CONTROL DISTRIBUTION DEVICES

*BY F. HODGE O'NEAL**

I. Introduction

THIS ARTICLE will discuss the various devices which may be utilized in allocating control and management powers in a close corporation. Specifically, it will analyze the following devices and techniques: (1) classification of stock and allocation of shares of the various classes among the shareholders; (2) class voting for directors; (3) charter or by-law provisions requiring unanimity or high percentage votes for shareholder or director action; (4) miscellaneous special charter or by-law clauses affecting management; (5) voting agreements and other agreements among shareholders; (6) voting trusts; (7) irrevocable proxies; (8) holding companies; and (9) management contracts. The objective of this article is to provide an overall view of these control devices and to provide "idea guides" for the lawyer planning the control pattern of a close corporation.[1]

II. Classification of Stock

A useful technique in distributing control is to create two or more classes of shares and carefully allocate shares of the various classes among the participants in the close corporation. Provision can be made in the charter for several classes of shares with different voting power, rights to dividends, rights on liquidation and other qualities. Some classes of shares can be common shares, others preferred. Shares in some classes can be given a par value; shares in other classes can be without par value. Shares in some classes can be made callable at the option of the corporation, while shares in other classes can be convertible into other securities at the option of the holders. A class of shares can be made nonvoting, or voting rights can be made to vary according to the question under consideration. For example, a class of shares may be deprived of the right to vote only in the election of directors or on by-laws or on fundamental corporate action; or it may be deprived of the right to vote altogether (subject to mandatory statutes in some jurisdictions granting certain voting rights to all shareholders). Furthermore, it can be provided that votes on some types of action be by shares and on other kinds of action by classes. By varying the voting powers, dividend rights, and other qualities of the several classes of stock,

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[1] This article will not discuss the case law in detail. The author has examined the authorities in F. O'Neal, Close Corporations: Law and Practice, chs. III, IV, V (Supp. 1968).

and by using different combinations in allocating shares of the various classes, almost any desired control arrangement can be achieved.

In Illinois,[2] and perhaps a few other states, nonvoting shares cannot be created. In such jurisdictions the desired control arrangement usually can be attained by using several classes of stock. Each share, regardless of its class, must be given a vote; but the number of shares in a class can vary, and the financial interests (the claim on dividends and the assets on dissolution) represented by the shares can differ from class to class. Thus, $1 par value common stock can be issued to some of the participants and $100 par value preferred stock to others. If all the shares are issued at par value, the recipients of the $1 par stock will get a favorable 100 to 1 ratio of control to investment. Dividend and liquidation rights of the two classes can be adjusted to fit the business bargain of the participants. Likewise, no-par stock or a combination of par value and no-par stock can also be used to obtain a desired allocation of control. To achieve the desired pattern of control, several classes of shares are issued at different prices and a large number of shares are placed in the hands of the participants who are to have control. In formulating the stock structure and control plan, the lawyer must of course remember that par value shares normally cannot legally be issued for less than their par value.

III. Class Voting for Directors

One of the best techniques for assuring that all or several of the participants in a close corporation will be represented on the board of directors is to create two or more classes of shares and provide that each class shall elect a specified number or a stated percentage of the directors.[3] Thus, class *A* common stock might be given the power to elect three directors and class *B* common stock the power to elect two.[4]

If all of the shares in a class are issued to one individual, he will be able to transfer 49 per cent of his shares and still retain the power to elect all the directors represented by that class of shares. This type of arrangement facilitates estate planning since the recipient of a class of shares can give shares to his children or to others without any loss of control as long as he retains more than half the shares in the class.

Where there are two groups of shareholders, each wanting a veto power over director action, a board with an even number of directors can be created and each group given a class of stock with power to elect

[2] Ill. Const. art. XI, § 3; Ill. Rev. Stat. ch. 32, § 157.28 (1968). *See* People *ex rel.* Watseka Tel. Co. v. Emmerson, 302 Ill. 300, 134 N.E. 707 (1922).

[3] Illinois prohibits class voting. *See* Wolfson v. Avery, 6 Ill. 2d 78, 126 N.E.2d 701 (1955).

