

CHAPTER TWO — CLOSE CORPORATIONS

The Fate of Closely Held Business Associations: The Debatable Wisdom of “Incorporation”

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This article questions the assumptions underlying discrete statutory treatment of closely held corporations. In the view of the author, corporate status is a privilege conferred in the course of a social contract which presumes an assumption of responsibilities beyond the capacity of these increasingly popular entities. The suggestion is not that a business venture owned by a handful of individuals should observe the formalities of the classical corporate profile, but that they should not incorporate at all.

INTRODUCTION

As the decade opens numerous legislative campaigns can be expected to intensify assaults upon states uncommitted on such important causes as equal rights, pro-life, and balanced budget amendments. Another cause will advance along less noticed lines with a near unanimous endorsement from academic commentators. Its less controversial objective is to obtain discrete statutory treatment for the “closely held business.” Already an impressive array of jurisdictions have gone to extraordinary lengths

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to accommodate this call.¹ Their efforts have been generally praised, with reservations being limited to the contention that legislatures have not gone far enough.² The modest ambition of

¹ State legislatures have adopted two basic approaches to "discrete statutory treatment" of the close corporation. Seven states have adopted so-called "integrated" statutes which deal with the close corporation in a separate article or grouping of the corporation code. See ARIZ. REV. STAT. ANN. §§ 10-201 to 10-218 (1977); DEL. CODE ANN. tit. 8, §§ 341 to 356 (1975); ILL. ANN. STAT. ch. 32, §§ 1201 to 1216 (Smith-Hurd Cum. Supp. 1979); KAN. STAT. §§ 17-201 to 7216 (1974 and Cum. Supp. 1979); MD. CORP. & ASS'NS CODE ANN. §§ 4-101 to 603 (1975 and Cum. Supp. 1979); PA. STAT. ANN. tit. 15, §§ 1371 to 1386 (Purdon Cum. Supp. 1979); TEX. BUS. CORP. ACT ANN. art. 2.30-1 to 5 (Vernon Cum. Supp. 1979). Florida enacted discrete close corporation legislation in 1963, but repealed it in 1975.

Eight other states have granted special concessions to close corporations without enacting a comprehensive statute. See CAL. CORP. CODE § 158 (West Cum. Supp. 1980); FLA. STAT. ANN. § 607.107 (West 1977); ME. REV. STAT. tit. 13A, § 102(5) (1974); MICH. STAT. ANN. ch. 195A § 21.200(103)(c) (1974); N.Y. BUS. CORP. LAW §§ 620, 630 (McKinney 1963); N.C. GEN. STAT. §§ 55-1 to 175 (1975); S.C. CODE §§ 33-1 to 25 (1977).

Although there is no one accepted definition of a "close" corporation, many states use the number of shareholders, ranging from ten to thirty-five, as the determining factor. See CAL. CORP. CODE § 158 (West Cum. Supp. 1980) (10); TEX. BUS. CORP. ACT ANN. art. 2.30-1 (Vernon Cum. Supp. 1979) (35). See generally F. O'NEAL, CLOSE CORPORATIONS § 1.02, at 2-7 (1971).

It would appear that developments in the United States have not kept pace with European efforts to accommodate closely held companies. In the Common Market only the Netherlands has failed to produce comprehensive legislation distinguishing closely held business from public issue enterprise. See, H. DeVries and F. Juenger, *Limited Liability Contract: The GmbH*, 64 COLUM. L. REV. 866 (1964). Apparently the concession of limited liability to aggregations which clearly do not aspire to keep the social contract outlined in this essay does not trouble the civil law systems reviewed by the authors.

² See, e.g., Bradley, *A Comparative Evaluation of the Delaware and Maryland Close Corporation Statutes*, 1968 DUKE L.J. 525; Berger, *California's New General Corporation Law: Close and Closely Held Corporations*, 7 PAC. L.J. 585 (1976); O'Neal & Magill, *California's New Close Corporation Legislation*, 23 U.C.L.A. L. REV. 1155 (1976); Birgbauer, *Close Corporations*, 18 WAYNE L. REV. 915 (1972). See also Comment, *Close Corporations and the South Dakota Business Corporation Act: Time for Reform?*, 23 S. DAKOTA L. REV. 427, n.5 (1978), for a collection of articles supporting close corporation legislation. But see Shapiro, *The Statutory Close Corporation: A Critique and a Corporate Planning Alternative*, 36 MD. L. REV. 289 (1976) (reexamining the premises underlying Maryland's close corporations statute); Deutsch, *Roses in Search of Gertrude Stein: The Puzzle of the Close Corporation*, 9 U. OF TOL. L. REV. 458 (1978) (discussing the inherent contradictions of placing the close corporation in a structure designed for the large public corporation).

this essay is to examine the wisdom or folly implicit in the basic proposition: that a state should modify its corporate law so as to accommodate the asserted special needs of a closely held entity. While the past two decades have witnessed legislative and judicial developments premised upon an affirmative answer to this question, in the mind of this writer the matter is open, and open to a negative response.

The essential arguments of the negative position are these: that corporate status is a privilege conferred upon certain members of society at the demonstrable expense of others; that this privilege is extended upon the assumption that it facilitates combinations of capital and management skills otherwise unattainable to society; that the essence of a business held by a few persons with entry closed to outsiders is the exact opposite of the combination fostered by incorporation; that the "advantages of incorporation" (essentially limited liability and tax concessions) are properly tied to the function of that status; and that the bid for such advantage by entities unable to perform the capital formation and management centralization function should be rejected. The reader will immediately recognize this as a "social contract" argument. If accepted it does not prompt the conclusion that closely held entities should be held to the formal standards of organization, structure, and accountability presently reflected in corporate legislation, *but that they should not incorporate at all*. Indeed, it is a sub-theme of this essay that the ambition to incorporate may well spring from profound ignorance of the advantageous possibilities offered by alternatives such as general and limited partnerships and joint ventures.

I. THE SOCIAL CONTRACT

As a creature of the state, a "corporation" is the product of a social contract. Speaking in the most general of terms, the state offers the following advantages in the course of incorporation: access to non-debt capital; limited liability; favorable tax treatment; centralization of management; free transferability of interest; and continuity of life.³ While these concepts will be explored in some detail, to list them is sufficient to prompt the question why society should incur either sacrifice or strain to bestow ex-

³ For a discussion of these general attributes of incorporation, see W. CARY, *CASES AND MATERIALS ON CORPORATIONS* 22-25 (4th ed. 1969).

traordinary advantage on any private enterprise. For more than a century the answer has been that incorporation fosters capital formation in the hands of dynamic management with the consequence that wealth is expanded within the society. This is the social contract: concessions and advantages will be allowed in the expectation that the corporate entity will provide employment, goods and services.⁴ Any entity which fails to attain these objectives disappoints correlative social expectations. A private project claiming the advantages of incorporation with a predetermined plan to disappoint these public expectations flirts with fraud. Suspicion that self-styled "close corporations" will fail to attain the objectives defined for corporate accomplishment implants doubt as to the wisdom of tolerating their creation. If it

⁴ "So we can allow a larger liberty of incorporation because the law, by strongly adhering to the view that incorporation is a privilege granted by the state, is in a position to dictate terms to the groups which it thus allows." 3 W. HOLDSWORTH, *A HISTORY OF ENGLISH LAW* 479 (3d ed. 1923). In the middle ages, the corporate vehicle was used initially for ecclesiastical purposes or public incorporation, particularly of municipalities. As mercantile interests became increasingly important in the sixteenth and seventeenth centuries, Royal Charters were granted to *private* enterprisers, but only upon petition to the monarch. The crown was willing to grant limited liability to the enterprisers only when necessary to encourage investment of capital in risky overseas ventures. See W. NICHOLLS, *ENGLISH LAW FOR BUSINESS STUDIES* 42-3 (2d ed. 1970). The gradual development of the legal concept "incorporation", as applied to enterprises for private profit, was accompanied by government regulation of the corporate status. This status has always been considered a privilege, not a right, and the benefit of limited liability is only provided in return for adherence to corporate formalities. See generally 1 F. POLLOCK & F. MAITLAND, *THE HISTORY OF ENGLISH LAW* 469-95 (1895).

