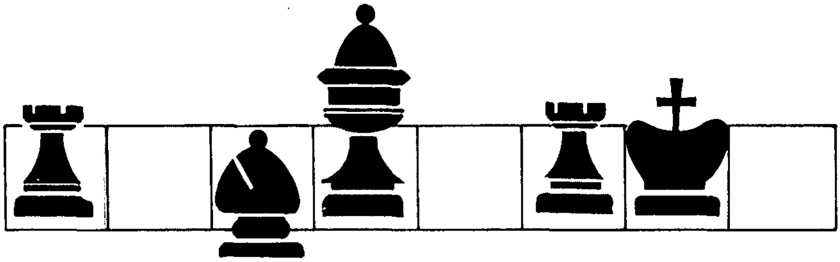

CONTROL ARRANGEMENTS IN CLOSE CORPORATIONS

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This article discusses in broad outline the principal devices that can be utilized to allocate control and management powers in a close corporation. Its objective is to give an overall view of these control schemes and provide "idea guides" on how they can be used in setting up control patterns for close corporations.

A few of the arrangements discussed may be of doubtful validity in some states. The fact that a desired control mechanism is not available under a local law may be a factor for the attorney to weigh in determining whether to incorporate in some other state, e.g., under the Delaware corporation statute or under the progressive and well-drafted new Michigan statute.

Classification of Stock

In most states, provision can be made in a corporation's articles of incorporation for several classes of shares with different voting power, rights to dividends, rights on liquidation, and other qualities. A class of shares can be made non-voting, or its voting rights can be made to vary according to the question under consideration. Thus, a class of shares can be given the right to vote only for the election of directors, or on amendments to articles of incorporation, or on other fundamental corporate action. Furthermore, provision can be made for votes on some types of action to be by shares and on other types of action to be by classes.

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27

By varying the voting powers, dividend rights, and other qualities of the several classes of stock and by using different combinations in allocating shares of the various classes, almost any desired control arrangement can be achieved.

An interesting question exists under the law of some states as to whether use can be made of a class of stock with voting power but no proprietary rights; that is, a class of stock which gives the holder the power to vote but does not bestow any right to dividends or to share in the assets on dissolution. An Illinois case upheld, without the aid of a specific statutory provision, a class of shares with voting power but no proprietary rights. *Stroh v. Blackhawk Holding Corp.*, 48 Ill. 2d 471, 272 N.E. 2d 1 (1971).

In an interesting Delaware decision, *Lehrman v. Cohen*, 43 Del. Ch. 222, 222 A.2d 800 (Sup. Ct. 1966), a corporation was owned by two families, the Lehrmans and the Cohens. It originally had two classes of stocks, a class A-L stock held by the Lehrmans and a class A-C stock held by the Cohens. Each class of stock elected two of the four directors. Because of the fear of deadlock—past experience in the company indicated that corporate paralysis was likely—the shareholders amended the corporation's charter to create a third class of stock, consisting of a single share with a ten-dollar par value, which entitled the holder to elect a fifth or deadlock-breaking director. That share of stock was issued to the company's attorney. He became the "swing man," able to break an impasse between the two families. His share of stock, however, was callable by the corporation on the vote of four of the five directors, which meant that the Lehrmans and the Cohens could eliminate him by redeeming his share of stock. The share of stock carried no proprietary rights, except the right to recover ten dollars on redemption of the share of stock or on dissolution of the corporation. The court upheld this deadlock-breaking arrangement. Incidentally, the attorney, when this litigation ended, was the company's chief executive officer.

Class Voting for Directors

In most states, stock can be classified and provision made for each class to eleet a director or a specified number of directors. Then a separate class of stock or a majority of the shares of a class of stock can be issued to each shareholder. Hence, if each member of a four-man company wants to be assured of representation on the board, four classes of stock, identical in all respects except that each class elects a different director, can be issued, one class to eaeh shareholder. The number of directors elected by a class can be varied by providing, for example, that the class of stock held by one shareholder can elect two directors, while another class owned by another shareholder can select three directors. An arrangement under which all of the shares of a class are issued to a single person facilitates estate planning, because he can dispose of almost half of his stock without losing the power to choose a director.

