helpful to briefly contrast the characteristics of a partnership with those of a corporation. A partnership is not a juristic entity as is a corporation. Partners as principals own the assets directly, and each is a principal and an agent to his fellow partners. Each partner has implied authority to act for all within the scope of the partnership business; and, in the absence of an agreement to the contrary, each partner has the right to take part in the management of the business. A partnership does not survive the death or withdrawal of a partner. These characteristics are needed by partners because of the absence of limited liability. Since each partner is a direct owner and has full personal liability for acts of his fellow partners within the scope of the partnership, it is necessary that he have complete confidence in all his partners and that new partners not be substituted without his consent. He needs to participate in the management, since he has so much at stake. Also, it is important that the partnership be dissolved whenever a partner desires to terminate his risk. It is possible to modify many of these characteristics by a partnership agreement. Limited liability can be achieved through the use of the limited partnership, and it is generally conceded that partners may provide that the death of a partner shall not result in winding up. Statutes often permit use of a common name. The Uniform Limited Partnership Act has done a great deal to give the partnership certain attributes of a corporate entity. Yet, as has been pointed out earlier, the limited partnership does not answer the needs of Gator and Growl. They both want to manage, and neither can

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ground floor of a big contract that calls for many skills. And it allows a large company to participate in many mammoth research efforts, when any one of them alone could easily soak up all its scientific talents.

"Some of the projects now in the works, such as exploring outer space or developing supersensitive devices to warn against enemy attack, almost require this kind of organizational approach. The method seems certain to spread as business men become more familiar with its benefits — and mechanics."

See also Broden and Scanlan, *The Legal Status of Joint Venture Corporations,* 11 VAND. L. REV. 673 (1958).

be a limited partner because one's livelihood and the other's fortune depend on retaining managerial control over the enterprise. They desire to have a partnership arrangement in corporate form, with legal recognition of the entity of a corporation which will assure them of freedom from personal liability beyond their investments in the undertaking. There is also the possibility of tax considerations favoring the corporate form, although there is certainly nothing permanent about the tax advantage one business form may have over another, due to the frequent changes in the tax laws and the differing and changing tax postures of the individual participants.[11]

Is it possible to wed corporation with partnership so as to produce the attractive features of the corporation blended with the partnership characteristics the owners wish to retain? The giving of corporate attributes to the partnership in the limited partnership statutes has fallen short of the result desired by many. The other possibility is considered here: basting the corporation turkey with partnership gravy.

People like Gator and Growl, while desiring limited liability and perhaps some tax advantages, dislike four consequences of incorporating to get them: (1) centralized management of a board of directors; (2) free transferability of shares; (3) survival of the business unit despite the death or withdrawal of a participant; and (4) the legal formalities required by most business corporation acts for the conduct of the affairs of a corporation. They want to incorporate without reaping these consequences. The traditional expectation is that stockholders and directors will act by majority vote rigidly conforming to the formalities prescribed by statute and custom, that shares will be freely transferable, and that dissolution will be avoided except in the most extreme situations. Deviations from this pattern by charter, bylaw, or agreement have raised doubts as to legal validity. There has been little effort by legislatures or courts to make any distinction between the publicly held corporation and the close corporation, though it is obvious that the two types are quite different and need not be subjected to the same inflexible mold. The deviations from the orthodox corporate pattern desired by Gator and Growl are limited to the internal organization of the corporation, and there is probably no substantial risk of injury to shareholders, creditors, or the public. The corporate norms they wish to avoid were created largely for the protection of stockholders in publicly held corpora-

[11]See note 2 *supra*.

tions. There has been much attention focused on this subject recently.[12] It is the purpose of this article to explore the problem, with particular attention being given to the Business Corporation Act of Florida and the decisions of Florida courts.

MINORITY CONTROL ARRANGEMENTS

Gator fears control by a majority of a board of directors and fears a majority vote of stockholders that might change the membership of the board. This raises a very complicated problem. Assuming that the majority stock interest is agreeable, is it possible to dispense with majority rule in the modern business corporation?

An agreement signed by all stockholders to vote at meetings of stockholders for certain persons as directors is probably valid and enforceable.[13] Such agreements among all stockholders relating to the employment of certain of them as officers and employees have sometimes been enforced.[14] Similarly, such agreements among all stock-

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[12]O'NEAL, CLOSE CORPORATIONS: LAW AND PRACTICE (1958); Cary, *How Illinois Corporations May Enjoy Partnership Advantages,* 48 NW. U.L. REV. 427 (1953); Delaney, *The Corporate Director: Can His Hands Be Tied in Advance?,* 50 COLUM. L. REV. 52 (1950); Hornstein, *Judicial Tolerance of the Incorporated Partnership,* 18 LAW & CONTEMP. PROB. 435 (1953); Hornstein, *Stockholders' Agreements in the Closely Held Corporation,* 59 YALE L.J. 1040 (1950); Israels, *The Close Corporation and the Law,* 33 CORNELL L.Q. 488 (1948); Latty, *The Close Corporation and the New North Carolina Business Corporation Act,* 34 N.C.L. REV. 432 (1956); O'Neal, *Protecting Shareholders' Control Agreements Against Attack,* 14 BUS. LAW. 184 (1958); O'Neal, *Recent Legislation Affecting Close Corporations,* 23 LAW & CONTEMP. PROB. 341 (1958); O'Neal, *Molding the Corporate Form to Particular Business Situations: Optional Charter Clauses,* 10 VAND. L. REV. 1 (1956); O'Neal, *Giving Shareholders Power to Veto Corporate Decisions: Use of Special Charter and By-Law Provisions,* 18 LAW & CONTEMP. PROB. 451 (1953); Robinson, *"Shareholders' Agreements" and the Statutory Norm,* 43 CORNELL L.Q. 68 (1957); *Symposium — The Close Corporation,* 52 NW. U.L. REV. 345 (1957); The Business Lawyer, Nov. 1954, p. 9.

[13]Ringling Bros.-Barnum & Bailey Combined Shows, Inc. v. Ringling, 29 Del. Ch. 610, 53 A.2d 441 (Sup. Ct. 1947); E. K. Buck Retail Stores v. Harkert, 157 Neb. 867, 62 N.W.2d 288 (1954); Storer v. Ripley, 1 Misc. 2d 235, 125 N.Y.S.2d 831 (Sup. Ct.), *aff'd,* 282 App. Div. 950, 125 N.Y.S.2d 339 (2d Dep't 1953); Baran v. Baran, 59 Pa. D. & C. 556 (C.P. 1947).

[14]Thompson v. J. D. Thompson Carnation Co., 279 Ill. 54, 116 N.E. 648 (1917); Clark v. Dodge, 269 N.Y. 410, 199 N.E. 641 (1936); Kronenberg v. Sullivan County Steam Laundry Co., 91 N.Y.S.2d 144 (Sup. Ct. 1949); Matter of Seymour Grean & Co., 274 App. Div. 279, 82 N.Y.S.2d 787 (1st Dep't 1948); Baran v. Baran, *supra* note 13. *Contra,* Borland v. Sass Printing Co., 95 Colo. 53, 32 P.2d 827 (1934);

holders requiring unanimity or near unanimity for any action at stockholders' meetings have been upheld,[15] though there are decisions to the contrary.[16] The dividing line seems to be controlled by the extent to which the arrangement among stockholders invades what the courts regard as the area of business management — the domain of the director.[17] In addition to pooling agreements, irrevocable proxies and voting trusts may also be used to confer some measure of control on a minority stock interest.

There are two levels to consider in connection with attempts to confer some control on a minority stock interest: some types of corporate action depend on votes of stockholders; others depend on votes of directors. The objective is to establish veto rights at each level so that minority stockholders may exercise partnership-like control. While veto power at the stockholder level alone would accomplish the end desired as to control over election of directors and adoption of fundamental changes, it alone is not enough to protect the minority stockholder in a Gator-Growl Corporation. The same can be said for veto power only at the director level. If that is the only place it is present, it would not help very much if the stockholder concerned could not be assured of election to the board of directors or could not block a damaging amendment of the certificate or bylaws. Conversely, it would help very little to be assured of election to the board of directors while at the same time being outvoted on the board by a simple majority of directors, perhaps even being removed as an officer-executive by a majority of directors. Growl, the majority stockholder, could make Gator's position untenable by majority voting control at either level.

What is needed at the stockholder level is assurance that each stockholder will be elected a director and that each will have the

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Lothrop v. Gowdeau, 142 La. 342, 76 So. 794 (1917); McQuade v. Stoneham, 263 N.Y. 323, 189 N.E. 234 (1934); Creed v. Copps, 103 Vt. 164, 152 Atl. 369 (1930). By contrast, agreements among less than all of the stockholders relating to the employment of one or more of them by the corporation have frequently been held to be unenforceable. Haldeman v. Haldeman, 176 Ky. 635, 197 S.W. 376 (1917); Bond v. Graf, 163 Ore. 264, 96 P.2d 1091 (1939); Scripps v. Sweeney, 160 Mich. 148, 125 N.W. 72 (1910); Funkhouser v. Capps, 174 S.W. 897 (Tex. Civ. App. 1915).

[15]Katcher v. Ohsman, 26 N.J. Super. 28, 97 A.2d 180 (Ch. 1953).

[16]Benintendi v. Kenton Hotel, Inc., 294 N.Y. 112, 60 N.E.2d 829 (1945).

[17]Bator v. United Sausage Co., 138 Conn. 18, 81 A.2d 442 (1951). Differing results in cases of this type involving similar facts may often be explained by the difference in the business corporation acts of different states. For this reason, a comparative study of the cases alone is not very helpful.

power to prevent any amendment to the charter or bylaws which would interfere with that right. This latter includes the power to prevent the issuance of additional shares in a manner which would dilute a minority stockholder's voting position. Sufficient control at the stockholder level to assure election to the board of directors might be gained in many states, including Florida, by provisions for cumulative voting in the charter.[18] It is not clear at the present time what the status of general unanimity or high voting requirements at stockholders' meetings is in Florida, though they are apparently not authorized for the election of directors.[19] The Business Corporation Act does not expressly cover the matter, and there are no significant cases. It seems clear that high quorum requirements for stockholders' meetings are permissible in Florida,[20] but this is not as effective as some device that will affirmatively assure each stockholder of being elected to the board.[21] Stockholders' agreements,[22] voting trusts,[23] and

[18]FLA. STAT. §608.03 (2) (j) (1957) authorizes provisions to be inserted in the articles relating to cumulative voting for directors.