The social contract theory has been adopted in American common law as well. Justice Brandeis briefly traced the history of the social contract in his partial dissent in *Louis K. Liggett Co. v. Lee*, 288 U.S. 517, 545 (1933): "If granted, the [corporate] privilege is conferred in order to achieve an end which the state deems desirable." Brandeis further commented on the denial of corporate status because of "[F]ear of encroachment upon the liberties and opportunities of the individual." Corporate status was granted "only when the grant seemed necessary in order to procure for the community some specific benefit otherwise unattainable." *Id.* at 548-9.

See also *Benintendi v. Kenton Hotel*, 294 N.Y. 112, 60 N.E.2d 829 (1945): "The State, granting to individuals the privilege of limiting their individual liabilities for business debts by forming themselves into an entity separate and distinct from the persons who own it, demands in turn that the entity take a prescribed form and conduct itself, procedurally, according to fixed rules." *Id.* at 118, 60 N.E. 2d at 831.

could be established that the close corporation is a creature congenitally disabled from the attainment of social goals, these doubts should be resolved against its creation.

Societal Benefits and Burdens of Incorporation

In order to serve as a vehicle for capital formation, a corporation is permitted to divide its residual ownership interest into shares which are sold to investors with no obligation that they ever be repurchased.⁵ In an era of increasingly prohibitive interest rates,⁶ it would be difficult to overstate the advantage conferred by this access to non-debt capital. A further attraction of corporate stock purchase is the concession that risks generated by an incorporated enterprise will not threaten the personal assets of shareholders. Their liability, or "downside risk," is limited to the invested amount.⁷ Income generated by the corporate vehicle is exempted from the steeply progressive tax rates imposed on all other taxpayers.⁸ In combination, these factors encourage initial capital formation and nurture the growth of capi-

⁵ In many jurisdictions, a corporation may not redeem its own shares unless redemption is specifically provided for in the articles of incorporation. Such provisions often include price formulas and notice requirements, as a corporate redemption is generally considered a deviation from the corporate function absent compelling reasons. *See generally* H. HENN, *HANDBOOK OF THE LAW OF CORPORATIONS AND OTHER BUSINESS ENTERPRISES* § 160 (2d ed. 1970).

⁶ On March 13, 1980, Chase Manhattan Bank of New York raised its prime rate to 18¼%, up from less than 12% in January. Industry analysts are quoted as saying "the end isn't in sight." *Wall Street Journal*, Mar. 14, 1980, at 1, col. 2. This trend has continued, as the prime rate charged by most major banks surpassed the unprecedented 20% barrier less than a month later. *Wall Street Journal*, Apr. 4, 1980, at 1, col. 2. Although there has since been a decline, interest rates are still hovering at levels unheard of prior to 1980.

⁷ *See, e.g.,* *Bing Crosby Minute Maid Corp. v. Eaton*, 46 Cal. 2d 484, 487, 297 P.2d 5, 7 (1956): "In this state a shareholder is ordinarily not personally liable for the debts of the corporation; he undertakes only the risk that his shares may become worthless." However, the court goes on to discuss exceptions to this general principle, such as where the shareholder receives "watered stock."

⁸ With certain important exceptions, the taxable income of a corporation is computed in a manner similar to that for individuals. However, while individual income is taxed at progressive rates from 14% to 70%, I.R.C. § 1, corporate income is taxed at a "graduated" rate of 17% to 40% for the first \$100,000, and 46% on all income above \$100,000. I.R.C. § 11(b). *See generally* B. BITTKER & J. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* ¶ 1.01 (4th ed. 1979).

tal by leaving a greater "after tax" proportion of earnings in the hands of the corporate vehicle.⁹ Assets so patiently fostered are divorced from the personal ownership dominion of the investors and placed at the disposal of a centralized management. Unlike the partnership, where all partners have certain rights of participation,¹⁰ the shareholder is relegated to an essentially passive posture while elected representatives (the directors) chart the major decisions and determine the officers who implement corporate objectives.¹¹ Should an individual shareholder become disenchanted with the direction set by the representatives of the majority or for any other reason desire to liquidate the investment, free transferability of shares facilitates both entry and exit from the corporation.¹² Finally, the corporate entity is given perpetual existence by a continuity of life that endures beyond the death or withdrawal of any or all of the original investors.

While the advantages of these features of corporate existence are obvious, there are undeniable disadvantages thrust upon other members of the society. If corporations may acquire non-debt capital, their competition for this scarce resource drives up the cost to all others. At the macroeconomic level this is reflected by the relationship between the stock and bond markets. An active market in "equities"¹³ requires an increase in the rate

⁹ The "double tax" bite that attends corporate earnings distributed in the form of dividends, wherein monies already taxed at corporate rates are taxed as personal income to the recipients, further fosters capital formation by discouraging the appetite of shareholders for such distributions. *Id.* at ¶ 4.01.

¹⁰ Subject to any agreement among the partners, § 18(a) of the Uniform Partnership Act [hereinafter cited as the "U.P.A."] provides: "[A]ll partners have equal rights in the management and conduct of the partnership business."

¹¹ See, e.g., 1 MODEL BUS. CORP. ACT ANN. § 33 (2d ed. 1971) "The business and affairs of a corporation shall be managed by a board of directors"; CAL. CORP. CODE § 300(a) (West Cum Supp. 1980) "[T]he business and affairs of the corporation shall be managed and all corporate powers shall be exercised by or under the direction of the board." To the same effect, see DEL. CODE ANN. tit. 8, § 141(a) (1975); N.Y. BUS. CORP. LAW § 701 (McKinney 1963 & Cum. Supp. 1980).

¹² Free transferability of interest is the basis for the perpetual existence of a corporation, whereas there are substantial restrictions on the transfer of a partnership interest, particularly on the transferee's right of participation. U.P.A. § 27. However, restrictions placed on the transferability of shares are sanctioned in close corporations, in order to lock-in the original "close" group of enterprisers. See note 56 *infra*.

¹³ Equity securities represent an ownership interest in the corporation and

of return on all borrowing if there is to be an effective competition for scarce dollars. More obvious is the disadvantage to the tort claimant who discovers that a corporate tortfeasor is responsible for the injury. If the assets of the corporate entity amount to only seventy cents on the dollar of the inflicted injury, the presence of a "victim" is more than a figure of speech.¹⁴ One further social cost of limited liability becomes evident in the event of bankruptcy or insolvency; contract creditors must absorb the loss.¹⁵

Finally, in the field of taxation, if it is assumed that the government must raise a certain quantum of revenue, then it follows that for every concession to the corporate sector other sources must be found to make up the shortfall. These are the burdens thrust upon some or all of the other members of a society which tolerates corporate enterprise within its midst. For those who elect to enter the family of investors, there are disadvantages of a different kind. Parting with funds that need never be repaid and relegation to a passive role are the most obvious.¹⁶

The point bears repetition: only so long as the benefits to soci-

should be distinguished from debt instruments issued by the corporation.