[4] For a corporation charter providing for class voting for directors, *see* Investment Associates v. Standard Power & Light Corp., 29 Del. Ch. 225, 48 A.2d 501 (Ch. 1946), *aff'd*, 29 Del. Ch. 593, 51 A.2d 572 (Sup. Ct. 1947).

half of the board. This arrangement, of course, might lead to a deadlock.

Despite its usefulness as a control device, class voting for directors is objected to on the grounds that it often makes an increase in the number of directors difficult to obtain. This is particularly crucial when the corporation is growing and needs a larger board.

In focusing on class voting for directors, the lawyer must be aware of the manner in which the voting power is going to be distributed on other matters. Corporation statutes generally require the consent of the holders of two-thirds or three-fourths of the voting shares for charter amendments, mergers, sale of substantially all corporate assets not in the usual course of business, and other fundamental changes. Thus, the lawyer must note where the two-thirds or three-fourths voting power will lie and whether one shareholder or group of shareholders will have the power to veto corporate action requiring a larger-than-majority vote of the shareholders.

The lawyer must also protect against disruption of a control arrangement of this kind by an amendment to the charter abolishing classified voting, increasing the size of the board of directors, or authorizing the issuance of additional shares within a class. In most states, this problem can be solved by requiring a class vote or a high overall shareholder vote to amend the charter.

IV. Charter or By-Law Clauses Requiring High Votes

Businessmen acquiring minority interests in close corporations often seek protection against the broad powers vested in shareholders and directors to determine corporate policies and to make decisions by simple majority vote.[5] In effect, they want the power to veto some or all corporate decisions. One of the most effective ways to provide this veto is by charter or by-law provisions requiring unanimity or concurrence of a high percentage of voting units for shareholder or director action.[6]

[5] For a discussion of techniques of oppression and of squeeze-out devices available to majority shareholders in a close corporation where a minority shareholder does not insist on a veto power or other protective arrangements when he comes into the enterprise, *see* F. O'Neal & J. Derwin, Expulsion or Oppression of Business Associates: "Squeeze-Outs" in Small Enterprises §§ 3.01-5.05 (1961).

[6] Illinois law authorizes by-laws or provisions in the articles of incorporation which require a high vote, *i.e.*, greater than majority, to constitute action of the board of directors:

> "A majority of the number of directors . . . shall constitute a quorum . . . unless a greater number is required by the articles of incorporation or the by-laws. The act of the majority of the directors present at a meeting at which a quorum is present shall be the act of the board of directors, unless the act of a greater number is required by the articles of incorporation or the by-laws."

Ill. Bus. Corp. Act § 37, Ill. Rev. Stat. ch. 32, § 157.37 (1967). Section 31 of the Illinois Act authorizes high vote requirements for shareholder action. *See* Moss v. Waytz, 4 Ill. 2d 296, 124 N.E.2d 91 (1st Dist. 1955), where a preincorporation contract requiring a unanimous vote was held binding and was not effected by a subsequent by-law providing for only a majority vote. Also upholding an unanimous vote requirement was Fitzgerald v. Christy, 242 Ill. App. 343 (1st Dist. 1926).

In most jurisdictions, a veto over fundamental changes in the corporate structure can easily be accomplished. Modern corporation statutes provide for shareholder participation in fundamental corporate acts such as charter amendment, merger, consolidation, dissolution, and sale of assets other than in the usual course of business. If properly protected against amendment, a charter provision requiring unanimity for shareholder action on these matters will give each shareholder an effective veto over fundamental corporate changes. Similarly, a provision requiring approval by the holders of a high percentage of the shares for shareholder action can be used to provide a veto over fundamental acts. For instance, a requirement of approval by the holders of 75 per cent of the shares obviously empowers a person holding 30 per cent of the shares to prevent shareholder action, provided the requirement is protected against circumvention through the issuance of additional stock.