[19]FLA. STAT. §608.08 (1) (1957): "The directors of every corporation shall be chosen . . . by a *plurality* of the votes cast at such election." (Emphasis added.) It was because of such a provision in the New York Stock Corporation Law that a unanimity provision for the election of directors was held invalid in Benintendi v. Kenton Hotel, Inc., *supra* note 16. It may be very significant that this legislative command is not modified by the familiar "unless the certificate of incorporation provides otherwise." The situation is different when stockholder approval of fundamental changes is involved, high voting requirments being expressly authorized: FLA. STAT. §608.18 (1) (1957) (charter amendment), §608.19 (1) (sale of assets), §608.20 (2) (consolidation and merger), §608.27 (1) (voluntary dissolution). The Florida Business Corporation Act has no voting provisions relating to the adoption by stockholders of bylaws or ordinary resolutions.

[20]FLA. STAT. §608.10 (4) (1957): "A majority of the stock entitled to vote shall constitute a quorum at any stockholders' meeting unless the certificate of incorporation or by-laws otherwise provide." A bylaw establishing a high quorum requirement for stockholder action was held void in Gentry-Futch Co. v. Gentry, 90 Fla. 595, 106 So. 473 (1925), but the applicable section of the Florida Business Corporation Act at that time did not contain the last nine words just quoted. FLA. REV. GEN. STAT. §4082 (1920).

[21]A high quorum requirement for holding a stockholders' meeting may enable a minority stockholder to block the holding of a meeting, but this would be helpful to him only if he was already on the board of directors; the inability to hold a meeting would mean that the old directors would hold over, since no successors could be elected. See O'Neal, *Giving Shareholders Power to Veto Corporate Decisions: Use of Special Charter and By-Law Provisions*, 18 LAW & CONTEMP. PROB. 451, 464 (1953).

[22]Katcher v. Ohsman, 26 N.J. Super. 28, 97 A.2d 180 (Ch. 1953).

[23]FLA. STAT. §608.43 (1957).

class voting[24] have been used to establish some degree of minority control at the stockholder level. In Florida, however, no device is as completely clean, uncomplicated, and legally certain as cumulative voting, which can enable each substantial stockholder to elect himself to the board of directors even though he is a minority stockholder.[25] Actually, such a stockholder will not care a great deal about a general veto power which may permit him to keep some other stockholder from being elected to the board as long as he has the veto power over fundamental changes, which it is apparently possible to confer in Florida.[26]

Another important and related matter is the power of stockholders to remove directors. If directors can be removed without cause by the stockholders, this will be a consideration causing a minority stockholder to insist on the unanimity or veto type of control in each stockholder as opposed to a cumulative voting right.

The conclusion is that there are several devices for providing some type of minority control at the stockholder level if the diligent attorney wishes to find and utilize them. Much can be said, of course, for statutes such as some states have enacted that expressly authorize high voting requirements.[27] The Model Business Corporation Act of the American Bar Association authorizes charter clauses requiring a high vote for stockholder action.[28]

If a close corporation has a three-man board of directors and the

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[24]Shares can be classified so that each stockholder is allocated all the shares of a given class, each class being permitted to elect a specified number of directors. The Florida Business Corporation Act permits the classification of shares with respect to, *inter alia,* voting powers. FLA. STAT. §608.14 (1) (1957).

[25]If cumulative voting of shares can be coupled with a high vote or unanimity requirement for director action, this may give each stockholder a veto over action within the province of the board of directors. O'Neal, *Molding the Corporate Form to Particular Business Situations: Optional Charter Clauses,* 10 VAND. L. REV. 1, 33 (1956). *But see* note 37 *infra.*

[26]See note 19 *supra.*

[27]*E.g.,* DEL. CODE ANN. tit. 8, §102 (b) (4) (1953); ILL. ANN. STAT. c. 32, §157.146 (Smith-Hurd 1954); KY. REV. STAT. ANN. §271.315 (7) (1955); MD. ANN. CODE art. 23, §42 (a) (1957); MICH. STAT. ANN. §21.32 (Supp. 1957); MO. ANN. STAT. §351.270 (1952); NEB. REV. STAT. §21-137 (1954); N.Y. STOCK CORP. LAW §9; N.C. GEN. STAT. §55-66 (b) (Supp. 1957); OHIO REV. CODE ANN. §1701.52 (Page Supp. 1958); TEX. BUS. CORP. ACT ANN. art. 9.08 (1956); VA. CODE ANN. §13.1-33 (1950); W. VA. CODE ANN. §3018 (j) (1955). N.D., Kans., Ore., and Utah also have such statutes. See O'Neal, *Recent Legislation Affecting Close Corporations,* 23 LAW & CONTEMP. PROB. 341 (1958).

[28]ABA-ALI MODEL BUS. CORP. ACT §136 (1953).

minority stockholder who desires some control owns less than one fourth of the shares plus one,[29] cumulative voting may not offer a solution. Such a stockholder would not own enough stock to be assured of a seat on the board of directors even with cumulative voting. This could be solved by providing for a larger board, but if there are only two stockholders this would mean bringing in even more dummy directors, which might make corporate action cumbersome as well as raise the problem of controlling the dummies. The best solution in this situation might be to have a three-man board of directors and three classes of stock, the certificate of incorporation providing that each class elect one director.[30] The stockholder with less than a one-fourth interest could be issued all the shares of one class. There are doubtless other ways to accomplish this with little risk as to validity.

One other device, already mentioned, for creating some minority stockholder control over the election of directors is a high voting requirement for stockholder action. There could be a charter provision or bylaw requiring unanimity or a ninety per cent vote of the outstanding shares in order to elect directors, which would give a holder of twenty per cent of the shares veto power at the stockholder level. There could then be no election of directors unless all such stockholders agreed. Couple this with a bylaw providing that all directors shall continue in office until their successors are elected. Then, if all the stockholders are named to the initial board of directors contained in the articles,[31] each stockholder will be assured of a seat on the board. The danger of this solution is that the Florida Business Corporation Act has a section covering the election of directors that is similar to a New York statute that resulted in this type of arrangement being held invalid there.[32]

Pre-emptive rights are an important consideration in the close corporation.[33] If new shares can be issued without according pre-

[29]Or a board of five, and the minority stockholder owns less than one sixth of the shares plus one; or a board of seven, and the minority stockholder owns less than one eighth of the shares plus one, etc.

[30]See note 24 *supra*.

[31]FLA. STAT. §608.03 (2) (h) (1957): "The articles of incorporation shall contain . . . the names and post office addresses of the members of the first board of directors, who, unless otherwise provided by the articles of incorporation or the bylaws, shall hold office for the first year of existence of the corporation or until their successors are elected or appointed and have qualified."

[32]See note 19 *supra*.

[33]O'Neal, *Molding the Corporate Form to Particular Business Situation: Op-*

emptive rights, it may be possible to change voting positions adversely to some stockholder. This consideration is not peculiar to close corporations; it is more important in such a context as a practical matter, however, because there are more compelling reasons for maintaining voting positions in the close corporation. Though the certificate of incorporation may provide otherwise, the Florida Business Corporation Act has a provision for pre-emptive rights[34] that is relatively weak.[35] The astute attorney may be prompted to draft a certificate provision for the close corporation providing stronger pre-emptive rights, though if a veto power to each stockholder and director is successfully conferred, of course this alone will make it possible for any stockholder who fears dilution of his voting position to block any new issues of stock.

Minority stockholder veto power over fundamental changes is quite common at the present time. This is because stockholder participation in charter amendments, consolidations, mergers, and voluntary dissolution is usually prescribed by statutory requirements for a favorable vote, approval, or consent of stockholders. If the certificate of incorporation can provide for a high voting requirement, a veto over such changes can be effectively conferred. Many business corporation acts, including that of Florida, permit the certificate to require greater than a majority vote of stockholders on proposals for such organic changes.[36]

Perhaps the simplest device for providing partner-like control in a close corporation is to renounce completely the corporate way of doing business by requiring unanimity, or voting requirements so high as to approach unanimity, for action by stockholders and directors. The difficulty here is that the judicial attitude has not been favorable toward attempts to modify the corporate norm of control by majority action of a board of directors.[37] Courts have indicated

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tional Charter Clauses, 10 VAND. L. REV. 1, 41-42 (1956).

[34]FLA. STAT. §608.42 (2) (1957): *"Unless otherwise provided by the certificate of incorporation,* every stockholder, upon the *sale for cash* of any *new* stock of the *same kind, class or series as that which he already holds,* shall have the right to purchase his pro rata share thereof . . . ." (Emphasis added.)

[35]Trau, *supra* note 8, at 72-74. The word *new* in FLA. STAT. §608.42 (2) (1957) apparently refers not only to newly authorized stock but also to previously authorized but newly issued stock, a strong position on a point much in dispute elsewhere. Rowland v. Times Publishing Co., 160 Fla. 465, 35 So.2d 399 (1948).