¹⁴ See, e.g., *Zubik v. Zubik*, 384 F.2d 267 (3d Cir. 1967) (court refused to hold individual liable in spite of commingled personal and corporate assets, because of adherence to corporate formalities); *Walkovszky v. Carlton*, 18 N.Y.2d 414, 223 N.E.2d 6, 276 N.Y.S.2d 585 (1966) (defendant shareholder of cab company was insulated from tort liability, even though corporate funds were inadequate to cover claim). *But see* *Minton v. Cavaney*, 56 Cal. 2d 576, 364 P.2d 473, 15 Cal. Rptr. 641 (1961) (corporate entity disregarded, and defendant director held liable on theory of inadequate capitalization).

¹⁵ See, e.g., *Brunswick Corp. v. Waxman*, 459 F. Supp. 1222 (E.D.N.Y., 1978), *aff'd*, 599 F.2d 34 (2d Cir. 1979) (incorporators of no-asset corporation are not liable on purchase contracts because no evidence of misappropriation); *Bartle v. Home Owners Co-Op., Inc.*, 309 N.Y. 103, 127 N.E.2d 832 (1955) (court refused to "pierce the corporate veil" and hold the parent company liable because the parent and subsidiary maintained the "indicia" of separate corporations, and there was no evidence of fraud.)

But see *Kagel v. First Commonwealth Co., Inc.*, 409 F. Supp. 1396 (N.D. Cal. 1973), *aff'd*, 534 F.2d 194 (9th Cir. 1976); *Automotriz Del Golfo De California v. Resnick*, 47 Cal. 2d 792, 306 P.2d 1 (1957); *Annot.*, 63 A.L.R.2d 1042 (1959).

¹⁶ In addition, the shareholder has no direct control over whether there will ever be a return on the investment in the form of dividends; dividend declaration generally is in the discretion of the board. See W. CARY, *supra* note 3, at 1484. In public issue corporations, the profitability of the shareholder's investment is largely subject to the vagaries of the stock market — a factor having nothing to do with the inherent worth of the investment.

ety outweigh this package of burdens is there legitimacy in "incorporation." Private aspirations cannot command this judgment, for they are infected by selfish interest. It is the task of a state legislature to strike the balance. If the foregoing analysis has merit, the asserted bid for statutory concession to closely held business goes far beyond technical amendments to existing codes. It seeks nothing less than the incursion of serious social costs.

Having sketched in general terms both the benefits and detriments caused by the corporation in modern society, we turn to the asserted need for statutory accommodation of the closely held concern.¹⁷ Although the matter is not free from technical difficulties, the concept of a closely held corporation is not hard to formulate. Assume that a relatively small number of individuals desire to associate for the purpose of conducting a business. Assume further that they are motivated by family ties or bonds of friendship which inspire an initial confidence in the stability of their association suggesting a further, mutual interest in limiting access to future members. This negative attitude toward the transferability of interest and freedom of admission will produce the conclusion that there will be little or no "market" for ownership rights in this closed entity. The term "closely held" tells the essence of the tale.

Now let us assume that this small band of individuals desires incorporation. At first blush it appears a strange ambition. The profile of a corporation presupposes a surrender of individual dominion over property and the aggregation of the "invested assets" in the hands of a centralized management conducted by individuals who may have no proprietary interest in the business at all. Classic corporate organization resembles a pyramid. There are many shareholders at the base electing a small number of individuals in whom is vested the power of management. These "directors" select the officers who carry into effect the business policies defined by the representative board. In so doing, the officers represent the corporate entity in dealings with all third parties. Fiduciary concepts articulated in both statutory and common law seek to fix duties of care and loyalty upon those who would manage other people's money. Extensive record keeping requirements and attention to form give further evi-

¹⁷ See note 2 *supra* for a collection of commentators advocating statutory accommodation.

dence of the state's interest in prompting accountability.¹⁸

The effort to unite individuals small in number and bound by unique qualities or ties with a deliberately impersonal, structured entity which is the corporation is somewhat akin to fixing a horse collar upon a flea. The fit is not comfortable; the result is not functional. There are at least two solutions to this problem: radically modify the nature of the corporation; or desist from the effort.

II. THE ATTRACTIONS OF INCORPORATION

Whatever the ultimate opinion as to the merits of incorporation, it cannot be denied that this goal is desired by many "closely held" business ventures and that this is encouraged by many attorneys. The professional encouragement is deserving of brief comment.

In the mid-1950's two developments gained momentum in law school curricula which have, by accident or design, influenced much human activity. First, the attraction of "corporations" as a legal discipline was enhanced by an era of rapid economic expansion and popular interest in "high finance" and the role of the Federal Securities and Exchange Commission. The expanded scope of this material demanded greater classroom time and it was inevitable that something had to give in order to facilitate this expansion.¹⁹

The candidate for "giving" was the law of agency and partnership. Once the forte of every lawyer's second year of schooling,

¹⁸ See cases cited in notes 14-15 *supra*. Adherence to corporate "formalities" can be an important factor in whether a court will look beyond the corporate entity to fix liability upon the individual investors. See *Zubik v. Zubik*, 384 F.2d 267 (3d Cir. 1967).

¹⁹ An interesting way to gauge the increasing importance of corporate study in the law school curricula is to compare the four editions of what is now W. CARY, *CASES AND MATERIALS ON CORPORATIONS* (4th ed. 1969). The first edition (DODD & BAKER, *CASES ON BUSINESS ASSOCIATIONS* (1949)) ran 1286 pages, the second edition (1951) ran 1400 pages, the third edition (BAKER & CARY, 1959) ran 1562 pages, and the current fourth edition, unabridged, runs 1816 pages without the appendix or supplements. In his preface to the fourth edition (*Id.* at xi), Professor Cary discusses the rapid growth of corporate law in justifying the expansion of his work. The fourth edition covers several important and expanding areas of corporate law that were minor subjects in earlier editions, including securities law, tax implications, problems of the closely held corporation, and activist shareholder participation.

this material was gradually pushed out of the curriculum. Today, it is formally studied in a handful of law schools, and generally only in upper division courses with small enrollments.²⁰ The popular and heavily enrolled "business associations" or "business organizations" courses concentrate solely on the corporation. In such a climate, the advice to incorporate is less the product of wisdom than the result of ignorance of alternatives. Joint ventures, general and limited partnerships have an ancient history and function in the marketplace but are increasingly neglected.²¹ With these advantages unknown and unweighed, many

²⁰ Professor Cary notes that "many law schools in the country have omitted any consideration of partnerships in curriculum . . .," in introducing his pamphlet on partnership planning, *id.* at xvi. As early as 1954, Professor John Mechem lamented that "a considerable part of the curriculum of every law school deals with corporation law; but Partnership as a law school course is becoming constantly more infrequent . . . some don't give it at all because there just isn't any room for it in an already crowded curriculum." Mechem, *How to Include Partnership in a Crowded Curriculum*, 6 J. OF LEGAL EDUC. 549 (1954).

"The separate course in agency and the separate course in partnership began to disappear from the law school curriculum some fifteen or twenty years ago." H. REUSCHLEIN & W. GREGORY, *HANDBOOK ON THE LAW OF AGENCY AND PARTNERSHIP* at xv (1979).