Where there are two groups of shareholders, each wanting a veto 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 half of the board.

Class voting for directors is in a sense inconsistent with a shareholder's right to vote his shares cumulatively for directors. Compare *Wolfson v. Avery,* 6 Ill. 2d 78, 126 N.E. 2d 701 (1955), with *Humphrys v. Winous Co.,* 72 Ohio L. Abst. 65, 57 Ohio Op. 44, 125 N.E. 2d 204 ((Cuyahoga County, 1956), *rev'd* 165 Ohio St. 45, 133 N.E. 2d 780 (1956). Therefore, if class voting for directors is to be used, a provision should be included in the articles of incorporation expressly stating that shareholders in the corporation do not have the right to vote cumulatively.

The effect of classification of a corporation's stock and provision for class voting for directors on the corporation's ability to elect the tax status provided by Subchapter S of the INTERNAL REVENUE CODE OF 1954 (IRC) should be considered. Broadly speaking, a corporation that elects Subchapter S tax status is not subject to federal tax on its income; instead, its income or losses are considered for tax purposes to be the income or losses of its shareholders. IRC §§1371-1379. Among the requirements for eligibility to elect Subchapter S status is that the company have only one class of stock. The Regulations provide, however, that where several groups of shares are identical except that each group has a right to elect a proportionate number of directors, the corporation will be treated as having only one class of stock for Subchapter S purposes. Treas. Reg. §1.371-1(g) (1966). Thus, if a corporation issues four identical classes of stock, each with 100 shares and each able to choose one director, those four classes will be considered as one class for Subchapter S purposes. Similarly, if a corporation has two classes of stock with identical characteristics, except that one class with 100 shares outstanding selects one director and a second class with 200 shares outstanding elects two directors, that arrangement also meets the one-class requirement of Subchapter S. It is probably possible, without losing Subchapter S eligibility, to parcel out the shares of a class so as to give one shareholder slightly over half of the stock in that class and thus power to elect a board member, but issue the other shares in the class to shareholders who own other stock and are capable of electing different directors in order to give them additional participation in dividends and in assets on dissolution.

An arrangement for class voting for directors needs to be shielded against modification by amendment of the articles of incorporation. Protection should also be provided against an increase in the size of the board of directors, and against the issuance of additional stock within a class that may reduce the holder of a majority of the shares to a minority holder of that class.

Some states may provide, as does Minnesota, that articles of incorporation "may confer upon the creditors of the corporation, or upon a class or classes thereof, the right to vote to the extent and subject to the limitations stated therein." Minn. Stat. Ann. §301.26(12) (1969). On occasion, creditors, or a particular class of creditors like debenture holders, may be given power to vote on corporate decisions.

High Voting and Quorum Requirements

Well-informed businessmen acquiring a minority interest in a close corporation usually want protection against the power of majority shareholders to make unilaterally fundamental changes in the corporation by amendment of the articles of incorporation, merger, and other action, and to control corporate management through election of the board of directors. The principal of majority rule is splendid, unless you own 40 percent of the stock of a close corporation while someone else owns 60 percent. A minority shareholder typically wants a veto over some, perhaps all, important corporate decisions. A person coming into a close corporation in a minority position may have sufficient bargaining power, because the corporation badly needs his services, patents, or other assets, to obtain the consent of majority shareholders to setting up a veto arrangement.

In most states, a veto over fundamental corporation action can be accomplished by requiring unanimity or a high vote for shareholder action. Corporation statutes usually require shareholder approval for amendment of the articles of incorporation, merger or consolidation, sale or disposition of all or substantially all corporate assets other than in the usual and regular course of business, and voluntary dissolution. Thus, a clause in the articles of incorporation requiring unanimity for shareholder action on these matters gives each shareholder an effective veto over these basic corporate changes. Similarly, a provision requiring approval by the holders of a high percentage of the shares can be used as well to assure a veto, as long as the requirement is protected against circumvention by the issuance of additional stock.