High voting requirements for shareholder action usually do not encompass the power to veto such important policy matters as changes in officers' salaries, or the day-to-day conduct of business. To provide a veto over those matters, unanimity or a high vote must be required for director action,[7] and the shareholders for whom a veto is sought must be assured representation on the board of directors. Furthermore, it may be necessary to define narrowly the authority and duties of corporate officers in the charter or by-laws; otherwise, corporate officers may have the authority to perform acts against which a veto is desired without obtaining director approval.

Whenever a shareholder has sufficient voting strength to maintain representation on the board, a requirement of unanimity for board action enables him to veto any action within the province of the board. Representation on the board can usually be assured a minority shareholder by employing cumulative voting or by classifying the shares and providing for election of some directors by one class of shares and other directors by a second class of shares.[8] To guard against possible board action while the shareholder's position on the board is vacant because of the death or resignation of his representative, a provision can be placed in the charter or by-laws prohibiting board action until the vacancy has been filled.[9]

Whenever a shareholder cannot be assured representation on the board

> "[T]he fact that the statutes provide that a majority of the directors elected shall constitute a quorum for the transaction of business does not prevent the directors, who include all the stockholders, [from] agreeing that a unanimous vote shall be required on certain questions."

Id. at 359.

[7] For an example of by-laws requiring unanimity for director action and a high vote for shareholder action, *see* Roland Park Shopping Center, Inc. v. Hendler, 206 Md. 10, 109 A.2d 753 (Ct. App. 1954).

[8] *See* note 3 *supra* and accompanying text.

[9] *See* Strong v. Fromm Laboratories, Inc., 273 Wis. 159, 77 N.W.2d 389 (1956) (by-law barred directors from transacting business while vacancy unfilled).

or whenever an effective veto of board action cannot be given, a veto over matters ordinarily within the province of the board can sometimes be achieved by transferring decision-making power over those matters from the directors to the shareholders and then requiring unanimity or a high vote for shareholder action. In most states the blanket transfer of *all* corporate power to the shareholder, completely divesting the board of its customary functions, probably would not be sustained. First, the great majority of corporation statutes contain sections which vest the management of the corporation and the control of ordinary corporate affairs in the board of directors. Second, some statutes contain provisions which empower the board to perform specified acts, such as the selection of corporate officers. In some jurisdictions, the control vested in the directors by these statutes apparently cannot be transferred to the shareholders or limited by a requirement that the shareholders must ratify action taken by the directors for it to become effective.[10]

Many corporation statutes, however, permit the charter or by-laws to determine whether certain corporate acts are to be performed by the shareholders or by the directors. The Pennsylvania statute, for example, states that "unless the article or by-laws provide otherwise, the board of directors shall elect and fix the compensation" of officers and assistant officers.[11] Thus, if the shareholders desire a veto over the selection of corporate officers and the fixing of their salaries, a clause can be inserted in the charter providing that the shareholders shall elect the officers and fix their salaries and that this action can be taken only by a unanimous vote or by a specified vote greater than a majority. Similarly, under the laws of a number of states, the charter may require shareholder consent for the execution of corporate mortgages.[12]

Some lawyers, with a view to conferring a veto, insert provisions in the charter or by-laws requiring the presence of a high percentage of shareholders or directors to constitute a quorum for the transaction of any business or of designated kinds of business. To protect shareholders or directors against their inadvertently appearing at a meeting in which action they oppose is to be considered, the high quorum requirement must be buttressed by a requirement that notices of meetings state the business that is to be transacted. Otherwise, a shareholder or director might attend a meeting, help form a quorum, and thereby permit action on a matter he opposes.[13]

[10] *See* Security Sav. & Trust Co. v. Coos Bay Lumber & Coal Co., 219 Wis. 647, 263 N.W. 187 (1935) (declaring invalid a by-law requiring shareholder consent for specified acts within the province of the directors).

[11] Pa. Stat. Ann. tit. 15, § 1406 (1967).

[12] *E.g.*, Cal. Corp. Code § 3900 (West 1955); Tenn. Code Ann. § 48-509 (1964). *See* Note, *Provisions for Stockholders' Consent in the Execution of Corporate Mortgages*, 51 Harv. L. Rev. 1074 (1938).