²¹ The partnership format has the additional benefit of a uniform body of law. The Uniform Partnership Act, first adopted by Pennsylvania in 1915, is currently in force in 49 states and the District of Columbia. The U.P.A. replaces a substantial body of often conflicting case law. The Commissioner's Prefatory Note suggests that the U.P.A. was created in order to provide for uniformity, eliminate uncertainty, and provide greater sources of authority for the practice of partnership law. 6 UNIFORM LAWS ANNOTATED 5, 7 (West 1969).

The limited partnership dates back to the twelfth century, but it did not become popular in the United States until the early nineteenth century. New York adopted the first Limited Partnership Act in 1822, and was followed by the other major commercial states over the next 30 years. See Shapiro, *The Need for Limited Partnership Reform: A Revised Uniform Act*, 37 MD. L. REV. 544 (1978). The Uniform Limited Partnership Act (U.L.P.A.) was prepared and recommended in 1916, and has served to standardize the varied approaches to the subject represented in various state statutes. The U.L.P.A. has now been enacted by over forty states. See generally 6 UNIFORM LAWS ANNOTATED 561, 563 (West 1969); Candill & Fendler, *The Uniform Limited Partnership Act*, 59 COMM. L. J. 5 (1954); Comment, *Limited Partnerships and the California Securities Law: Restricting the Public Sale of Limited Partnership Interests*, this issue at 618.

The growth of uniform partnership law should be contrasted with the widely divergent development of corporate law. The Model Business Corporation Act, prepared by the A.B.A. Committee on Corporate Laws and first published in

lawyers will incorporate anything that shows signs of life—except the nuclear family—but including themselves. The illusion of forethought can be implanted by the wiles of the “Green Gem” or the “Black Beauty.”²²

1950, has been substantially adopted or used as a basis for corporate legislation in at least 31 states. See 1 Model Bus. Corp. Act Ann. § 1, ¶ 2, at 4 (2d ed. 1971) [1977 Supp. at 1]. For a general history of the Model Act, see Eisenberg, *The Model Business Corporation Act and The Model Business Corporation Act Annotated*, 29 BUS. LAW. 1407 (1974); Hodge & Perry, *The Model Business Corporation Act: Does the Mississippi Version Lime the Bushes?*, 46 Miss. L. J. 371 (1975).

However, the “major market” states have generally ignored the Model Act in favor of highly individualistic state corporation codes. See CAL. CORP. CODE § 100 *et. seq.* (West Cum. Supp. 1980); DEL. CODE ANN. tit. 8 (1975); OHIO REV. CODE ANN. § 1701 *et. seq.* (Page 1978); PA. STAT. ANN. tit. 13 (Purdon Cum. Supp. 1979). See also N.Y. BUS. CORP. LAW (McKinney 1963 & Cum. Supp. 1980) (New York only adopted parts of the Model Act). Although the principal purpose of the Model Act was to provide a basis for national uniformity, *id.* at 372, it is questionable whether uniformity is in fact desirable. See Garrett, *Suggested Revisions of the Model Corporation Act*, 5 BUS. LAW. 24 (1949).

²² The facility with which incorporation may be accomplished is fostered by private companies purporting to provide “kits” that will render effortless the steps which need be taken by counsel. While a theme of modern corporate legislation has been to permit tailor-made provisions of the articles and bylaws to shape the governance structure of the corporation, these heavily merchandized avenues to corporate status feature preprinted contents of the articles and bylaws and even print the minutes of meetings by incorporators or initial directors long before such meetings are ever held! This trip into the world of Alice may be affected through the “Improved Black Beauty” (available from Excelsior-Legal) which boasts printed share certificates, blank or printed California minutes and by-laws, special forms for the close corporation, and a “high quality gold stamped cover”, all for a mere \$33.00. See CAL. ST. B.J., Feb. 1980, back cover.

For those attorneys interested in the “Big Board” look, the “Green Gem” corporate outfit (available from Corpex, Banknote Company, Inc.) provides a range of complete outfits from \$31.00 to \$45.00, including a seal at no extra cost. The “Green Gem” provides the incorporating attorney with “handsome stock certificates,” minutes and by-laws for the professional, model, not for profit, or close corporation, and a “corpexpediter” for “quick completion of minutes.” All of this will be shipped within 24 hours merely by calling a toll-free number. See CASE AND COMMENT, March-April 1980, back cover.

The distressing suggestion of these advertisements is that the corporate status which Justice Brandeis felt justified only when “necessary in order to procure for the community some specific benefit otherwise unattainable” (*supra* note 4), is increasingly within the grasp of even the most novice of counsel. Perhaps it is appropriate that the lack of considered reasoning that is often behind the decision to incorporate can now be matched by an absence of par-

Looking beyond this dubious professional preference, proponents of close corporations legislation justify their bid on several grounds.²³ They number among their ranks many of the most distinguished academicians and business practitioners. Their arguments have been found convincing by legislatures in numerous jurisdictions.²⁴

Particularly popular with the proponents of legislative accommodation is the argument that citizens should be indulged in their desire for freedom of choice.²⁵ A complementary contention is that the benefits of incorporation should not be limited to "big guys" but should be available to more humble aggregations of citizens.

It is asserted that certain business activity may not transpire unless incorporation is permitted. Ventures featuring a high degree of risk may not be pursued unless society is willing to hold the participants able to "cut their losses" by retreating behind the shield of limited liability.²⁶

Professor Edwin J. Bradley, a respected advocate of legislative accommodation, combines the classical claims and boldly recasts them in a "planning" argument.

The preeminent purpose of close corporation legislation is to free

ticularized drafting in the crucial process of incorporation. Whatever their utility, it is open to doubt that the standard features of the Black Beauty or Green Gem are suited to the potential rigors of a closely held association in a corporate form.

Indeed, the attorney may be shirking his or her ethical duty to the client by blindly incorporating:

If the attorney accedes and completes the [corporate] forms without first exploring the sole proprietorship and partnership forms of business with the client . . . the attorney has failed to give the client the full and disinterested advice to which he was entitled, and which the bar demands be given.

In re Kuzman, 335 N.E.2d 210, 211 (Ind. Sup. Ct. 1975). See also Haynsworth, *Competent Counseling of Small Business Clients*, this issue at 399.

²³ See, e.g., Bradley, *A Comparative Assessment of the California Close Corporation Provisions and a Proposal for Protecting Individual Participants*, 9 LOY. L.A.L. REV. 865 (1976); O'Neal, *Developments in the Regulation of the Close Corporation*, 50 CORN. L.Q. 641 (1965). See also articles collected in note 2 *supra*.

²⁴ For a collection of close corporation statutes, see note 1 *supra*.

²⁵ See O'Neal, *Close Corporations: Existing Legislation and Recommended Reform*, 33 BUS. LAW. 873 (1978).

²⁶ See W. CARY, *supra* note 3. See also Bing Crosby Minute Maid Corp. v. Eaton, 46 Cal. 2d 484, 487, 297 P.2d 5, 7 (1956).

planning from senseless legal obstacles. The strong legislative trend is opposed to hobbling the close corporation by a set of rigidified prescriptions pertaining to how a corporation ought to be set up and operated. The foremost expectation from a particular close corporation legislative reform is the declaration of a pervasive principle of freedom of contractual planning so that the participants may adopt whatever arrangements they decide are useful and conducive to the success of their venture. That principle should apply to every facet of the close corporation's affairs. The point should be made with the utmost clarity that the price for limited liability and the corporate entity privilege is not a planning straightjacket.²⁷

The invocation of the attractive term "planning" recalls another plea. The "bailout" argument notes that already many business ventures have incorporated and are encountering great frustration with centralized management, observance of the fiduciary responsibilities of directors, the transferability of ownership with the threat of uninvited strangers at the table, and other "rigid corporate norms." Following this litany of troubles comes the suggestion that the rigid nature of the "law" is at fault and should mend its ways while seeking the pardon of entrepreneurs for causing them needless trouble.