[36]See note 19 *supra.*

[37]*E.g.,* Finn Bondholders, Inc. v. Dukes, 157 Fla. 642, 26 So.2d 802 (1946) (*semble*); Jackson v. Hooper, 76 N.J. Eq. 592, 75 Atl. 568 (Ct. Err. & App. 1910);

that such requirements are against public policy,[38] so their validity would be doubtful even in the absence of the common provision in business corporation acts providing for the business of every corporation to be managed by a board of directors. Some modification of the corporate norms will be tolerated but not complete renunciation. There is no real reason, however, why stockholders in a closely held corporation should not be allowed to control each other as partners do in so far as internal decisions are concerned. No one is affected except the stockholders; if they all agree to it, it should be of no concern to the public or the state, but courts have said that stockholders cannot be partners *inter sese* and a corporation to the rest of the world.[39] There is a tinge of logic and righteousness about such a statement, but is there any substantial public interest involved? Why cannot two stockholders be partners, in a sense, as between themselves by agreement and a suitably implementing certificate of incorporation and bylaws? If creditors, the general public, and the state are not adversely affected, there is nothing about such an arrangement which can be described as immoral, indecent, or against public policy.[40]

It might be argued that limited liability has been granted to corporations to enable them to attract capital from the public and that, since the participants in a close corporation do not desire to attract capital from the public, it follows that there is no consideration of public policy that favors permitting them to attain limited liability by adopting the corporate form. The best answer to that argument is that the mechanics of representative government in the corporation, which the close corporation stockholders wish to avoid, have nothing to do with limited liability. Those persons outside the corporation who might run some greater risk because of the presence of limited liability are not protected by the observance of management by majority rule in the corporation. Creditors are not protected be-

Long Park, Inc. v. Trenton-New Brunswick Theatres Co., 297 N.Y. 174, 77 N.E.2d 633 (1948); Benintendi v. Kenton Hotel, Inc., 294 N.Y. 112, 60 N.E.2d 829 (1945); Kaplan v. Block, 183 Va. 327, 31 S.E.2d 893 (1944). *Contra,* DeBoy v. Harris, 207 Md. 212, 113 A.2d 903 (1954); Roland Park Shopping Center v. Hendler, 206 Md. 10, 109 A.2d 753 (1954); Katcher v. Ohsman, 26 N.J. Super. 28, 97 A.2d 180 (Ch. 1953) (apparently rejecting for New Jersey the approach of what was long the leading case on the point, Jackson v. Hooper, *supra*).

[38]Benintendi v. Kenton Hotel, Inc., *supra* note 37; Kaplan v. Block, *supra* note 37.

[39]Jackson v. Hooper, 76 N.J. Eq. 592, 598, 75 Atl. 568, 571 (Ch. 1910).

[40]Latty, *The Close Corporation and the North Carolina Business Corporation Act,* 34 N.C.L. REV. 432 (1956).

cause the principle of majority rule has no creditor-protection significance. Creditor protection is afforded by provisions restricting dividend declaration, capital impairment, and fraudulent transfers, none of which would be affected by permitting close corporations to dispense with majority rule at meetings of stockholders and directors. The public is not affected, since, when it is dealing with the close corporation, it is protected by doctrines of estoppel and apparent authority, which are not controlled by these internal arrangements among the stockholders.

There is no possible way in which the state could be affected by permitting the union of limited liability and partnership characteristics in the close corporation. The argument that the state has an interest in the success of business enterprises cuts as convincingly on one side as the other, for majority rule does not assure business success any more than minority veto power. When such a close corporation arrangement for minority veto control is held invalid, the only effect is to replace the arrangements freely agreed upon by the stockholders with a dictatorship of the majority stockholder or stockholders. There are no convincing policy considerations that justify imposing majority rule in a close corporation if a contractual arrangement to the contrary has been entered into by the participants, especially when majority rule can so easily degenerate into majority dictatorship, which may mean the utter ruin of the minority participants who contracted specifically against such a development. Or, to express it another way, what is gained by the state or society in general by insisting that, as the price for limited liability, incorporators must subject themselves to the principle of majority rule even though such control can culminate so disastrously for one or more of them when the "honeymoon" period is over?[41]

To illustrate, if Growl owns more than fifty per cent of the shares and Gator is not permitted to stipulate for some form of minority control, Gator can be completely excluded from the corporation except as a minority stockholder. With his livelihood depending upon his employment by the corporation, he cannot risk putting it in the power of Growl to discharge him. If Gator has a favorable bargaining position so that Growl will agree to some type of minority control arrangement for Gator's protection, it is difficult to discern anything wrong with their grafting it on the

[41] *Id.* at 435; Hornstein, *Stockholders' Agreements in the Closely Held Corporation*, 59 YALE L.J. 1040, 1046 (1950).

corporation. Some will argue that if the described situation exists, then Gator and Growl ought to do business as a partnership. They desire limited liability, however, and why should subjection to majority rule be the price of limited liability? There seems to be no substantial, logical connection. It is like requiring by law that one must join a country club in order to get married. Several states have enacted legislation to legalize such high vote or high quorum arrangements.[42] The Model Business Corporation Act of the American Bar Association authorizes high voting and high quorum arrangements at the director level.[43]

High vote and high quorum requirements for meetings of stockholders and directors are not entirely effective if they can be modified or abolished by a mere majority vote of directors and stockholders. So if high voting and high quorum requirements are provided in the certificate of incorporation, it should also contain similar high voting requirements for any such amendments of the certificate.[44]

Under the Florida Business Corporation Act a high quorum can be established for stockholder's meetings,[45] but the directors must be elected at such a meeting by a plurality of the votes cast.[46] The section covering quorum requirements for directors' meetings is not clear as to whether a high quorum can be required by the certificate or bylaws;[47] and the section on voting at directors' meetings[48] is very

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[42]Note 27 *supra* deals with state business corporation acts that expressly authorize high voting arrangements for stockholder action. Some states have gone even further and authorized high voting or other minority control arrangements for action by boards of directors: *e.g.*, ILL. ANN. STAT. c. 32, §157.37 (Smith-Hurd Supp. 1958); MD. ANN. CODE *art.* 23, §56 (d) (1957); N.Y. STOCK CORP. LAW §9; N.C. GEN. STAT. §55-28 (d) (Supp. 1957); OHIO REV. CODE ANN. §1701.62 (Page Supp. 1958); WIS. STAT. ANN. §180.35 (1957).

[43]ABA-ALI MODEL. BUS. CORP. ACT §37 (1953).

[44]While a high stockholder vote may be required by the certificate for amendment of a certificate of incorporation of a Florida corporation, FLA. STAT. §608.18 (1) (1957), there is no similar provision authorizing a high vote requirement applicable to director action proposing an amendment of the certificate.

[45]FLA. STAT. §608.10 (4) (1957).

[46]*Id.* §608.08 (1).

[47]*Id.* §608.09 (1): "Unless the certificate of incorporation or by-laws provide otherwise, the presence of a majority of all the directors shall be necessary at any meeting to constitute a quorum to transact business . . . ." Could this be subject to the construction that the certificate or bylaws may provide that less than a majority of directors may constitute a quorum, but not that more than a majority shall be necessary?

[48]FLA. STAT. §608.09 (1) (1957): "The act of a majority of directors present at

similar to statutes which have been construed to prohibit high voting or unanimity requirements in other states.[49] It is quite possible that a result similar to that of *Benintendi v. Kenton Hotel*[50] would be reached under the Florida Business Corporation Act. Some amendments to that act are needed to remove legal doubts which hover over close corporations that have minority participants protected from arbitrary majority rule by high vote charter clauses or similar arrangements.

It is difficult to find any convincing reason why legally competent persons should not be able to adapt the corporate business form provided in general business corporation acts to the structure that they want and need, as long as they do not endanger other stockholders, creditors, or the public. Since courts are reluctant to admit that incorporated partners can arrange such matters between them, the best solution seems to be legislation to legitimate this bastard of the business world. As stated previously, several states already have such legislation.[51]

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a meeting where a quorum is present shall be the act of the board of directors . . . ."

[49]See note 37 *supra*. An old Florida case contains a dictum indicating that a bylaw requiring a vote of two thirds of the directors to remove an officer was valid and enforceable. Stockton v. Harmon, 32 Fla. 312, 13 So. 833 (1893).

[50]294 N.Y. 112, 60 N.E.2d 829 (1945). This case concerned a two-man corporation. *B* owned less stock than *D*. In order to give *B* a check on majority stockholder *D*, bylaws were adopted that required unanimity for (1) all stockholders' resolutions, (2) election of directors, and (3) all directors' action. Unanimity for stockholders' resolutions was held to violate the statutory scheme of corporate management provided by the New York Stock Corporation Law. Unanimity for election of directors was held to violate a section (in almost the same words as FLA. STAT. §608.08(1) (1957) of the New York General Corporation Law which provided that directors be chosen "by a plurality of the votes at such election." The bylaw requiring unanimity for action by directors was stated to be "utterly inconsistent" with the common law rule and thus unenforceable, despite the fact that the applicable section of the New York General Corporation Law providing for majority rule at meetings of directors contained a typical "except when otherwise expressly required by law or the by-laws" clause. Florida's parallel, FLA. STAT. §608.09(1) (1957), contains no such "unless otherwise provided" clause. Thus the provision of the Florida act governing action by directors seems to call more peremptorily for the *Benintendi* treatment of such a bylaw or charter provision than did the New York act at the time the *Benintendi* case was decided. On the other hand, the broadly worded authorization of optional charter clauses found in *id.* §603.03(j) might support such a charter provision, and *id.* §608-13(5) might do the same for such a bylaw. O'Neal, *Recent Legislation Affecting Close Corporations*, 23 LAW & CONTEMP. PROB. 341, 344-45 (1958).

[51]See notes 27, 42 *supra*.

A provision in the Business Corporation Act such as the following might help to create a favorable judicial attitude:[52]

> 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.

This is designed to provide business and the bar with a legal framework in which partnership arrangements having any reasonable business purpose can be fashioned within the corporate form with a substantial assurance of validity.[53] It will be noted that the suggested section does not define the term *close corporation* but that the absence of general trading in its shares in the securities markets is the test of applicability. The shares of the close corporation are not often the subject of general trading. If they are, it will not long be a close corporation by any recognized definition of the concept. As a matter of fact, transfer restrictions usually make general trading in such shares impossible.

The draftsman can provide for transfer restrictions when he is drawing up the incorporation papers for a close corporation, thereby insuring the application of the suggested language. It is significant that the "generally traded" test would have given no trouble in most

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[52]See N.C. GEN. STAT. §55-73 (b) (Supp. 1957).

[53]"Many of the successful attacks on control arrangements departing from the orthodox pattern of corporation management have been based on the argument that such arrangements violate the statutory norm conferring on the board of directors power to manage corporate affairs. The North Carolina statute precludes that ground of attack." O'Neal, *Recent Legislation Affecting Close Corporations*, 23 LAW & CONTEMP. PROB. 341, 350 (1958).

of the cases involving the validity of partner-like arrangements within close corporations.[54]

In order to make it even clearer that the public policy of Florida is not hostile to close corporations of the type desired by Gator and Growl, section 608.09 (1) of Florida Statutes 1957 should be amended so that the first sentence will read as follows: *"Subject to the provisions of the certificate, the by-laws, or an agreement between the stockholders otherwise lawful,* the business of every corporation shall be managed and its corporate powers exercised by a board of not less than three directors."[55] This would help eradicate the idea that there is a sphere of jurisdiction for directors into which stockholders cannot venture even though they are the owners and unanimous in their desire to limit the power of the board of directors.