[13] The New York Court of Appeals has greatly diminished, if not completely eliminated, the protection afforded minority interests by high quorum requirements

Many lawyers apparently believe that the use of both high-quorum and high-vote requirements establishes a double hurdle which objectionable action must clear before it will become effective. Actually, this double obstacle is an illusion. If a shareholder or director does not attend a meeting in order to prevent the forming of a quorum, he never gets an opportunity to veto a proposal by voting against it. Conversely, if he appears and casts his vote against a proposal, the quorum obstacle disappears. In most situations, it is preferable to rely solely on a high vote requirement. This permits shareholders or directors in apparent disagreement to come together, discuss their differences, and possibly discover areas of agreement or devise policies satisfactory to all.

Although high vote provisions are very useful in fashioning management patterns for closely held corporations, the limitations and disadvantages of such provisions must not be overlooked. They give a veto and no more; they do not enable minority shareholders to determine policy affimatively and to go forward with the execution of that policy. Secondly, they deprive the corporation of the flexibility it may need to adjust to unexpected business situations. At the time of incorporation, the lawyer cannot foresee changes in policy and methods of operation which may become advantageous in the future. Finally, high vote requirements may place one or two shareholders in a position to extort unfair concessions from the other shareholders as a condition to approving beneficial corporate action. The use of such provisions, therefore, involves a problem of weighing the safeguards necessary to protect the interests of minority shareholders against the freedom of action that is beneficial to the corporation and the shareholders as a group.

V. SPECIAL CHARTER OR BY-LAW CLAUSES AFFECTING CONTROL

Special charter or by-law clauses are often very useful in tailoring the control pattern of a corporation. Among the clauses which may be employed are those which: (1) give shareholders the power to remove directors at any time without cause; (2) abolish the board of directors or sharply restrict the board's powers (in jurisdictions where this is permissible); (3) strengthen the shareholders' rights to inspect books and records; (4) strengthen, define, or abolish pre-emptive rights; (5) provide for arbitration or other procedures for settling disputes or resolving deadlocks; (6) authorize directors

for directors' meetings and has created a dangerous trap for the unwary by its decision in Gearing v. Kelly, 11 N.Y.2d 201, 182 N.E.2d 391, 227 N.Y.S.2d 897 (1962), *noted in* 62 COLUM. L. REV. 1518 (1962) and *Kessler, 1962 Survey of New York Law: Business Associations*, 14 SYRACUSE L. REV. 235 (1962). The court held that a director who prevented the presence of a quorum by refusing to attend a special board meeting called to fill a vacancy on the board, which would have given a majority to the opposing faction, could not later come into court and challenge the election of a director as being irregular since he himself caused the irregularity by deliberately refusing to attend the meeting.

to fix their own compensation; (7) require an increase in dividends when compensation of executives is increased.

The clauses enumerated are not exhaustive. Other special charter or by-law clauses undoubtedly will occur to resourceful and energetic draftsmen grappling with particular business situations.

VI. VOTING AGREEMENTS AND OTHER SHAREHOLDER CONTRACTS

Perhaps the most frequently used control device in close corporations is a shareholders' voting agreement or some other shareholder contract allocating control and management powers among the participants. All shareholders, a majority of the shareholders, or even the holders of a minority of the shares may enter into such an agreement.

A typical shareholders' control agreement covers some or all of the following matters: (1) who are to be the directors or how the participants' shares are to be voted in the election of directors; (2) who are to serve as the corporation's officers and key employees and what is to be their compensation; and (3) what voice the various participants are to have in management and policy decisions. An agreement may also contain provisions on how corporate earnings are to be distributed, how disputes among participants are to be resolved, and what procedure is to be followed in dissolving the corporation.[14]

In addition shareholders' agreements frequently contain provisions which do not deal directly with management or control, but which prevent transfers of stock that might upset carefully formulated control agreements. Among these nonmanagement provisions are restrictions on the alienability of shares and provisions for the purchase of the interest of a deceased shareholder.