Tax concessions essentially federal in nature suggest that state governments protect their citizens by facilitating broad access to incorporation. The use of a corporate taxpayer facilitates access to less onerous exactions on business earnings and qualifies certain of the human enterprises for deferred compensation schemes. If the business is expected to generate a loss and it is closely held, it may qualify for a Subchapter S election so that the entity status of the corporation is ignored and the losses are passed through to the shareholders to be offset against other personal income. The fragility of the Subchapter S election as well as the "double tax bite" already mentioned show that there are risks as well as rewards for participants in an incorporated venture.²⁸

Finally, it is claimed that if the legislature refuses to provide a rational and comprehensive approach there is danger that *litigation* will produce a fragmented and chaotic response to the as-

²⁷ Bradley, *A Comparative Assessment of the California Close Corporation Provisions and a Proposal for Protecting Individual Participants*, 9 *Loy. L.A.L. Rev.* 865, 866 (1976).

²⁸ For a discussion of the requirements for and consequences of the Subchapter S election, see B. BITTKER & J. EUSTICE, *supra* note 8, at ¶ 6.01.

served need.²⁹ In its extreme form this argument suggests that change is inevitable and that the state's only choice is to regulate the pace and quality of that change.

III. ARGUMENTS AGAINST STATUTORY ACCOMMODATION OF THE CLOSELY HELD ENTITY

The burden of dialogue with proponents of statutory "reform" includes response to the propositions just reviewed, and more. The argument that citizens should be indulged in freedom of choice as among business vehicles is easily met. One echoes the sentiments of Brandeis in rejecting entitlement to status if the choice requires concessions and sacrifice from non-participating citizens.³⁰ When this is the consequence, the request is not made as of "right," but is a matter of grace to be settled upon an assessment of advantage and disadvantage to the society. If closely held entities cannot discharge the functions of a "corporation," they are not entitled to that status.

In the sense that it is an accurate prediction, there is merit in the claim that certain business activity may not transpire unless incorporation is permitted. However, it is untrue that incorporation is indispensable to the attainment of non-debt capital. To some degree general and limited partnerships afford this same advantage. Nor is it inevitable that such resources be purchased at the expense of centralized management.³¹ Yet general and limited partnerships do not afford the same measure of risk avoidance.³² If the risk inherent in the venture is so great that

²⁹ See note 53 *infra*.

³⁰ "[I]f the [corporate] privilege is denied, it is denied because incidents of like corporate enterprise are deemed inimical to the public welfare and it is desired to protect the community from apprehended harm." Louis K. Liggett Co. v. Lee, 288 U.S. 517, 545 (1933) (Brandeis, J., dissenting in part). See note 4 *supra*.

³¹ It is a myth that all partners are entitled to equal rights in the management and control of the partnership business. This "right," conferred by § 18(e) of the Uniform Partnership Act, is expressly made subject to "any agreement between [the partners] . . ." Thus a partnership agreement is competent to restrict the role of a capital contributing partner. A passive role for capital contributing "limited" investors is at the heart of the Uniform Limited Partnership Act. See also Comment, *U.P.A. § 18(h); Majority Control, Dissenting Partners, and the need for Reform*, this issue at 902.

³² In the social contract offered by the limited partnership, an enterpriser may insulate assets beyond those invested in the business, provided such an investor retreats to an essentially passive role in the conduct of the firm and

none of the participants is willing to accept the full consequences of liability, it should not automatically be concluded that the road to that result should be paved by a concession of limited liability. An alternative, deserving of careful consideration, is that such activity ought not be encouraged at all.

Another response is that the concept of "limited liability" enjoyed by enterprisers operating as a closely held corporation may be an illusion of security. Here we must distinguish between tort and contract claimants.

If the plaintiff is a tort victim and the assets of the corporate entity prove insufficient to remedy the wrong, there is a strong possibility that a court will "pierce the corporate veil" and expose to recovery the personal assets of some (the active participants) if not all of the investors.³³ California leads a list of jurisdictions in adopting the late Professor Ballantine's theory of adequate capitalization as a price tag for limited liability in a tort setting.³⁴

Respecting the contract claimant, there is probably greater security that the corporate barrier will hold as an effective shield when an aggrieved creditor exhausts the assets of the corporation before obtaining satisfaction. This difference turns on the fact that, unlike the tort victim, the contract claimant can be charged with having taken the calculated risk at the formation

there has been compliance with the formal steps for creation of the firm including the participation of one or more "general partners" who assume full entrepreneurial risks. See §§ 1 and 7 of the U.L.P.A.

³³ See note 14 *supra*. See also Comment, *Corporations: "Disregarding the Corporate Entity" as a Regulatory Process*, 31 CALIF. L. REV. 426 (1943).

³⁴ "If the capital is illusory or trifling compared with the business to be done and the risks of loss, this is a ground for denying the separate entity privilege." H. BALLANTINE, *CORPORATIONS* § 129, at 302-03 (rev. ed. 1946). Professor Ballantine's theory was heavily relied on in the leading California case of *Minton v. Cavaney*, 56 Cal. 2d 576, 364 P.2d 473, 15 Cal. Rptr. 641 (1961) (corporate entity disregarded, and defendant director held liable on theory of inadequate capitalization). For more recent California cases interpreting the undercapitalization theory developed in *Minton*, see *Pearl v. Shore*, 17 Cal. App. 3d 608, 617, 95 Cal. Rptr. 157, 162 (2d Dist. 1971); *Lyons v. Stevenson*, 65 Cal. App. 3d 595, 606, 135 Cal. Rptr. 457, 464 (1st Dist. 1977).

Other jurisdictions have relied on the undercapitalization theory as at least a factor, if not the sole basis, for disregarding the corporate entity. See *Briggs Transp. Co. v. Starr Sales Co.*, 262 N.W. 2d 805, 810 (Sup. Ct. Iowa 1978); *Coll. Watercolor Group, Inc. v. Wm. H. Newbauer, Inc.*, 360 A.2d 200, 207 (Sup. Ct. Pa. 1976). *But see American Com. Lines, Inc. v. Ostertag*, 582 S.W. 2d 51, 53 (Ct. App. Ky. 1979).

of the bargain to accept the liability of the corporate entity, as opposed to demanding the further guarantees of the individual entrepreneurs.³⁵ The "you made your bed now lie in it" rationale runs as a theme through those cases which refuse to disregard limited liability at the behest of contract plaintiffs.³⁶

Yet even in the realm of contract litigation there is an assumption that the corporation will have been capitalized and operated in such a manner as to give the entity a "fighting chance" to remain responsible to creditors. Thus if the entrepreneurs are guilty of using the corporation in high-risk areas of their activities while exploiting the low risk aspects of what is, in retrospect, a single business in a non-corporate vehicle, this "heads we win, tails creditors lose" attitude will prove the undoing of

³⁵ See note 15 *supra*.