In most states, power to prevent changes in officers or employees, in salaries, or in the day-to-day conduct of the business can be given to a shareholder by requiring unanimity or a high vote for director action and coupling that prerequisite with an arrangement that insures the shareholder representation on the board of directors.

Representation on the board of directors can usually be assured a minority shareholder by:

- Executing a shareholders' agreement permitting him to designate a director;

- Requiring cumulative voting for the election of directors; or

- Classifying the shares, providing for election of some directors by one class of shares and other directors by a second class of shares and giving him all or a majority of one class of stock.

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 clause can be inserted in the articles of incorporation prohibiting board action until the vacancy has been filled. See, e.g., *Strong v. Fromm Laboratories, Inc.,* 273 Wis. 159, 77 N.W. 2d 389 (1956) (bylaw barred directors from transacting business while vacancy unfilled).

Perhaps a slight doubt exists whether, absent explicit statutory language, a provision requiring *unanimity* of the shareholders, as distinguished from the concurrence of holders of a large *proportion* of the shares, would be held valid for these corporate actions. See *Sellers v. Joseph Bancroft & Sons, Co.,* 23 Del. Ch. 13, 26, 2 A. 2d 108, 114 (1938).

Where a statute does not specifically authorize a high vote requirement for some shareholder action, e.g., the election of directors or approval of voluntary liquidation, but specifically permits it for other actions by shareholders, the argument can be made that, in validating greater-than-majority requirements for specified shareholder action, the legislature must have intended to disapprove higher than usual vote requirements for other shareholder action. See *Benintendi v. Kenton Hotel,* 294 N.Y. 112, 60 N.E. 2d 829 (1945) (invalidating, under a former New York statute, high vote requirements for shareholder and director action.)

In some states, if a shareholder cannot be assured representation on the board, he can be given a veto over matters ordinarily within the province of the board of directors, as the selection of corporate officers, by transferring certain decision-making powers in those matters from the directors to the shareholders and then requiring unanimity for shareholder action. In other states, the statutes that confer powers on the directors are phrased in mandatory terms and seemingly do not contemplate provisions in the articles transferring to the shareholders powers that are normally within the province of directors. See, for example, Minn. Stat. Ann. §301.28(1) (1969)—"The business of a corporation shall be managed by a board of directors."

As a rule, high vote requirements for shareholder and director action are preferable to high quorum requirements or to a combination of high quorum and high vote requirements. If high quorum requirements are used, shareholders and directors must be protected against their inadvertent attendance at a meeting that is to consider action they oppose. Thus, 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 may attend a meeting, help form a quorum, and thereby permit action on a matter which he opposes.

Furthermore, the protection furnished minority shareholders by high quorum requirements for directors' meetings may be illusory, because courts may decree that directors are under a duty to attend meetings and cannot refuse to be present in order to block action to which they object. In a New York case in which a director deliberately stayed away from a board meeting in an effort to preclude the other two directors from filling a board vacancy with another representative of their faction, the New York Court of Appeals—in a highly questionable decision—held that the absent director and a shareholder supporting his acts, who together owned 50 percent of the corporation's stock, were estopped from claiming that the board's action in filling the vacancy was invalid because taken at a meeting at which a quorum was not present. The court commented that "they may not now complain of an irregularity which they themselves have caused." *Gearing v. Kelly,* 11 N.Y. 2d 201, 203, 182 N.E. 2d 391, 227 N.Y.S. 2d 897, 898 (1962).

Many lawyers apparently believe that the use of both high quorum and high vote requirements sets up a double hurdle that objectionable action must clear before it can become operative. Actually, this double obstacle is an illusion. If a shareholder or director refrains from attending a meeting in order to prevent the formation of a quorum, he, of course, never gets an opportunity to veto a proposal by voting against it. In most states it is preferable to rely solely on a high vote requirement. This permits shareholders or directors in apparent disagreement to get together, discuss their differences, and possibly discover areas of agreement or evolve policies satisfactory to all.