The lawyer needs to remember that shareholders' control agreements are frequently challenged as being invalid, especially those that purport to regulate matters which are normally within the province of the board of directors. Special precautions should be taken to protect such agreements against attack or circumvention.[15]

[14] In Galler v. Galler, 32 Ill. 2d 16, 203 N.E.2d 577 (1965), the Illinois Supreme Court upheld a stockholder voting agreement which provided that: (1) the board of directors was to be composed of four directors, three of whom would constitute a quorum; (2) ten days advance notice to all directors was required for any directors meeting; (3) the participants in the agreement were required to elect four named persons to directorships (the two majority shareholders and their wives); (4) in the event of either majority shareholder's death, his wife could nominate a director to take his place; (5) annual dividends of $50,000 were to be declared out of earned surplus in excess of $500,000; (6) salary continuation agreements were provided in the event of the death of one of the majority shareholders (twice his annual salary to his wife over a five-year period); and (7) heirs of a deceased shareholder were guaranteed the same voting representation and dividend payment, even if the corporation elected to exercise its authority under the agreement to purchase some of their shares to enable the heirs to pay the inheritance and estate taxes of the deceased shareholder's estate.

[15] *See* O'Neal, *Protecting Shareholders' Control Agreements Against Attack*, 14 BUS. LAW. 184 (1959).

VII. Voting Trusts

The voting trust is not just a "big business" instrument as is sometimes supposed. It is a flexible device which can be very useful in working out the control arrangement in a close corporation.

Shareholders may create a voting trust by entering into trust agreements or by transferring title to their shares to voting trustees who in return issue certificates of beneficial interest, usually called "voting trust certificates," to the shareholders. The trustees then vote the shares in accordance with the terms of the trust agreement.

Apart from limitations imposed by statute or public policy, the parties to a voting trust agreement may adopt whatever provisions, as to both substance and procedure, that they desire. For example, a trust agreement can name the persons for whom the trustees are to vote in the election of directors, or it can establish a board of trustees with an equal number of members and provide for an arbitrator to cast the deciding vote in the event of an equal division among the trustees. Even in the absence of statute, the prevailing view is that a voting trust is valid if it has a proper purpose. Although the intended duration of a voting trust is a factor which courts consider in passing on its validity, voting trusts have been sustained which were to last 25 years or longer.

Most states now have statutes which expressly authorize the creation of voting trusts, thus removing doubt as to their validity when the statutory terms are met and the purposes of the trusts are proper. The voting trust statutes usually place a maximum on the duration of such trusts, typically 10 years,[16] and often contain some type of registration requirement.

Holders of a majority of the voting shares in a close corporation sometimes use a voting trust instead of a voting agreement as a device for consolidating their voting power and assuring that their shares will be voted as a unit. In a particular jurisdiction a voting trust may be chosen instead of a shareholders' agreement because a statute expressly recognizes the legality of voting trusts and sets forth the procedure for their creation, while satisfactory statutory or judicial support for shareholders' agreements cannot be found. Furthermore, a voting trust may be selected because it is self-executing, while specific performance of a shareholders' agreement might not be available and, in any event, would involve risks and delays.

Nevertheless, in most jurisdictions a shareholders' agreement is usually preferable to a voting trust for allocating control in a close corporation. As has been pointed out, voting trust statutes set a maximum limit on the duration of voting trusts, usually 10 years. A particular business situation may well require a control arrangement of longer duration. Other limitations or conditions established by some of the voting trust statutes may

[16] *See* Ill. Bus. Corp. Act § 30a, Ill. Rev. Stat. ch. 32, § 157.30a (1967), limiting the duration of a voting trust to 10 years.

prove to be undesirable to the persons establishing a trust. For example, some statutes require that a copy of the trust agreement be deposited with the corporation,[17] thus making the terms of the agreement available to all shareholders; and a few statutes give all shareholders the privilege of coming into a trust—a privilege which precludes the establishment of a trust limited to shareholders with the same interests and goals. Furthermore, a voting trust is somewhat more complicated to set up than is a control arrangement by shareholders' agreement. The establishment of a voting trust involves the selection of voting trustees, the transfer of title in the shares to the trustees, and the issuance of voting trust certificates. Of considerable practical importance is the fact that the transfer of title to the trustees in some jurisdictions is subject to state transfer taxes.[18]