Evidence of social disquiet with limited liability in contract settings may have its most interesting history in New York. In what may then, and would surely later, have been regarded as a startling exception to that norm, the legislature passed an act declaring that every shareholder of any company organized for the purpose of manufacturing, mining, mechanical or chemical business ". . . shall be jointly and severally individually liable for all debts that may be due and owing to all their laborers, servants and apprentices, for services performed for such corporation." The date was 17 February, 1848. 1848 N.Y. Laws, Ch. 40, §§ 1 and 18, pp. 54, 58. The social and economic implications of this statute were discussed in *Coffin v. Reynolds*, 5 Tiffany 74, 76-80, 37 N.Y. 640 (1868). Though much litigated and amended over the course of nearly one and three-quarters centuries, the provision has remained. N.Y. Bus. Cor. Law § 630(a) carries far beyond the traditional candidates for close corporate treatment to embrace ". . . every corporation" save for those which list shares on a national exchange or regularly quote shares on the over-the-counter market. Liability with respect to the wage claims of laborers, servants and employees is now fixed only on the ten largest shareholders. Such history is a cogent reminder that limited liability is an aspect of the social contract.

³⁶ One of the most troubling aspects of limited liability in a contract setting is the degree to which "little guys" are the victims. Typically, institutional lenders protect themselves by demanding personal guarantees or other security before extending credit to an incorporated entity. It is the claim of the materialman, supplier, or other small, recurrent creditor which is disappointed when the business goes under. As a practical matter, if a supplier is owed \$20,000, the cost of litigating the propriety of limited liability imparted by a set of corporate papers (see note 22 *supra*) places the matter beyond principled resolution. If a large creditor has sought protection in the course of a negotiated extension, the issue of limited liability is of academic interest. If the creditor has ignored this occasion for self-protection, perhaps he or she is deserving of little judicial sympathy. Neither of these fates addresses the problem of the small creditor. One will look in vain for literature extolling as a feature of incorporation the potential for taking advantage of small creditors. Professor Robert A. Kessler's *NEW YORK CLOSE CORPORATIONS* (Callaghan 1968) comes close with his reminder to the reader that: "Most trade suppliers, it must be

the party claiming limited liability.³⁷ By the same token, if the enterprise is begun with insufficient assets placed at risk in the form of investment while the balance of necessary funds is characterized as "loans" by the shareholders, a court is likely to order "reclassification" of these spurious creditor claims so as to subordinate them to those of outside creditors.³⁸

The point is distressing: if plaintiff is well represented by counsel, there is no certain protection for investors in a closely held corporate entity. But there is a social cost. While the assets of enterprisers are presumably at stake in the case of a partnership or sole proprietorship, they must be the object of litigation where an identical business has been organized as a corporation. The unpalatable consequence is the emergence of two classes of "victims": those who can afford and obtain the services of competent counsel (who may eventually defeat the claim of limited liability); and those who must live without recompense because somebody bought a "Black Beauty."³⁹

The planning idea of Professor Bradley contains some of the best and worst aspects of the pro-concession arguments. To his credit, Professor Bradley recognizes that attainment of corporate entity status is a "privilege." Yet he holds the view that the classical structure of corporate organization is a "straightjacket" imposing "senseless legal obstacles" to the business planner. However, if there is wisdom in the view that a "corporation" has

remembered, do not insist on personal guarantees." §3.03, at 21. The social costs implicit in this proposition should be considered before extending the corporate mantle.

³⁷ For the classic case establishing the liability of an individual attempting to utilize the corporate status only where convenient, see *Zaist v. Olson*, 154 Conn. 563, 227 A.2d 552 (1967); "When, however, the corporation is so manipulated by an individual or another corporate entity as to become a mere puppet or tool for the manipulator, justice may require the courts to disregard the corporate fiction and impose liability on the real actor." *Id.* 227 A.2d at 558.

³⁸ There are many tax benefits in the use (or overuse) of debt financing. These may often overshadow valid business reasons for using equity financing. Therefore tax considerations may artificially encourage "thin capitalization." See B. BITTKER & J. EUSTICE, *supra* note 8, at ¶ 4.01.

Should the Internal Revenue Service come to the conviction that a corporation's debt to equity ratio is excessive it will seek to reclassify some or all of this spurious debt as equity, thus eliminating favorable tax treatment. In concert with doctrines developed to pierce the corporate veil, reclassification is a remedy for a breach of the social contract. For cases involving "reclassification" by the Service, see *Tomlinson v. 1661 Corp.*, 377 F.2d 291 (5th Cir. 1967); *Nassau Lens Co. v. Comm'r.*, 308 F.2d 39 (2d Cir. 1962). See generally 1978 P-H FED. TAX. SERV. ¶13,096.

³⁹ For a discussion of commercial exploitation of the desire for rote incorporation, see note 22 *supra*.

been created to serve a utilitarian purpose in society, its prescribed structure is no more deserving of pejorative characterization than would be the girders in a bridge or the beams in a ceiling. Again, if the classical profile is rationalized from the nature of the corporate mission, the mandatory prescription is not "senseless." The lack of sense arises from the aspirations of Professor Bradley's "participants" to adopt a form of association ill-suited to their purposes. An analogy may illustrate the point. Should five individuals desire to use an automobile to "drive" to Hawaii, the ensuing disappointment of their "plans" and potential loss of life and property cannot be laid at the door of design limitations of the vehicle. The frustration and loss is traceable to the senseless selection of the mode of transportation. To select an automobile over a boat for purposes of water transportation because of a fixed preference for styling or an asserted familiarity with a steering wheel should be frankly discouraged.

A similar tone must be adopted in rejecting the pleas of those who have followed the ill-founded advice (or proceeded without the benefit of counsel) to incorporate and now find the "straightjacket" uncomfortable. Before we react with the concession of limited liability or "entity" status to pseudomorphs, society has a right to examine the likely direction of the participants. If they are found to be hell-bent for an arrangement classically regulated within the context of a partnership or limited partnership, then is it not both "sensible" and pragmatic to redirect their attention to business vehicles designed for these needs?

Bailout advocates go beyond deploring the rigidity of the classical corporate structure to reveal problems peculiar to the "close" nature of the close corporation. Implicit in the following statement by Professor Bradley is broad recognition of trouble arising within the closely knit group of "participants." It is clear that problems inherent in the fallen nature of humankind have not been cured by the wand of incorporation.

In addressing the problem of unfairness and oppression in the close corporation, legislation will have to first define the close corporation in a manner which does not make that status merely optional. In addition, care must be taken to make sure that the substantive provisions do not affirmatively assist the majority in effecting an unfair situation for minority shareholders. Finally, the statute should formulate a set of minimum rights which each participant is entitled to, however, only presumptively and subject to the agreement of the parties. An equal voice in management and

an equal share of profits would deserve the highest priority for inclusion in a catalogue of minimum rights, as would the right to information about the business. Other rights may be similarly deduced from the innate features of the close corporation relationship. The objective is to protect individual participants against exclusion from management, employment, salaries, dividends or other forms of corporate freeze-out, unless it is clear that what is happening is according to a compact unanimously arrived at. Legislation should nourish the principle that the close corporation is a cooperative undertaking for the mutual benefit of all of the parties involved.⁴⁰

It is respectfully submitted that what Professor Bradley is calling for is re-invention of the Uniform Partnership Act. The questions of an equal voice in the management and an equal share of profits, which Professor Bradley urges receive the highest priority, are assured by sections 18(e) and 24 of the U.P.A. (subject to agreement among the partners, every partner has equal rights in the management and conduct of the partnership business, and these are "property rights") and section 26 (defining a partner's interest in the partnership as his share of the profits and surplus). The fiduciary quality of the relationship *inter se* is the hallmark of the partnership at all stages of its life: formation, operation, and dissolution.⁴¹

Of an importance rivaling the apt text of these provisions is the *spirit* of the partnership, which is well understood within the marketplace. In the event of violation, there is ample judicial precedent for application of the tested formulas of the U.P.A.⁴²

Also deserving of attention are the "costs" implicit in some of the rescue legislation. When the operation of shareholder agreements that reject centralized management in favor of unanimity requirements results in paralysis, some commentators, some courts, and some legislatures have reacted by making such a cor-

⁴⁰ Bradley, *A Comparative Assessment of the California Close Corporation Provisions and a Proposal for Protecting the Individual Participants*, 9 *Lox. L.A.L. REV.* 865, 867 (1976).