In order to remove any lingering doubts, it would be well to amend section 608.9 (1) with respect to action of directors so that "the act of a majority of directors present at a meeting where a quorum is present shall be the act of the board of directors, *unless the act of a greater number is required by the charter or the by-laws.*"[56] Also, in regard to stockholders' action, section 608.10 should be amended to make it clear that the certificate or bylaws may require the concurrence of a greater proportion of the votes than a simple majority of the shares represented at a meeting. Similarly, though not as critically needed, quorum requirements for meetings of directors could more clearly permit the charter or bylaws to require a "greater number than a majority."

It might be argued that veto power or some other form of control in a minority of stockholders is subject to abuse, but the answer is that the voting powers of the majority can also be abused in a close corporation, especially if the owners have unanimously agreed to dispense with orthodox majority control. The promised protection of such an agreement may have lured some of the minority stockholders into the enterprise. In a typical close corporation, in which each participant except a majority stockholder needs such protection, it seems that it should be made legally available if there is no majority share interest that is opposed. If a majority interest is opposed, there will be no question of the legality of such an arrangement, for there will never be one. Indeed, unanimous agreement of the par-

[54]Latty, *The Close Corporation and the North Carolina Business Corporation Act,* 34 N.C.L. REV. 432 (1956).

[55]The suggested new language is in italics.

[56]The suggested new language is in italics.

ticipants should be required for the imposition of such a departure from the normal corporate pattern.

Nearly three quarters of the states have a statutory declaration like that of Florida[57] providing that the business of every corporation shall be managed by a board of directors. In contrast to early decisions that held almost any type of stockholders' arrangement seeking to modify management by the board of directors to be void, either because in conflict with a statutory norm or because inconsistent with the general plan for corporate management provided by the legislature, recent cases disclose a tendency to permit some infringement upon the principle of management by a centralized board even in the absence of legislative change.[58]

For the minority stockholder who is concerned about his employment by the corporation, a long-term employment contract with the corporation may not suffice because the power of removal may be available in spite of the contract, damages for the breach of which would hardly be adequate in view of the application of the doctrine of avoidable consequences to employment contracts. Also, some decisions have held long-term contracts to usurp the functions of the board of directors. It follows that he needs a general veto power on the board of directors, so that the corporation cannot intentionally breach by discharging him. The agreement among all the participants that Gator is to be the president or general manager will then mean something.[59] Some states permit election of officers by the stockholders, and this might be a solution to the problem of tenure of the minority stockholder as an officer without infringing on the area of discretion reserved for directors. The Florida act, however, provides for officers to be elected by the board of directors,[60] and this eliminates such a possibility here in the absence of an amendment to the act.

Should there be legislation to remove the uncertainties which affect the legal status of the close corporation, some limitation in order to keep the stockholders of a publicly-held corporation from using such a device might be considered. It is not believed that use by such a corporation is very likely, however, because of the difficulty of obtaining underwriting for stock issues when such partnership-

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[57]FLA. STAT. §608.09 (1) (1957).

[58]See Hornstein, *Judicial Tolerance of the Incorporated Partnership*, 18 LAW & CONTEMP. PROB. 435, 443 (1953).

[59]See The Business Lawyer, Nov. 1954, pp. 34-35.

[60]FLA. STAT. §608.40 (1957).

type arrangements have been made. Yet the gradual evolution from proprietorship to partnership to close corporation to publicly-held corporation will reach a point where the partner-like control arrangement and the need for public financing cannot be reconciled. Stock cannot be marketed or generally traded if subject to all sorts of side agreements, bylaws, and charter provisions, varying the usual corporate pattern. This would destroy the ease with which such shares are now traded. The publicly financed corporation cannot wear close corporation garb with any more aplomb than the close corporation that tries to fit into the publicly-held corporation uniform. There is no place for Procrusteanism here.

One of the best arguments for permitting close corporations to have minority control arrangement is that the same objective can be attained by using other devices. For example, the principle of majority control by those contributing the most capital can be nullified by giving voting shares to some stockholders and nonvoting shares to others,[61] or by use of multiple voting shares allocated to achieve the same purpose.[62] It can also be done with a voting trust.[63] What kind of magic is there in these particular devices? It might even be legally possible to form an orthodox partnership and then have the partnership acquire all the stock of the corporation. With the partnership controlling the corporation, the unwanted corporate norms could be jettisoned.[64] If these devices are available, why not instead let the partners incorporate and then graft their partnership arrangement upon the corporation? To forthrightly provide for this halfway house in the statutes would be less devious and not give such an advantage to the cunning and the clever.

Stock Transfer Restrictions

Another major purpose of stockholders in a close corporation is to remain closed; they desire to have some control over the selection of new associates on the death or withdrawal of the present stockholder-participants. This purpose may spring from their desire to protect themselves against having to deal with uncongenial, untalented, or downright hostile "partners." It may arise because of

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[61] *Id.* §608.14 (1).

[62] *Ibid.; id.* §608.10 (3).

[63] *Id.* §608.43.

[64] La Varre v. Hall, 42 F.2d 65 (5th Cir. 1930); DeBoy v. Harris, 207 Md. 212, 113 A.2d 903 (1955).

the danger of predatory competitors buying into the corporation. The stockholder-officers of the close corporation are as much concerned with the identity of their associates as are partners and hence are likely to make arrangements to restrict shareholdings to acceptable persons. While some of the old cases held that all restrictions on transfer of shares were illegal restraints on alienation, the present weight of authority favors permitting reasonable restrictions, especially if they are provided for in the certificate of incorporation.[65]

There are three basic types of stock transfer restrictions: (1) the purchase option in favor of the corporation, which is the most widely used type of restriction; (2) a consent restraint, in which the stockholder must obtain the consent of someone before he can dispose of his stock; and (3) the buy-and-sell agreement, in which the surviving stockholders agree to buy the stock of a stockholder when he dies.

A number of courts, however tolerant they must be of a first refusal type of restriction, will not recognize a consent type on the ground that this puts the transfer of one man's property at the mercy of another man's veto, which may be exercised arbitrarily.[66] There is a sharp division among the courts over the validity of this second type of transfer restriction, which requires directors or stockholders to approve before shares can be transferred.[67] As a practical matter, a first refusal restraint on the sale by a stockholder and a right to purchase in case of transfer by operation of law may be all that the incorporated partners really need. This type of stock transfer restriction has been held valid in Florida.[68] The Florida Supreme Court relied on two sections of the Business Corporation Act, one of them having been changed somewhat since that case.[69] The other section,

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[65]*E.g.*, Lawson v. Household Finance Corp., 17 Del. Ch. 343, 152 Atl. 723 (Sup. Ct. 1930); Weissman v. Lincoln Corp., 76 So.2d 478 (Fla. 1954); Allen v. Biltmore Tissue Corp., 2 N.Y.2d 534, 141 N.E.2d 812 (1957); see Annot., 2 A.L.R.2d 745 (1948); Note, 10 U. FLA. L. REV. 54 (1957). The older judicial attitude probably survives in the rule of strict construction applied to restrictions on transfer of shares even in the most recent cases.

[66]BALLANTINE, CORPORATIONS 778 (1946); Latty, *supra* note 40, at 450-51.

[67]A consent restraint type of transfer restriction was present in Weissman v. Lincoln Corp., *supra* note 65, but it was not in issue and its validity was not determined. Note, 10 U. FLA. L. REV. 54, 59 (1957).

[68]Weissman v. Lincoln Corp., *supra* note 65, 8 U. FLA. L. REV. 321 (1955).

[69]FLA. STAT. §610.03 (6) (1951) provided that "every corporation . . . shall have power to . . . make . . . by-laws . . . for . . . the transfer of its stock . . . ." FLA. STAT. §608.13 (5) (1957), which succeeds this section, reads substantially the same except that the last phrase is "the transfer *on its records* of its stock . . . ." (Em-

remaining unchanged, is 608.03 (2) (j) of Florida Statutes 1957.[70]

There are no statutory provisions relating to transfer restrictions on stock in close corporations as distinguished from business corporations generally.[71] Cases indicate that transfer restrictions contained in the certificate are a better risk than those contained in the bylaws.[72] It may be argued that this is because of the lack of notice of the bylaws as distinguished from the constructive notice of the certificate, but this is not convincing in view of the fact that purchasers without notice of the restriction can rely on the Uniform Stock Transfer Act provision[73] requiring the restriction to be stated on the share certificate in order to be effective.[74] The careful lawyer will put transfer restrictions in the certificate, and perhaps in the bylaws and agreement as well.

The first refusal type of transfer restrictions should be made in favor of the corporation first and the stockholders next.[75] In this way, a possible difficulty might be avoided in a situation in which

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phasis added.) The amendment came in 1953. Fla. Laws 1953, c. 28170, §1. See Note, 10 U. FLA. L. REV. 54, 56-57 (1957).

[70]"The articles of incorporation shall contain:

". . . .

" (j) Any provision which the incorporators may choose to insert for the regulation of the business and for the conduct of the affairs of the corporation and any provision creating, dividing, limiting and regulating the powers of the corporation, the directors and the stockholders or any class of the stockholders, including, but not limited to, provision for cumulative voting for directors, a list of officers, and provisions governing the issuance of stock certificates to replace lost or destroyed certificates."

To banish any lingering doubt regarding the status of such a restriction in the certificate of a Florida corporation, it might be well to add to FLA. STAT. §608.03 (2) a clause to the effect that the charter may include "any provision relating to the transfer of the shares of the corporation and restrictions thereon."

[71]At least one state, however, has attempted to regulate by statute stock transfer restrictions in general. TEX. BUS. CORP. ACT art. 2.22 (Supp. 1958).

[72]See Hornstein, *Judicial Tolerance of the Incorporated Partnership*, 18 LAW & CONTEMP. PROB. 435, 447 (1953).

[73]§15.