Another grave disadvantage of the voting trust which arises out of the transfer of title to the shares is that the parties to the agreement may become legal strangers to the corporation and thereby lose some of the rights and remedies which they had as shareholders. Under the law of some jurisdictions, it is not clear whether holders of voting trust certificates are entitled to inspect corporate books and records, to receive reports, or to bring shareholders' derivative actions.[19]

VIII. Irrevocable Proxies

The parties to a shareholders' agreement, instead of merely binding themselves to vote their shares as a unit or in accordance with a predetermined plan, sometimes relinquish their power to vote their own shares and confer that power, in the form of an irrevocable proxy, upon one or more of their number or upon some person not a party to the agreement. Even though a shareholders' agreement does not expressly provide for an irrevocable proxy, such a proxy may be inferred from the content and purposes of the agreement.[20] A proxy may be advantageous in a voting agreement to facilitate implementation of the agreement and to avoid the possibility that a suit for specific performance, with the attendant uncertainties and delays, will be necessary to put into effect decisions reached under the agreement.[21]

[17] *Id.*

[18] *See In re* Chilson, 19 Del. Ch. 398, 404, 168 A. 82, 84 (Ch. 1933), for an instance in which the expenses of transferring the shares to the trustees, particularly the cost of transfer stamps, were found to be prohibitive.

[19] *See* H. Ballantine, Corporation § 184b (rev. ed. 1946); Ill. Bus. Corp. Act § 45, Ill. Rev. Stat. ch. 32, § 157.45 (1967), permitting inspection of books and records by any person holding a voting trust certificate for at least six months prior to demand.

[20] *See, e.g.*, Smith v. San Francisco & N.P. Ry., 115 Cal. 584, 47 P. 582 (1897); *but see* Ringling Bros.-Barnum & Bailey Combined Shows, Inc. v. Ringling, 29 Del. Ch. 610, 53 A.2d 441 (Sup. Ct. 1947), *modifying* 29 Del. Ch. 318, 49 A.2d 603 (Ch. 1946). *See also* 46 Mich. L. Rev. 70, 76 (1947). *See generally* Note, *The Irrevocable Proxy and Voting Control of Small Business Corporations*, 98 U. Pa. L. Rev. 401 (1950).

[21] *See* Ringling Bros.-Barnum & Bailey Combined Shows, Inc. v. Ringling, 29 Del.

IX. Holding Companies

A holding company can be used instead of a shareholders' voting agreement or a voting trust to consolidate the voting power of a group of majority shareholders. The holders of a majority of the voting shares in company *A* can create another corporation, company *B*, and transfer their shares to it. Thereafter the shares in company *B* will be voted as a unit pursuant to directions from *B*'s board of directors.

In *Baum v. Baum Holding Company*,[22] the holders of a majority of the shares in a realty company assigned their shares to a holding company which they had formed, and received in exchange an equal number of holding company shares. Thereafter Baum, the owner of a majority of the holding company's shares, was able to vote the holding company's shares in the realty company and exert control over both corporations even though he was only a minority shareholder in the realty company.

X. Management Contracts

To be distinguished from control agreements among some or all of the shareholders are agreements executed by the corporation itself under which its management or the control over certain aspects of its operations are entrusted to a creditor or to some other individual or corporation. The contract is usually referred to as a "management agreement" when it attempts to vest the entire management of the corporation or even substantial management powers in another corporation or individual, particularly when a substantial fee is to be paid for these management services. A distinction also should be made between management agreements and the common arrangements under which the directors temporarily delegate part of their functions to an executive committee or to corporate officers. An arrangement delegating authority to an executive committee or some of the corporation's officers is always subject to the supervision and overriding power of the directors, and the directors usually can modify or terminate the authority of a committee or an officer at any time. A management agreement, on the other hand, does not leave final power in the board.