⁴¹ See § 21(1) of the U.P.A.. For an early case establishing the fiduciary nature of the relationship between joint adventurers, see *Meinhard v. Salmon*, 164 N.E. 545 (N.Y. Ct. App. 1928). For a case reaffirming that the partnership relationship "is of a fiduciary character which carries with it the requirement of utmost good faith and loyalty . . .," see *Herring v. Offutt*, 266 Md. 593, 295 A.2d 876, 879 (1972).

⁴² See, e.g., *Herring v. Offutt*, 266 Md. 593, 295 A.2d 876 (1972).

poration a ward of the state.⁴³ No examination of the entries in a citator for the milestone case of *Galler v. Galler*,⁴⁴ can fail to excite depression at the continual attention demanded of the inferior Illinois judiciary in attempting to undo the schemes, plots, and ploys of two branches of a family bent upon war.⁴⁵ If this case were multiplied even a hundred times, the burden upon all others awaiting a day in court would be obvious.⁴⁶ Perhaps special tribunals should be created to act as receivers of glass jawed close corporations afflicted with shareholder agreements that ceased to be functional at the first breath of disagreement. Were such businesses formed as partnerships, "dissolution" would have resolved the impasse while ferreting out the villains. The business would likely have continued, but the enterprisers who had threatened its life would be forced to lift their siege.⁴⁷

⁴³ Several states provide for court-appointed provisional or custodial directors in the event of management deadlock in a close corporation. A provisional director votes as an additional director to help break a specific deadlock, while a custodial director actually functions as a full director when a court finds that more traditional remedies of dissolution or arbitration are inappropriate. Currently, seven states provide for a custodial director in certain circumstances. See DEL. CODE ANN. tit. 8, § 352 (1975); KAN. STAT. § 17-7212 (1974); LA. STAT. ANN. § 12:151 (West 1969); NEV. REV. STAT. § 78-650 (1973); N.J. STAT. ANN. § 14A:12-7 (West Cum. Supp. 1979); PA. STAT. ANN. tit. 15 § 1383 (Purdon Cum. Supp. 1979); VA. CODE § 13.1-94 (1978). For a discussion of deadlock remedies and a call for legislative adoption of the custodial remedy, see Comment, *The Custodial Remedy for Deadlocks in Close Corporations*, this issue at 498.

⁴⁴ 32 Ill. 2d 16, 203 N.E.2d 577 (1965).

⁴⁵ To follow the exploits of the litigious Galler family, see: *Galler v. Galler*, 45 Ill. App. 2d 452, 196 N.E.2d 5 (1964); *Galler v. Galler*, 32 Ill. 2d 16, 203 N.E.2d 577 (1965); *Galler v. Galler*, 69 Ill. App. 2d 397, 217 N.E.2d 111 (1966); *Galler v. Galler*, 95 Ill. App. 2d 340, 238 N.E.2d 274 (1968); *Galler v. Galler*, 21 Ill. App. 3d 811, 316 N.E.2d 114 (1974); and *Galler v. Galler*, 61 Ill. 2d 464, 336 N.E.2d 886 (1975).

⁴⁶ This possibility is not remote. Recently, the Los Angeles County courts have had to close one branch to civil actions because of a backlog of 7,000 cases. The cases will now be transferred to the central courthouse, where litigants will be put at the end of a 67,000 case backlog. *Van Nuys Superior Court to Take No Civil Cases*, Los Angeles Daily Journal, April 15, 1980, at 1, col. 6.

⁴⁷ Dissolution of a partnership is defined as "the change in the relation of the partners caused by any partner ceasing to be associated in the carrying on as distinguished from the winding up of the business" U.P.A. § 29. After dissolution, the partnership continues in existence until complete winding up of partnership affairs. Upon dissolution, every partner has a right to liquidation of assets, and distribution depends on the reason for dissolution.

Rather than return such business associations to the realm of the partnership, proponents of legislative concession urge the creation of state supported wards where non-functional close corporations may languish for an indefinite period. It is fair to greet these proposals with the question "why?"

The argument respecting access to federal tax concessions is far more difficult to refute. As a consequence of historical accident, and notwithstanding efforts of the Internal Revenue Service to overcome it,⁴⁸ qualification for taxation at the significantly less onerous corporate rates generally hinges upon the willingness of a *state* to grant a corporate charter. While Congress could change this result tomorrow, it shows no inclination to do so. As a result, even individuals may incorporate and, having obtained a charter, see their income from enterprise activity taxed at rates which do not exceed 46 per cent. A non-incorporated taxpayer earning the same income could be subjected to taxation which runs as high as 70 per cent.⁴⁹ Certain tax reforms such as the maximum 50 per cent tax bracket for income produced by the rendition of "personal service" has gone some dis-

For two recent cases discussing dissolution and later liquidation, see *King v. Stoddard*, 28 Cal. App. 3d 708, 104 Cal. Rptr. 903 (1972); *Prentiss v. Sheffel*, 20 Ariz. App. 411, 513 P.2d 949 (1973).

⁴⁸ An "association" can qualify for corporate taxation, even if it is not a corporate entity, under I.R.C. § 7701(a)(3) and regulations promulgated thereunder. Characterization as an "association" for corporate tax purposes depends on the characteristics of continuity of life, centralized management, limited liability, and free transferability of interests, as well as the common characteristics of associates, and an objective to carry on a business for profit. Treas. Reg. § 301.7701-2(g). Therefore, many partnerships that have several of the above corporate characteristics claim the benefits of corporate taxation.

The Internal Revenue Service has fought taxpayer attempts to qualify partnerships as corporations, and the regulations reflect this tendency. In 1954, the Ninth Circuit recognized the validity of corporate taxation for professional corporations (i.e., incorporated law or medical "partnerships") in *United States v. Kintner*, 216 F.2d 418 (9th Cir. 1954). The Service reacted with substantial amendments to the regulations. In 1976, a divided tax court granted "association" status to a limited partnership. *Phillip G. Larson*, 65 TC No. 10 (issued Oct. 21, 1975, withdrawn Nov. 7, 1975, reissued, 66 T.C. 159 (1976)). The Service again reacted with new regulations, which were later withdrawn. The Service has since acquiesced in *Larson*. 1979 - 1 C.B.1. The current state of the law is unclear, but the Service clearly is unhappy granting "association" status to any partnership formed under the U.P.A. or the U.L.P.A. See generally B. BITTKER & J. EUSTICE, *supra* note 8, at ¶¶ 2.04-2.06.