[74]FLA. STAT. §614.17 (1957). The fact that restrictions on the transfer of shares are covered by this section is implied recognition of their validity, provided there is compliance with this section. The specific reference to transfer restrictions, "by virtue of any *by-laws* of such corporation, or otherwise" (emphasis added), is some indication that they may be contained in the bylaws of Florida corporations.

[75]O'Neal, *Restrictions on Transfer of Stock in Closely Held Corporations: Planning and Drafting*, 65 HARV. L. REV. 773, 794-95 (1952); Note, 10 U. FLA. L. REV. 54, 65-66 (1957).

the corporation either cannot purchase legally or does not have the resources to do so, and yet the remaining stockholders do not wish the stock involved to get into the hands of outsiders and are financially able to purchase it themselves.[76]

The courts will not enlarge transfer restrictions by implication, and so it is very important that the restriction clearly specify whether it applies to voluntary inter vivos transfers of the shares only, or also to gifts, testamentary dispositions, intestate succession, or other transfers by operation of law. Similarly, it should cover the matter of whether a transfer to existing stockholders or members of a stockholder's immediate family is within the restrictions.[77]

A serious problem in connection with transfer restrictions is that of arriving at the price at which the affected stock is to be sold. A method that has come into frequent use in recent years involves appraisal and arbitration. Such a transfer restriction specifies the manner in which the appraisers or arbitrators are to be selected and usually provides that if the arbitrators can agree on a price, that price shall be conclusive.[78]

The book value standard of evaluation is sometimes used instead of appraisal by arbitrators, though book value often has little relationship to the actual value of the shares. Since asset value is subject to some manipulation by the board of directors, it is possible that book value might be a poor test because the withdrawing stockholder might find book value maneuvered against his interest.[79]

In the absence of any express statutory prohibition or a restriction against such purchases in the certificate or bylaws, it is generally held that every corporation has the power in good faith to purchase its own stock if there is surplus sufficient to cover the purchase. The power to make such purchases if surplus is available is expressly con-

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[76]It might be well to provide that stockholders' rights to purchase are in proportion to their respective holdings. As a matter of fact, the first option type of restriction on transferability can be viewed as a sort of glorified pre-emptive right, with the corporation or its stockholders having the right to participate, not only in new issues but in *any* change in ownership of shares.

[77]Trau, *Florida's Corporate Code: Draftsmanship and Practice*, 12 U. MIAMI L. REV. 63, 69-72 (1957).

[78]Hornstein, *Stockholders' Agreements in the Closely-Held Corporation*, 59 YALE L.J. 1040, 1049-51 (1950); Trau, *supra* note 77, at 71.

[79]At best, book value is based on the historical accounting valuation of assets and thus usually ignores the going value of the business, good will, and appreciation in the value of assets.

ferred on Florida corporations.[80] The act should make it clear, however, that a corporation can exercise its rights to purchase shares pursuant to restrictions on transfer thereof even though there is no surplus to cover the purchase. Otherwise, a purchase the corporation desired to make might be prohibited and the transfer restriction nullified.[81]

Some time limit should be set in a first refusal type of transfer restriction within which the option must be exercised. This is often thirty days. After the expiration of this period the selling stockholder is free to sell his shares to whomever he pleases.

Courts tend to sustain a transfer restraint imposed when the corporation is first organized. The explanation is that the agreement to restrict transferability is part of the conditions under which the corporation was formed and the shares issued, and that free transferability was limited before the shares came into existence. This being true, it may be sound planning and drafting to have the restrictions stated in the preincorporation agreement as well as in the certificate.

In contrast to the first two types of transfer restrictions is the third type of restriction — the buy-and-sell agreement. Some sort of arrangement should be available in many close corporations whereby a withdrawing stockholder will have the right to have his shares purchased by someone. A mere restriction on sale does not necessarily imply an obligation on anyone to purchase. Since the shares in a close corporation are not easy to sell in many instances, it is often important that the withdrawing stockholder have assurance that he can get his interest out intact. As a practical matter, the remaining stockholders are usually the only prospective purchasers of stock in a closely held corporation. Unless protected by such an arrangement compelling the others in the corporation to purchase at a fair price, the withdrawing stockholder may have to sell for whatever is offered. The bid may be only a small fraction of what the stock is really worth. So the transfer restriction may go further and create a duty, rather than a mere option, for the corporation or remaining stockholders to purchase the shares of those withdrawing or dying.

As with the transfer restriction, some formula must be included

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[80]FLA. STAT. §608.13 (9) (b) (1957).

[81]Since to carry out such a purchase would amount to an illegal withdrawal of capital, participating directors might be liable under FLA. STAT. §608.54 (1957).

for determining the selling price. It is certainly easier to reach an agreement about the formula or price in advance than it is when buyer and seller bicker with keen interest in the result. Again, appraisal and arbitration or book value may be used to arrive at a price.

Since there is usually no readily available market for shares in a close corporation, it is very important that any agreement to purchase be specifically enforceable. Specific performance is often the only adequate remedy for the withdrawing stockholder or his survivors.[82]

Some provisions may also be included as to whether payment is to be in cash or over a period of years. To make sure the cash is available when wanted, life insurance policies are frequently purchased. In the event of default on the part of the corporation or the stockholders in executing a purchase agreement, the draftsman might consider providing for compulsory dissolution and liquidation.[83]

While it is not clear that Florida courts will recognize just any type of transfer restriction, it is very clear, even without a statutory change, that the popular first refusal type of transfer restriction is recognized. Presumably, this could be made in favor of the corporation, or the other stockholders, or both, in whatever sequence might be agreed upon. In view of *Weissman v. Lincoln Corporation*,[84] lawyers should include such restrictions in the certificate of incorporation of Florida corporations and, in view of section 614.17 of Florida Statutes 1957, on the stock certificate. As to this latter, however, the *Weissman* case held that the restriction does not have to be published verbatim on the share certificate; notice of the restriction and incorporation of it by reference to the minutes of the corporation sufficed in that case.[85] There is no reason to experiment with transfer

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[82]Trau, *supra* note 77, at 72.

[83]Cataldo, *Stock Transfer Restrictions and the Closed Corporation*, 37 VA. L. REV. 229 (1951).

[84]76 So.2d 478 (Fla. 1954). The restriction held valid in this case was actually contained in a stockholders' agreement, but the transferee had notice of the restriction prior to his purchase of the shares. Also, the certificate and bylaws provided that the stockholders could impose transfer restrictions on shares by agreement. The opinion by Sebring, J., was careful to note that the case did not deal with a restriction "contained in a by-law standing alone." *Id.* at 481. A first option contained only in an agreement was specifically enforced in favor of the optionee in Greenwood v. Rotfort, 158 Fla. 197, 28 So.2d 825 (1946).

[85]76 So.2d 478, 483-84. Not all courts have been so easily satisfied. Citizens' Bank v. Bank of Penfield, 24 Ga. App. 435, 101 S.E. 203 (1919); Chandler v. Blanke

restrictions in bylaws or agreements alone when some doubt exists as to their effectiveness, though there may be good reason to include them in all three: certificate, bylaws, and shareholders' agreement.[86]

It is fair to conclude that stock transfer restrictions do not breed such uncertainties, either in Florida or elsewhere, as do minority control arrangements. The judicial attitude toward stock transfer restrictions is in marked contrast to the judicial attitude toward arrangements for minority control. In spite of the policy in favor of free transferability, the courts are increasingly holding reasonable restrictions to be valid, although this norm of free transferability causes any restriction to be strictly construed in favor of transferability.

Provisions for Dissolution and Arbitration: Safeguards Against Deadlock

A very real crisis may develop when there is a serious disagreement among the participants in a close corporation. There is a simple solution in a partnership. When an impasse arises, a partner can usually bring about a judicial dissolution even though the partnership term has not expired.[87] If the courts will not decree dissolution of the partnership, a partner may breach the partnership agreement and dissolve if he is willing to run the risk of paying damages for his breach. It is clear that in a partnership even a junior partner has the power to break a deadlock by dissolution. The close corporation is particularly susceptible to deadlock because of the minority control arrangements, which may give a minority interest disproportionate voting power or even a veto power. It would be unwise to give such control to minority participants in a close corporation through statutory or judicial tolerance of high vote and high quorum requirements and other partner-like characteristics and yet, despite the increased danger of deadlocks, to provide no remedy for the cases of corporate paralysis thereby arising.

The difficulty surrounding deadlocks is one of the principal reasons given by the courts for invalidating minority control arrangements.[88] Probably implicit in such decisions are the objectives of

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Tea & Coffee Co., 183 Mo. App. 91, 165 S.W. 819 (1914).

[86]Note, 10 U. Fla. L. Rev. 54, 62-64 (1957).

[87]Uniform Partnership Act §32 (1) (d) (f).

[88]Kaplan v. Block, 183 Va. 327, 31 S.E.2d 893 (1944). The giving of veto powers to stockholders increases the chance of deadlocks and creates a need for a speedy means of resolving differences or for a satisfactory method of dissolving

protecting creditors and employees by insuring the continuance of the business and preventing some stockholders from exploiting others at dissolution sales. Yet the continuance of a corporation whose stockholders are willing to ruin it rather than agree is not a satisfactory solution either. Arbitration and sale of shares by one stockholder either to the other or to an outsider may not be possible; dissolution may be the best available solution. This is another area in which state business corporation acts drafted for the publicly held corporation have generally overlooked the problem of the close corporation.

There are several possibilities. First, the minority participant may, pursuant to the close corporation arrangement embodied in the certificate, bylaws, and side agreement, hold a guaranteed position in the corporation with a stipulated salary. Even so, he will probably have to go to court to enforce his rights, and the judicial attitude towards such close corporation arrangements has not always been helpful. At any rate, litigation is expensive. Second, a minority participant may try to sell his stock. This theoretical possibility is often a practical illusion. Minority stock in a close corporation has an uncertain market value, and sometimes none at all. Not only this, but the sale of stock may be restricted in such a manner as to give the corporation or the majority stock interest a first option to purchase at a favorable price. This leaves two remaining possible remedies: dissolution and arbitration.