In those jurisdictions where high vote requirements for director or shareholder action may be of doubtful validity, it is, of course, prudent to "backstop" high vote requirements with high quorum provisions. But see *Berkowitz v. Firestone,* 192 So.2d 298 (Fla. Dist. Ct. App. 1966), where the court held that bylaws prescribing a high vote requirement for shareholder and director action were invalid, inter alia, because the statute which authorized high quorum requirements did not authorize the imposition of high vote requirements.

A widely used method of providing a veto over important action by officers, including the drawing of checks and borrowing of money, is for thc articles of incorporation or the bylaws to require for the execution of checks, promissory notes, and other important documents, the signatures of two or more officers, each representing a different shareholder or faction of shareholders. A variation of this type of arrangement limits a corporate officer's authority to act to a relatively small dollar amount or short period of time, unless he obtains the approval of another officer or the consent of the board of directors.

The limitations and disadvantages of high vote requirements must not be overlooked:

- They providc a veto and no more; they do not enable minority shareholders to determine policy affirmatively and to go forward with its execution.

- They deprive the corporation of the flexibility it may need to adjust to unexpected business situations.

- Even if all the shareholders can be expected to act in good faith, the presence of veto arrangements increases the chance that a deadlock will occur in the corporation's management that will paralyze the corporation.

- High vote requirements may place an unscrupulous shareholder in a position to extort unfair concessions from the other shareholders in return for his approving beneficial corporate actions.

In deciding whether to use high vote rcquirements, therefore, the lawyer must weigh the need to protect the interests of minority shareholders against the desirability of retaining that freedom of action which is beneficial to the corporation and the shareholders as a group.

Special Incorporation or Bylaw Clauses

Inclusion of "optional" provisions in the articles of incorporation and special provisions in the bylaws can often be useful in tailoring the control pattern of a corporation. Most statutes clearly sanction such provisions. The ALI-ABA Model Business Corporation Act, for example, permits a corporation's articles of incorporation to include "Any provision, not inconsistent with law, which the incorporators elect to set forth in the articles of incorporation for the regulation of the internal affairs of the corporation, including any provision restricting the transfer of shares and any provision which under this Act is required or permitted to be set forth in the by-laws." ALI-ABA Model Bus. Corp. Act §54(h) (Rev. 1969). The bylaws "may contain any provisions for the regulation and management of the affairs of the corporation not inconsistent with law or the articles of incorporation." ALI-ABA Model Bus. Corp. Act §27 (Rev. 1969).

A lawyer may find useful clauses that:

- Broaden the shareholders' rights to inspect books and records and gain access to information about corporate affairs;
- Define and strengthen the shareholders' preemptive rights, which can be a valuable protection to shareholders of close corporations, though they are a source of irritation in public-issue corporations;
- Impose restrictions on the transferability of the corporation's stock;
- Provide for arbitration or other procedures for settling disputes or resolving deadlocks;
- Require an increase in dividends when compensation of executives is increased; or
- Otherwise control the corporation's dividend policies.

Other special article of incorporation or bylaw clauses undoubtedly will occur to resourceful and energetic draftsmen grappling with particular business problems.

Shareholder Agreements

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 the shareholders, or only some, holders of a majority of the shares or owners of a substantial minority interest, may enter into an agreement among themselves to assure that they continue to act together in making decisions concerning corporate affairs.

Whenever all the shareholders are to become parties to an agreement, minority shareholders usually want to be assured membership on the board of directors or the power to select one or more directors, some voice in the management of the corporation, and protection against the power vested in the majority by the principle of majority rulc. Holders of a controlling interest may be willing to share their control in order to bring into the enterprise persons whose money, skills, or business connections are badly needed, and who otherwise would not buy a minority interest in a close corporation.