Judicial opinions dealing with the validity and effect of management agreements and other corporate contracts which vest control of the corporation in managers other than its duly selected directors and officers are few in number and in some instances rather unsatisfactory. In particular, there seems to be a tendency in the decisions to lump together indiscrimi-

Ch. 610, 53 A.2d 441 (Sup. Ct. 1947), *modifying* 29 Del. Ch. 318, 49 A.2d 603 (Ch. 1946), where the purpose of the voting agreement was frustrated by the failure of the Delaware Supreme Court to require the recalcitrant party to vote her shares in accordance with the decision of an arbitrator. The inclusion of irrevocable proxies in a shareholders' agreement, however, opens the agreement up to considerable risks. For a discussion of these dangers, *see* F. O'Neal, Close Corporations: Law and Practice § 5.36 (1958).

[22] 158 Neb. 197, 62 N.W.2d 864 (1954).

nately cases dealing with corporate contracts and those relating to shareholders' agreements. The decisions indicate, however, that a management contract may be subject to attack on two grounds:[23] (1) the contract violates a statute which provides that the affairs of a corporation shall be managed by its board of directors;[24] and (2) the directors of a corporation, in view of their limited term of office, do not have the capacity to enter into long-term contracts which would bind future boards for long or indefinite periods on basic policy or management matters.[25]

Taking the decisions as a whole, the validity of a contract by which a corporation vests control of its affairs in another person or company seems to depend upon the number and importance of the powers that are delegated, the length of time for which the powers are to be held,[26] and perhaps the purpose of the contract or the situation out of which it arose. Management contracts delegating substantially all management powers to outsiders for indefinite or extended periods of time are usually held invalid. Thus, a court struck down a contract between two insurance companies which gave one the "underwriting and executive management" of the other for a period of 20 years.[27] From the terms of the agreement and the length of time it was to remain in effect, the court concluded that "not only managerial powers were delegated, but the entire policy" of one company was to be fixed and determined by the other.[28] Similarly, an agreement by a corporation giving the purchaser of some of its five-year convertible bonds

[23] A management agreement for the control of a public utility or other special type of corporation may also contravene federal or state legislation. *See, e.g.*, Investment Company Act of 1940 § 15, 15 U.S.C. § 80a-15 (1964); Public Utility Holding Company Act of 1935 § 13, 15 U.S.C. § 79m (1964); Wis. Stat. § 182.0135 (1955).

[24] Shaw v. Bankers' Nat'l Life Ins. Co., 61 Ind. App. 346, 357-59, 112 N.E. 16, 20 (1916); Marvin v. Solventol Chem. Prods., Inc., 298 Mich. 296, 301-02, 298 N.W. 782, 784 (1941); Long Park, Inc. v. Trenton-New Brunswick Theatres Co., 297 N.Y. 174, 77 N.E.2d 633 (1948).

[25] *See* General Paint Corp. v. Kramer, 57 F.2d 698 (10th Cir. 1932); Beaton v. Continental Southland Sav. & Loan Ass'n, 101 S.W.2d 905 (Tex. Civ. App. 1937); 2 W. Fletcher, Private Corporations § 495 (perm. ed. rev. 1954); 85 U. Pa. L. Rev. 849 (1937).

"These directors could not impose an obligation on the corporation or its constantly changing membership to continue for a long period beyond their term of office and thus hamper the action of future boards." Clifford v. Firemen's Mut. Benevolent Ass'n, 232 App. Div. 260, 261, 249 N.Y.S. 713, 714 (1931), *aff'd mem.*, 259 N.Y. 547, 182 N.E. 175 (1932).

[26] *See* Sherman & Ellis, Inc. v. Indiana Mut. Cas. Co., 41 F.2d 588, 591 (7th Cir.), *cert. denied*, 282 U.S. 893, 51 S. Ct. 107 (1930).

[27] Sherman & Ellis, Inc. v. Indiana Mut. Cas. Co., 41 F.2d 588 (7th Cir.), *cert. denied*, 282 U.S. 893, 51 S. Ct. 107 (1930); *accord*, Shaw v. Bankers' Nat'l Life Ins. Co., 61 Ind. App. 346, 357-59, 112 N.E. 16, 20 (1916) (dictum); Long Park, Inc. v. Trenton-New Brunswick Theatres Co., 297 N.Y. 174, 77 N.E.2d 633 (1948) (corporation and all of its shareholders were parties to agreement vesting management in one shareholder for a period of 19 years).