In the publicly held corporation, friction cannot lead to deadlock. If a particular director makes trouble for the stockholders in control, he is simply not re-elected when his term expires. It is for this reason that most corporation acts in their dissolution provisions go no further than to set forth a procedure for voluntary dissolution, usually by the board of directors recommending dissolution followed by a favorable vote of stockholders. Both director and stockholder action will usually be by majority vote.[89] If minority control devices are in existence, this type of dissolution can be blocked by the minority, thus intensifying the deadlock. There are also involuntary dissolution provisions, of course, but these normally have no bearing on the problem of stalemate and deadlock.[90]

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the enterprise when corporate paralysis ensues. Israels, *The Sacred Cow of Corporate Existence: Problems of Deadlock and Dissolution*, 19 U. CHI. L. REV. 778 (1952).

[89]FLA. STAT. §608.27 (1) (1957). More than a majority vote of stockholders in favor of voluntary dissolution may be required by the certificate of incorporation or bylaws.

[90]FLA. STAT. §608.36 (1957). This section provides for involuntary dissolution

A court faced with a close corporation afflicted with a deadlock that would justify a partnership dissolution will usually hold that it lacks power to decree a dissolution except on statutory grounds.[91] There is authority to the contrary.[92] Florida has devised the unique remedy of decreeing the sale of the property of a close corporation paralyzed by deadlock and ordering the proceeds distributed among the stockholders according to interest, disregarding the corporate entity and the question of dissolution.[93] This solution has its appealing practical side, but something more certain than this discretionary dispensation by a court of equity may be desired by the business community. State business corporation acts have begun to include deadlock as one of the grounds for compulsory dissolution at the instance of less than a majority interest.[94] There is much variation in the language used in these statutes, but several of them clearly authorize dissolution when deadlock is brought about through the operation of minority control arrangements.

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as a penalty for failure to file the annual report required by *id.* §608.32 and for failure to pay the capital stock tax required by *id.* §608.33. The secretary of state initiates this type of dissolution, with the governor proclaiming the dissolution.

[91]Central Standard Life Ins. Co. v. Davis, 10 Ill. 2d 566, 141 N.E.2d 45 (1957); see Annot., 13 A.L.R.2d 1260 (1950); Latty, *The Close Corporation and the New North Carolina Business Corporation Act,* 34 N.C.L. REV. 432, 448 (1956). Such seems to be the Florida position: Jones v. Harvey, 82 So.2d 371 (Fla. 1955); Freedman v. Fox, 67 So.2d 692 (Fla. 1953); Hanes v. Watkins, 63 So.2d 625 (Fla. 1953); Finn Bondholders, Inc. v. Dukes, 157 Fla. 642, 26 So.2d 802 (1946) (*semble*); News-Journal Corp. v. Gore, 147 Fla. 217, 2 So.2d 741 (1941). See also Strong v. Broward County Kennel Club, Inc., 65 F. Supp. 407 (S.D. Fla. 1946); *In re* Hollywood Bond & Mortgage Co., 51 F.2d 255 (S.D. Fla. 1931). An exception is recognized when the corporation has practically discontinued all of its business, or is no longer capable of being made to carry out the corporate functions for which it was chartered. Mills Dev. Corp. v. Shipp & Head, Inc., 126 Fla. 490, 171 So. 533 (1937); Tampa Waterworks Co. v. Wood, 97 Fla. 493, 121 So. 789 (1929); Knight & Wall Co. v. Tampa Sand Lime Brick Co., 55 Fla. 728, 46 So. 285 (1908).

[92]Guaranty Laundry Co. v. Pulliam, 200 Okla. 185, 191 P.2d 975 (1948); BALLANTINE, CORPORATIONS 715 (1946); STEVENS, CORPORATIONS 956-58 (1949); Hornstein, *Stockholders' Agreements in the Closely Held Corporation,* 59 YALE L.J. 1040, 1046 (1950); Note, 36 TEXAS L. REV. 660 (1958).

[93]Kay v. Key West Dev. Co., 72 So.2d 786 (Fla. 1954); Wofford v. Wofford, 129 Fla. 445, 176 So. 499 (1937).

[94]*E.g.,* CAL. CORP. CODE §4651 (b)-(d) (1953); ILL. ANN. STAT. c. 32, §157.86 (a) (Smith-Hurd 1954); IND. ANN. STAT. §25-242 (6) (1948); MINN. STAT. §301.49 (4) (1957); MO. ANN. STAT. §351.485, 1 (1) (a) (1952); N.Y. GEN. CORP. LAW §103; N.C. GEN. STAT. §55-125 (a) (1) (2) (Supp. 1957); PA. STAT. ANN. tit. 15 §2852-1107 (A) (4) (1958); WIS. STAT. ANN. §180.771 (1) (a) (1957); ABA-ALI MODEL BUS. CORP. ACT

Florida has a provision in its Business Corporation Act making compulsory dissolution available in deadlock situations when opposing ownership interests are evenly divided.[95] Construed according to its plain meaning, this statutory language would seem to cover only the situation of a corporation deadlocked by an even split in stock ownership and an evenly divided board of directors. This does not cover the type of deadlock caused by minority control arrangements. It is doubtful, therefore, that it would be effective to break a deadlock other than in the narrow situation expressly described therein.[96]

What is needed is a provision that would give a court power to order dissolution and liquidation in an action brought by a stockholder when a deadlock among directors cannot be broken by vote of the stockholders. This may be the case not only in an evenly divided situation but also when deadlock is caused by high vote or unanimity arrangements embodied in the certificate or bylaws of a

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§90 (a) (1) (1953).

[95]FLA. STAT. §608.28 (1957): "When the total stock voting power is evenly divided into two independent ownerships or interests, and the number of directors is even and equally divided respecting the management of the corporation with one-half of the ownership favoring the course advocated by one-half of the directors, and the other half of the ownership favoring the course of the other half, or where the ownership is equally divided and the number of directors is uneven, but the two halves of the ownership are unable to agree on or elect successor directors and the old directors are holding over, the circuit court, sitting in chancery, may entertain a petition from any stockholder for involuntary dissolution of the corporation. If, after hearing thereon, the court finds that the division of ownership is equal and cannot be reconciled, he may appoint a receiver or trustee of the corporation, and enter an order that it be dissolved."

[96]"Most of the deadlock statutory provisions clearly cover a situation in which a board with an even number of members divides equally and the shareholders cannot resolve the deadlock by election of a new board because the shares are evenly divided between two shareholders or two factions. Some of the statutes, however, apparently do not authorize the dissolution of a corporation which is deadlocked because the charter or bylaws of the corporation require unanimity or a high vote [for] director or shareholder action and no faction can get the necessary vote; or, if they do authorize dissolution in such a situation, they do not permit a shareholder with relative small holdings to bring the petition." O'Neal, *Recent Legislation Affecting Close Corporations*, 23 LAW & CONTEMP. PROB. 341, 357 (1958). For other statutes limited substantially as that of Florida, see MASS. ANN. LAWS c. 155, §50 (1948); N.J. STAT. ANN. §14:13-15 (Supp. 1958). It is very significant that, in the absence of a broader statute, equitable relief for deadlock of a close corporation is available from a Florida court "under its broad equity powers without getting into the question of whether the corporate entity itself may be dissolved by decree of the court." Kay v. Key West Dev. Co., 72 So.2d 786, 789 (Fla. 1954).

close corporation. Under such a provision the court should be given the power to order dissolution and liquidation rather than required to order it. Whether it exercises the power should be determined by whether the situation calls for this extreme remedy. It is possible that the inability of a majority stockholder to muster enough votes to change the existing directorate may have been exactly what the minority stockholder sought to effect by the minority control arrangement in the charter or bylaws. It should follow that deadlock in electing new and different directors does not automatically call for dissolution and liquidation. A finding of irreparable injury to the corporation or its stockholders should be a requirement for such dissolution. Such a limitation on this type of dissolution finds support in the deadlock dissolution provisions of other states.[97]

Another solution for the corporate deadlock problem is to provide statutory authorization for the participants to make their own arrangement with respect to dissolution because of deadlock by providing in the certificate, bylaws, or agreement for those situations in which a stockholder is entitled to dissolution. In the absence of an authorizing statute there is doubt as to whether the courts would give effect to such a dissolution arrangement even if all the stockholders were parties to it.[98] It should be possible for Gator and Growl to work out an arrangement, if they so wish, by which a right to require dissolution and liquidation would be conferred on each of them upon the occurrence of certain events or conditions. For example, each participant could be given the right to require dissolution if he first offers his shares to the other stockholder at a specified price and the latter does not accept. Similarly, death or disability of a stockholder could be an event upon the occurrence of which the other stockholder or stockholders could obtain dissolution, but the most useful provision would be one giving each stockholder the right to compulsory dissolution in the event of a deadlock among directors that stockholders are not able to break. Such dissolution arrangements by agreement

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[97]See note 94 *supra*. Dissolution of a deadlocked corporation under such a statutory provision has been denied when it was operating profitably or the business was not seriously affected. *In re* Radom & Neidorff, Inc., 307 N.Y. 1, 119 N.E.2d 563 (1954); Application of Cantelmo, 275 App. Div. 231, 88 N.Y.S.2d 604 (1st Dep't 1949).

[98]Israels, *supra* note 88, at 792; Latty, *The Close Corporation and the New North Carolina Business Corporation Act*, 34 N.C.L. REV. 432, 449 (1956); O'Neal, *Recent Legislation Affecting Close Corporations*, 23 LAW & CONTEMP. PROB. 341, 354 (1958).

have been upheld in a few cases,[99] but there is no reason why the business corporation act of a state should not specifically authorize them, dispelling all doubt. Some states now have such provisions.[100]

A refinement in dealing with corporate deadlock would be to confer a statutory or contractual right upon the majority stockholder or stockholders to buy out a complaining minority stockholder who is seeking dissolution and liquidation. It would be necessary to establish some method for appraisal of shares if this plan were made a part of the Business Corporation Act. Some states have tried this.[101] The provision could specify that when a deadlock results from the operation of minority control arrangements the majority stock interest will have an option to purchase the minority stockholder's shares at a price determined by appraisal or in some fair manner.