⁴⁹ See note 8 *supra*.

tance in removing this irrational result.⁵⁰ Nonetheless, if a closely held enterprise operates as a partnership or limited partnership the net business income is taxed to the owners in proportion to their interests in the firm, even though it is not distributed but retained for eventual expansion of the business. By contrast, the same business income which is not distributed by a corporation is taxed to the corporate entity at the lesser rates, and there is no tax liability to the individual enterprisers for undistributed earnings. If any portion of this "after tax" corporate income is taken by the investors as a return on their capital (dividends), it is taxed a second time at the rates applicable to their personal brackets.⁵¹ Both legal and accounting practices thrive on these non-self evident truths.

Corporate tax concessions obviously facilitate capital formation. Should the privilege be abused and the business earnings simply accumulated using the corporate entity as a tax minimizing piggy bank, the accumulated earnings tax will be the unpleasant consequence.⁵² Yet no other business vehicle is afforded even the chance for such accumulation.

Finally, the argument that the choice is between ordered change orchestrated by legislation or chaos produced by litigation contains elements of sound warning.⁵³ Yet one need not sur-

⁵⁰ I.R.C. § 1348.

⁵¹ See B. BITTKER & J. EUSTICE, *supra* note 8, at ¶ 4.01 for a discussion of the "double tax" bite.

⁵² Generally, a corporation is free to distribute earnings in the form of dividends or retain the earnings for the asserted purpose of reinvesting in the enterprise. However, the Internal Revenue Service has a powerful tool to tax "excess" retained earnings in I.R.C. §§ 531-537. The difficulty with the retained earnings tax is that the definition of "excess" retained earnings is very vague; seemingly appropriate accumulations often result in an unexpected tax ranging from 27.5% to 38.5%. As a result, many corporate boards err on the side of excess dividends in order to avoid the Service's harsh penalty. See generally B. BITTKER & J. EUSTICE, *supra* note 8, at ¶ 8.01; Comment, *The Accumulated Earnings Tax: A Trap for the Unwary or a Workable Statute?*, this issue at 520.

⁵³ Acceding to the demands for discrete statutory treatment does *not* create immunity from what may be viewed as common law meddling, and thus the vision of ordered change produced by legislative concession is destined to be frayed by experience. A common feature of many of the legislative responses has been the attempt to define the close corporation in terms of a maximum number of shareholders. If the entity is organized with shareholders not exceeding this maximum, there is permission to claim the concessions implicit in the scheme. Such an arbitrary numerical limitation renders inevitable the case

render to the cries of this Cassandra. While the approach has not been tested, a legislature could provide in the corporation code that it had expressly considered the question of discrete treatment for closely held associations and found the social costs opposed to such a result. Such a declaration could not destroy the power of the courts to create common law, but common sense, as well as comity, suggests that a court so alerted would not rush to embrace a consciously avoided result.

CONCLUSION

The most crucial argument against discrete statutory treatment of close corporations directly assaults the essence of the modification scheme. From the earliest efforts in New York to the more radical legislation in Arizona, closely held corporation provisions increasingly transgress the fundamental assumptions upon which the concept of a "corporation" is founded and experienced. The board is either stripped of all meaningful power or eliminated in favor of non-centralized management;⁵⁴ voting rights are locked into agreements which destroy the concept of majority rule;⁵⁵ free transferability of interest is denied by restrictions upon sale or inheritance of stock;⁵⁶ and, continuity of

in which a court is plied with the argument that this particular entity has but "one more" shareholder and yet is deserving of a fate far closer to that of the *de jure* close corporation than the alternative statutory scheme which will be characterized as functionally appropriate to General Motors. Already, there are predictions that such pleas will meet with a receptive judiciary. See Berger, *Statutory Close or Closely Held Corporation?*, 11 PAC. L.J. 688 (1980).

For cases creating new close corporation definitions and duties out of common law cloth, see *Donahue v. Rodd Electrotype*, 367 Mass. 733, 328 N.E.2d 503 (1975); *68th Street Apts., Inc. v. Laurioella*, 142 N.J. Super. 546, 362 A.2d 78 (1976), *aff'd.*, 150 N.J. Super. 47, 374 A.2d 1222 (1977). See also *Darvin v. Belmont Indus., Inc.*, 40 Mich. App. 672, 199 N.W.2d 542 (1972).

⁵⁴ For examples of statutorily permissible limitations on the traditional powers of a corporate board of directors, see N.Y. BUS. CORP. LAW § 620(b) (McKinney 1963) (allowing transfer of most board functions to the shareholders if certain conditions are met); FLA. STAT. ANN. § 607.107 (1977) (allowing transfer of functions upon any unanimous shareholder agreement); N.J. STAT. ANN. §§ 14A:5-21 (West Cum. Supp. 1979). See also DEL. CODE ANN. tit. 8, § 354 (1975) (providing that shareholder agreements may regulate the affairs of a corporation in effect as if it were a partnership).

⁵⁵ Voting agreements are permissible means of distorting majority rule in all of the states with separate close corporation legislation. See note 1 *supra*.

⁵⁶ While close corporation legislation generally allows for restrictions on the free transferability of shares, several states *require* restrictions to qualify for

life is threatened by permitting disagreement (or even lack of unanimity) to become the source of paralysis and then using this pretext for dissolution of the entity.⁵⁷ The road to this result is open and well traveled. Questions remain as to the utility of the journey.

A negative answer is suggested by a brief recollection of the role of the corporation. The accumulation of investment capital placed in the hands of centralized management is thought to produce wealth and thus a public good. Yet to "incorporate a partnership" and hamstring its function with shareholder agreements or provisions of the articles is to undermine the premise upon which the expectation of public advantage is grounded. True, limited liability is claimed, but the view has already been asserted that this is a concession to, and not the object of, a working corporation. Tax advantages are garnered in an essentially irrational interplay of state and federal law. Yet if the creation of corporate rates is traced to a desire to foster accumulation of capital for efficient deployment by centralized management, then this policy, like the essence of the corporate concept, is mocked by the close corporation.

The case for the opposition comes down to this: the modification of the corporate entity in the attempted accommodation of the "close client" involves the compromise if not the surrender of fundamental goals and vital assumptions. It is a transaction

close corporate status. See ILL. ANN. STAT. ch. 32, § 1203 (Smith-Hurd Cum. Supp. 1979)(a close corporation must have at least one of five types of share restrictions); DEL. CODE ANN. tit. 8, § 342(a)(2) (1975); KAN. STAT. § 17-7202(a)(2) (1974); PA. STAT. ANN. tit. 15 § 1372A(2) (Purdon Supp. 1977). California (CAL. CORP. CODE § 418 (West Cum. Supp. 1980)) allows a close corporation to retain its status by invalidating all inter vivos transfers of stock which impermissibly enlarge the number of shareholders beyond 10.

⁵⁷ As has been repeatedly stressed by commentators who have no declared hostility to the concept, accommodation of the closely held corporation is no guarantee that enterprisers gathered under that umbrella will live in amity. See notes 38-42 and accompanying text *supra*. Indeed, enticing investors into an entity with a presumed continuity of life sets the stage for "gang up" and other exploitative combinations exerted against a minority. Unlike rightful dissolution for breach of a partnership agreement, the victim of this harm-dealing or income-starving combination requires the extraordinary intervention of litigation to obtain relief which is neither certain nor clear. Thus while the thrust of the anti-concession arguments has been disservice to the public implicit in fostering "close corporations," there may be significant danger to individual enterprisers as well.

fraught with cost and without discernible benefit to the public. For the state to countenance such a result would be strange. To facilitate that end seems senseless.