[28] Sherman & Ellis, Inc. v. Indiana Mut. Cas. Co., 41 F.2d 588, 591 (7th Cir.), *cert. denied*, 282 U.S. 893, 51 S. Ct. 107 (1930).

the power to designate a comptroller for the corporation and providing that the comptroller would have complete charge of all finances of the company and that no expenditures should be made or authorized without his prior approval, was declared to be against public policy and thus unenforceable.[29] On the other hand, corporations have been permitted to delegate to outsiders, at least for a limited period, some of the functions usually performed by their directors and officers. For example, an agreement employing an executive and giving him the position of editor and manager of a large daily newspaper, with power to determine editorial policy, was held to be permissible.[30] And a contract among manufacturing companies establishing a joint committee with exclusive authority to represent the parties to the contract in negotiations with employees was sustained against a claim that it constituted an unlawful delegation of the discretionary functions of the directors.[31]

XI. Conclusion

The lawyer organizing a close corporation often does not utilize the considerable freedom that modern corporation statutes give him to shape the corporate form to the particular business to be served. What the lawyer has done in the past and what his colleagues are presently doing naturally color his thinking, and tend to limit what he puts into his documents. Perhaps this partly explains the uniformity in control arrangements typically used in close corporations, a "dull sameness" that contrasts sharply with the uniqueness of the business enterprises served by the control arrangements.

By careful planning and drafting the lawyer often can clarify legal relationships in areas where the law is uncertain and provide answers to control problems or difficulties that easily can be anticipated. But even more important than clearing up legal ambiguities is the thoughtful and careful tailoring of the control devices to the needs of the particular enterprise being organized. The control pattern for a close corporation should be individually tailored. The ideal control pattern will vary with the nature and scope of the enterprise, the number of persons who are to participate in it, the contribution in money, credit, and services that each participant is to make, the business skills and the personalities of the participants, and the preferences of the participants.

To achieve a desired control pattern, the control devices discussed in this article may have to be used in various combinations. Furthermore, the choice of control devices, even in very similar business situations, may vary

[29] Marvin v. Solventol Chem. Prods., Inc., 298 Mich. 296, 298 N.W. 782 (1941).

[30] Jones v. Williams, 139 Mo. 1, 40 S.W. 353 (1897) (all of the shareholders and directors approved the contract; in fact, the dissenting judges viewed it as an agreement of the individual shareholders rather than as a corporate contract).

[31] Dyers Bros. Golden West Iron Works v. Central Iron Works, 182 Cal. 588, 189 P. 445 (1920).

from state to state because statutes and judicial decisions affecting the legality and efficacy of the various devices differ from one jurisdiction to another. Control arrangements are far more frequently subject to challenge in the courts than most lawyers realize. Therefore, the lawyer establishing control arrangements must study the laws of the state in which the corporation is being organized.

The stability of a control pattern, once established, can sometimes be affected by the transfer of shares. Thus, careful attention must be given to restrictions on the transfer of shares, buy-and-sell agreements, and various types of buy out arrangements. Furthermore, as the security of any control arrangement increases, thought must be given to provisions for avoiding dissension, settling disputes, and breaking deadlocks which may develop in the corporation's management.

One final word of caution is necessary. Preoccupation with achieving a desired control pattern should not be permitted to result in an inadvertent loss of other important business, tax, and legal advantages. Inflexible control arrangements may make it difficult for an enterprise to meet unforeseen contingencies or to take advantage of unexpected opportunities. Furthermore, the use of some control devices, such as the classification of shares, precludes the corporation's election of the favorable tax status authorized by Subchapter S of the Internal Revenue Code.[32] In other words, the planning of a close corporation's control pattern and the drafting of documents to implement those plans should not be isolated from other business and legal decisions that are made in establishing an enterprise.

[32] Int. Rev. Code of 1954, §§ 1371-77. To be eligible to elect the tax status provided in subchapter *S*, a company must be a domestic corporation with one class of stock and 10 or fewer shareholders. Int. Rev. Code of 1954, § 1371(a).