Some may prefer a solution to corporate deadlock that preserves the corporation as a going concern rather than one that calls for its dissolution. Arbitration may offer such a solution. Not only does the arbitration device preserve the corporate existence, but it is clearly less expensive as a method for resolving paralyzing disputes among the participants in a close corporation than either litigation or dissolution. Also, it is quicker and attended with less publicity. The arbitration clause can be inserted in the preincorporation agreement and in the certificate, with the exact procedure, including a method for selecting the arbitrators, clearly specified.[102]

The usual arbitration clause will, of course, cover many more matters than the deadlock problem with which this article is concerned, but its possible utility in that connection is of great significance. Unfortunately, it is also shrouded in legal uncertainties. In the absence of statute, an agreement to arbitrate future disputes is unenforceable, revocable by a party thereto, and will not prevent a party from resorting to the courts.[103] These common law rules were based on the notion that an agreement to arbitrate future disputes had the

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[99]Wolf v. Arant, 88 Ga. App. 568, 77 S.E.2d 116 (1953); Leventhal v. Atlantic Finance Corp., 316 Mass. 194, 55 N.E.2d 20 (1944).

[100]*E.g.*, MASS. ANN. LAWS c. 156, §6(h) (1948); N.C. GEN. STAT. §55-125(a)(3) (Supp. 1957).

[101]CAL. CORP. CODE §§4658-59 (1947); CONN. GEN. STAT. §5228 (1949); W. VA. CODE ANN. §3093 (1955).

[102]2 O'NEAL, CLOSE CORPORATIONS §§9.22-.23 (1958); O'Neal, *Resolving Disputes in Closely Held Corporations: Intra-Institutional Arbitration*, 67 HARV. L. REV. 786, 819 (1956).

[103]Steinhardt v. Consolidated Grocery Co., 80 Fla. 531, 86 So. 431 (1920).

effect of depriving the courts of their jurisdiction.[104] The Florida arbitration statute was amended in 1957 to make it clear that written agreements to arbitrate future disputes are enforceable and irrevocable.[105]

There has been expressed by some courts, however, a specific judicial hostility to arbitration arrangements within the corporate context on the ground that they are inconsistent with the corporate norms provided by the business corporation act.[106] This type of objection may be encountered even in a state having an arbitration statute. Even so, there are some decisions favorable to the use of arbitration clauses to break deadlocks in close corporations.[107] Others are opposed on one ground or another.[108] There seems to be a definite feeling that the arbitration device will eventually be widely accepted as an alternative to compulsory dissolution in cases of corporate paralysis.[109] Objections have been raised to this prophecy on the grounds that arbitration of disputes in close corporations requires those who sought to keep the business away from outsiders to submit a crucial question to the decision of a stranger, and, further, that the assumption that those who are in a serious deadlock can be reconciled

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[104]2 O'NEAL, CLOSE CORPORATIONS §9.14 (1958); Sayre, *Development of Commercial Arbitration Law*, 37 YALE L.J. 595 (1928); Simpson, *Specific Enforcement of Arbitration Contracts*, 83 U. PA. L. REV. 160 (1934).

[105]FLA. STAT. §57.11 (1957): "Two or more parties may agree in writing to submit to arbitration any controversy existing between them at the time of the agreement, or they may include in a written contract a provision for the settlement by arbitration of any controversy thereafter arising between them relating to such contract or the failure or refusal to perform the whole or any part thereof. Such agreement or provision shall be valid, enforceable and irrevocable without regard to the justiciable character of the controversy; provided that this act shall not apply to any such agreement or provision to arbitrate in which it is stipulated that this law shall not apply or to any arbitration or award thereunder." Prior to the 1957 change it was felt that the Florida arbitration statute (originally enacted in 1828) did not apply to future disputes. See Yonge, *Arbitration of an Ordinary Civil Claim in Florida*, 6 U. FLA. L. REV. 157, 165 (1953).

[106]2 O'NEAL, CLOSE CORPORATIONS §9.15 (1958).

[107]Ringling v. Ringling Bros.-Barnum & Bailey Combined Shows, Inc., 29 Del. Ch. 318, 49 A.2d 603 (Ch. 1946), *modified*, 29 Del. Ch. 610, 53 A.2d 441 (Sup. Ct. 1947); Martocci v. Martocci, 42 N.Y.S.2d 222 (Sup. Ct.), *aff'd mem.*, 266 App. Div. 840, 43 N.Y.S.2d 516 (1st Dep't 1943).

[108]Application of Burkin, 1 N.Y.2d. 570, 136 N.E.2d 862 (1956), *reversing* 1 App. Div. 2d 665, 147 N.Y.S.2d 2 (1st Dep't 1955) (holding that the particular controversy was not arbitrable); Roberts v. Whitson, 188 S.W.2d 875 (Tex. Civ. App. 1945).

[109]The Business Lawyer, Nov. 1954, pp. 36-39.

by arbitration so that they will become co-operative is questionable.[110] However this may be, the availability of the arbitration device for breaking corporate deadlocks is clearer in Florida than in many states because of the recent legislative changes.

RELAXATION OF CORPORATE FORMALITIES

A close corporation such as that of Gator and Growl is very likely to conduct its business without observing those formalities of corporate life which are thought by many to be essential to the corporate way of doing business. The stockholders and directors are usually the same people, and it is quite common for them to fail to differentiate between what they do as stockholders and what they do as directors.[111] Also, many close corporations do not keep bylaws or minute books.

It is orthodox corporation law that neither stockholders nor directors can act except at duly called meetings.[112] Nevertheless, the courts often relax these traditional rules in order to sustain informal action taken by stockholders or directors in a close corporation. Florida has gone far in holding that decisions reached by all the stockholders and directors in an informal conference, without a valid meeting of either, bind the corporation and the participants.[113]

Along with this liberal judicial attitude, state legislatures are gradually relaxing the formal requirements for corporate meetings, and some modern corporation acts permit stockholders and directors to act informally by signing a written consent.[114] In order to clear

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[110]Scott, *The Close Corporation in Contemporary Business*, 13 BUS. LAW. 741, 754 (1958).

[111]1 O'NEAL, CLOSE CORPORATIONS §1.12 (1958).

[112]BALLENTINE, CORPORATIONS §170 (stockholders' meetings), §44 (directors' meetings) (1946).

[113]Patchen v. Robertson, 146 Fla. 138, 200 So. 400 (1941); Redstone v. Redstone Lumber & Supply Co., 101 Fla. 226, 133 So. 882 (1931); Sommers v. Apalachicola Northern R.R., 85 Fla. 9, 96 So. 151 (1922) (*semble*); South Florida Citrus Land Co. v. Waldin, 61 Fla. 766, 55 So. 862 (1911); Etheredge v. Barrow, 102 So.2d 660 (2d D.C.A. Fla. 1958). While the *Redstone* case seemed to depend on the doctrine of ratification by acquiescence, the *Etheredge* case did not mention it. Also, both cases indicated that failure of the board of directors to record their actions in the minutes did not reflect on the validity of the acts. In both of these cases all the stockholders and directors were present at the informal meetings.

[114]*E.g.*, DEL. CODE ANN. tit. 8, §228 (1953) (shareholders only); MINN. STAT. §§301.26(11), 301.28(7) (1957); N.C. GEN. STAT. §§55-29, 55-63 (Supp. 1957);

any lingering doubts concerning the validity of informal actions taken by the directors of a close corporation, it might be well to enact a new section of the Business Corporation Act that would treat as board action the action taken by a majority of the directors even without a formal meeting if either written consent to the action is signed by all directors and filed in the minute book, or if all the stockholders know of the action and make no prompt objection, or if the directors have, to the knowledge of all the stockholders, been accustomed to taking action informally. A similar section could be enacted to accord validity to stockholders' action without a meeting or at an irregular meeting. Florida already has something going much further than this in section 608.11 of Florida Statutes 1957, which provides that, unless otherwise provided in the certificate or bylaws,

> "[W]hen stockholders who hold four-fifths of the voting stock having the right and entitled to vote at any meeting shall be present at such meeting, however called or notified, and shall sign a written consent thereto on the record of the meeting, the acts of such meeting shall be as valid as if legally called and notified."

In connection with this section of the act, it might be well for the draftsman to "otherwise provide" in the certificate of incorporation in order to avoid the "freezing out" of some stockholder owning no more than one fifth of the voting stock in a close corporation.

The argument may be made that these statutory provisions are not needed because courts have been very understanding about departures from traditional formalities, particularly by close corporations. Nevertheless, it is certain that no harm would come from such provisions, and nothing in them should discourage a court from validating irregular corporate action under familiar doctrines of ratification by acquiscence or estoppel. The Attorney General of Florida has recently rendered an opinion disapproving a charter provision providing for informal action by agreement of all stockholders in

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PA. STAT. ANN. tit. 15, §2852-402(5) (1958); WIS. STAT. ANN. §180.91 (1957). Also see ABA-ALI MODEL BUS. CORP. ACT §138 (1953), which permits stockholders to act informally; Latty, *The Close Corporation and the New North Carolina Business Corporation Act,* 34 N.C.L. REV. 432, 453-54 (1956); O'Neal, *Recent Legislation Affecting Close Corporations,* 23 LAW & CONTEMP. PROB. 341 (1958).

writing.[115] Presumably, since this opinion was in reply to a question of the Secretary of State of Florida, charter provisions for informal action by shareholders or directors that do not observe the statutory formalities of chapter 608 will be disapproved if inserted in articles of incorporation, thus blocking by administrative action efforts to test them in the courts. Statutory sanction for such irregular action by close corporations would remove the threat of litigation in an area in which litigation has generally proved fruitless and would clarify the matter for those charged with accepting corporate documents for official filing.

Also, it might be well to note that section 608.09 (2) of Florida Statutes 1957 authorizes a board of directors to designate an executive committee composed of two or more of their number that may exercise the powers of the board of directors. This provision will permit considerable corporate business to be transacted without full, formal board action even in a publicly held corporation. That the legislative attitude toward legalizing informal action is favorable can be seen in an amendment enacted in 1957 authorizing informal charter amendment — without meetings of directors or stockholders — when all directors and stockholders sign a written statement manifesting their intention to amend the certificate.[116]

Conclusion

What basis is there for denying the limited liability of the corporate form to "partners" who desire to enjoy that and other corporate attributes but, for very practical reasons, cannot risk complete divestment of the partnership arrangement? It might be argued that if a business does not currently need public financing the participants should not be permitted to use the corporate form on the theory that they should be forced to do business as a partnership, with the attendant full personal liability, so that maximum protection for creditors will be provided. It should be noted that this line of reasoning applies with equal cogency to the one-man corporation also.

This argument collapses when it is remembered that one-man and close corporations are permitted, creditors notwithstanding, provided the formalities prescribed by law for the good corporate life are observed. Yet it is clear that such protocol is not the equivalent

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[115] Ops. Att'y Gen. Fla. 056-197 (1956).

[116] Fla. Stat. §608.18 (8) (1957).

of personal liability of the participants, nor does it provide any appreciable protection for creditors dealing with such corporations. The theory of corporation law is, rather, that the various limitations on distributions, plus the public declarations contained in documents on file in public offices, perform the function of protecting creditors; but perhaps this whole theory needs rethinking.

The information on file in the typical secretary of state's office is not the information that is helpful in determining whether to extend credit to the corporation; and no one would expect a state securities commission, created for the purpose of protecting purchasers of corporate securities, to provide any helpful information for general creditors.[117] An item of information, for example, that might be most helpful in determining whether to extend credit to a corporation would be the ratio of current assets to current liabilities, but the current ratio will be looked for in vain in public offices. The practical answer is, of course, that the corporation seeking credit supplies the information direct to its prospective creditors when establishing its credit. This being true, there would seem to be no justification based on creditor-protection considerations for discriminating against the participants in a close corporation, because they will have to furnish their prospective creditors with similar information, the data of real credit significance insisted upon by bankers and careful businessmen. Generally speaking, neither the partnership nor the corporation is required to file such information in a public office. If corporations were required to file information of real credit significance, an even better case for legalizing the informal close corporation could be made, for the close corporation as well as the publicly held corporation would each have to file such information for the benefit of creditors, this proposed norm not being subject to modification or relaxation by agreement among the participants. There would then be no semblance of justification for insistence on observance of the present so-called norms for creditor-protection purposes.

Creditors and credit information agencies are too realistic and sophisticated to depend on the information they can find on file in the typical secretary of state's office. Since the business world has

[117]There would be no occasion for a corporation to file financial information with the typical state securities commission in the absence of a proposed issue of securities. General creditors cannot, of course, wait for such a fortuitous development. See FLA. STAT. c. 517 (1957). It is believed that the same general statement applies to the Securities and Exchange Commission of the Federal Government.

discovered methods for evaluating the credit risk status of all corporations, why should there be concern over the absence of full personal liability of the participants in a close corporation and pressure in the form of nonrecognition of partner-like arrangements to force them to do business as a partnership? Most creditors are able to look out for themselves. Most of them are too clever to extend credit on the basis of public information that means nothing credit-wise; if they make a practice of relying on such information they are not long for the business world anyway. The intelligent and careful businessman who is going to survive has better sources of information for evaluating the credit risk of corporations with which he may wish to do business; and it is safe to speculate that these sources supply information of a type that is not vastly different for proprietorships, partnerships, and corporations, close or otherwise. Forcing partners who wish to incorporate to submit to majority rule and the formal mechanics of publicly held corporations will not contribute an iota to the protection of creditors or to the progress and stability of the world of business and should not be regarded as the *quid pro quo* for limited liability.

The policy justification for according legal validity to close corporation arrangements wherein some partnership attributes are preserved has thus far been that of eliminating an irrational discrimination against the business organization with few participants, usually a small business. Such discrimination results in a clog on business development because it is the close corporation of today that will be the future's publicly held giant. The development of our economy has been encouraged by the doctrine of limited liability — the limitation of one's risk to his investment. If limited liability is available only to big businesses, then relatively small businesses are threatened; and the economy is threatened because the big corporation of tomorrow is a close corporation today. There is no justification for a policy of corporate infanticide.

This would be reason enough for clarifying the legal status of the close corporation if that were all, but it is not. One form of close corporation is the joint venture corporation. It is coming into wide use.[118] The joint venture corporation is merely the traditional joint venture arrangement cast into a corporate form. Without incorporating, the joint venture has all the attributes of a partnership with the participants being other corporations. In large operations of a

[118]See note 10 *supra*.

highly speculative nature involving immense financial risk, such as the exploration and production of oil in foreign countries, the need for limitation of liability makes the corporate form particularly desirable. But, just as with other close corporations, the participating corporations seek to retain partnership attributes such as a voice in ordinary management decisions and some control over the admission of new participants to the joint venture. Such corporations are being utilized in the oil, chemical, electronic, and atomic power industries.[119] They are being used for joint bidding on defense jobs when the undertaking is too large or too risky for any single participating corporation.[120] The judicial attitude has been favorable,[121] recognition being given to the plain difference between such corporations and publicly held corporations. The feeling has been that when no injury to outsiders such as creditors is involved, the rules of corporation law designed primarily for the public issue incorporation should not be applied just for the sake of consistency, particularly when this means that arrangements agreed upon by the participants will be ignored and unenforced. This same line of reasoning should apply with equal force to all close corporations.

Considerations such as these are bringing both courts and legislatures to a more sympathetic approach to the legal status of the close corporation and its stockholders. Close corporation arrangements of the type described herein are being permitted with an infinite variety of variations to accommodate the needs of the particular business enterprise and its owners.[122] Representative of this changed attitude are the many provisions contained in the Model Business Corporation Act of the American Bar Association enabling close corporations to adapt the orthodox corporate form to the particular needs of the participants.[123]

The necessity for legal treatment of the close corporation dif-

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[119]Broden and Scanlan, *supra* note 10; Hale, *Joint Ventures: Collaborative Subsidiaries and the Antitrust Laws,* 42 VA. L. REV. 927 (1956).

[120]The Wall Street Journal, Aug. 18, 1958, p. 1, col. 6.

[121]Wabash Ry. v. American Refrigerator Transit Co., 7 F.2d 335 (8th Cir. 1925), *cert. denied,* 270 U.S. 643 (1926); Seaboard Air Line Ry. v. Atlantic C.L.R.R., 240 N.C. 495, 82 S.E.2d 771 (1954). *But cf.* Abercrombie v. Davies, 130 A.2d 338 (Del. 1957).

[122]Sturdy, *The Significance of "Form" and "Purpose" in Determining the Effectiveness of Agreements Among Stockholders to Control Corporate Management,* 13 BUS. LAW. 283 (1958).

[123]Campbell, *The Model Business Corporation Act,* The Business Lawyer, July 1956. pp. 98, 105-06.

ferent from that accorded the publicly held corporation has long been recognized in England. Special provision is made for "private" companies having fifty or less stockholders. A great deal of flexibility is permitted in such a corporation, its charter being essentially contractual in character and the statutory provisions applying only in the event there is no contrary provision agreed upon by the incorporating stockholders. There is an absence of the statutory corporate norms that have caused so much difficulty in this country in the past when the bar has tried to meet the practical needs of the business community.[124]

There is a problem as to where the attorney should set forth the contractual arrangement which protects the close corporation's participants from the undesired corporate norms. The maximum in safety may be achieved by providing for the various partnership attributes in the preincorporation agreement among the participants, in the articles of incorporation, and in the bylaws. This may seem like "gilding the lily" to some, but there are reasons for such caution. Some agreements have been held enforceable as contracts among the participants although the parallel provisions in the articles were held invalid. The arrangement should be set out in the articles because the preincorporation agreement may not bind the corporation, and the validity of some aspects of the arrangement may depend on the corporation being bound. For example, restrictions on the transfer of shares may depend for validity on their advancing some interest of the corporation, and it is difficult to show such an interest if the corporation is not a party to the arrangement. There is a very practical reason for including the particulars of the arrangement in the bylaws; this keeps the deviations from the normal corporate pattern more clearly before all concerned, particularly management.[125]

It is very dangerous to use corporation forms generally found in form books in drafting the articles and bylaws of a close corporation that is expected to have partnership attributes. The same may be said for using as models the papers drafted for the incorporation of publicly held corporations.[126] The danger is that provisions incon-

[124]Gower, *Some Contrasts Between British and American Corporation Law*, 69 HARV. L. REV. 1369, 1376-77 (1956); Mc Fadyean, *The American Close Corporation and Its British Equivalent*, 14 BUS. LAW. 215 (1958); Scott, *Developments in Corporate Laws*, 12 BUS. LAW. 438-39 (1957).

[125]O'Neal, *Molding the Corporate Form to Particular Business Situations: Optional Charter Clauses*, 10 VAND. L. REV. 1, 46-52 (1946).

[126]2 O'NEAL, CLOSE CORPORATIONS c. X (1958) contains suggested provisions for

sistent with the desired partner-like arrangements will inadvertently be inserted. The reason this may happen is that the usual corporation forms are prepared with publicly held corporations in mind. A bylaw inadvertently adopted may be held to have superseded a carefully drawn preincorporation agreement containing provisions for the arrangement desired by the incorporated "partners."[127]

It is very important that the uncertainties still hanging over the close corporation be dissipated. Legally, the close corporation is the most unsatisfactory stage in the evolution of the typical business unit. It begins as a proprietorship. It grows and becomes a partnership as more capital and more talent are needed. The partners then incorporate, largely to obtain limited liability and tax advantages. This is the law's halfway house, the close corporation. As the partners retire or die their shares go to relatives and outsiders, or else new capital is needed to meet the need for expansion, so new issues of stock are sold to the public. At this point the business has matured, and the corporation is no longer "closed." When the stage of the publicly held corporation is reached, the partnership attributes retained during the close corporation stage are no longer useful and may be harmful. Amendment of charter and bylaws is called for, and this may seem difficult in view of the very minority control arrangement that the corporation has outgrown. The difficulty may be a mirage, however, because at this stage the stock is by hypothesis more widely held already and in hands of persons who no longer have any great interest in retaining a minority control arrangement, particularly when it stands in the way of increased earnings and dividends. The stock of a stubborn survivor of the close corporation might be purchased. If that fails, dissolution or arbitration may be used to effect the metamorphosis to full corporate maturity.

The healthy growth of American business is not facilitated by insisting that the transition from proprietorship or partnership to publicly held corporation be accomplished without legal provision for the intermediate stage of development — the close corporation with certain retained partnership characteristics. There is too much risk and time involved in development of the needed legal principles through the process of courageous draftsmanship and expensive adjudication. Legislation to clarify the legal status of the close corporation is in order.

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close corporation documents.

[127]Kear v. Levinson, 71 Pa. D. & C. 475 (C.P. 1950).