Management matters most often covered by a shareholders' agreement are the following:

- How the shares of parties to the agreement are to be voted in elections of directors;

- Who are to be the officers of the corporation;

- Long-term employment arrangements for some or all of the participants;

- The salaries to be paid shareholder-employees;

- The amount of time each participant must devote to the business, and whether he is to be privileged to engage part time in other activities;

- The power of one or more of the participants to veto corporate decisions;

- The circumstances in which dividends arc to be declared; and

- A way of resolving corporate disputes, through an arbitration provision or by some method for dissolving the corporation in the event of dissension or deadlock among the shareholders or directors.

The validity of shareholders' agreements, especially those that purport to regulate matters which are normally within the province of the board of directors, has frequently been challenged. Contracts that encroach on the power of the directors, by designating corporate officers and other key employees and fixing the salaries to be paid them, or specifying the circumstances under which dividends may be declared, have mct with highly variable and inconsistent treatment.

Many decisions have laid down the principle that the shareholders cannot by agreement bind themselves to select a board of directors that will consent to be "dummies." "Clearly the law does not permit the stockholders to create a sterilized board of directors," was the pithy comment of the New York Court of Appeals in *Manson v. Curtis,* 223 N.Y. 313, 323, 119 N.E. 559, 562 (1918). On the other hand, a significant number of decisions, including many recent ones, have sustained agreements deciding important matters of corporate policy and thus taking away from the directors a substantial part of their normal decision-making power. Many of the contracts upheld have designated persons to occupy corporate offices or fixed the corporation's dividend policy.

In some of the decisions there are suggestions that the validity of shareholders' agreements limiting the powers of directors may turn on the number and importance of the functions taken from the directors, and on the extent to which the agreements deviate from the statutory norm giving corporate management to the directors. For a discussion of the authorities, see F. O'Neal, CLOSE CORPORATIONS: LAW AND PRACTICE §§5.16-5.20 (Callaghan, Chicago, 2d ed. 1971).

Whenever the holders of all, or almost all, of a corporation's shares are parties to a contract, modern courts are disposed—and properly so—to uphold it even though it affects important powers of the directors.

Most of the modern corporation acts contain specific provisions dealing with the validity of shareholders' agreements. Even where the local statute is silent on the subject, courts are inclined to uphold a shareholders' agreement that has a proper business purpose even though it encroaches to some extent on directors' powers. In *Hart v. Bell,* 222 Minn. 69, 23 N.W. 2d 375 (1946), a shareholder was induced to lend large sums of money to his floundering corporation. An agreement among the holders of a majority, but less than all, of the corporation's shares provided that the corporation would not declare dividends until it repaid the shareholder loan. Some of the corporation's shareholders brought suit, claiming that the agreement was invalid because it divested the corporation's directors and officers of the right and duty to exercise independent judgment and discretion in determining corporate policy and action. The court upheld the agreement, stating:

"It is not the province of courts to emasculate the liberty of contract by enabling parties to escape their contractual obligations on the pretext of public policy unless the preservation of the public welfare imperatively so demands. . . . The practical conduct of a modern business corporation compels a frank recognition that an agreement by a number of stockholders to combine their votes in order to effectuate a particular policy is not of itself unlawful in the absence of evidence of an intent to defraud the other stockholders or to secure a private benefit at the expense of the corporation or the other stockholders.' " *Id.* at 75 and 78, 23 N.W. 2d at 379 and 380.

Voting Trusts

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

Shareholders may create a voting trust by entering into a trust agreement and transferring title to their shares to voting trustees who, in turn, 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.

Holders of a majority of the voting shares in a close corporation can use the 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. 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. On the other hand, a voting trust may have some disadvantages in some states, where, by statute, voting trusts may be in effect for a limited number of years, or must be open to inspection by shareholders. Minnesota, for example, fixes the maximum duration of a voting trust at 15 years, unless it was created in connection with a corporate indebtedness, when it may extend through the period of indebtedness. Minn. Stat. Ann. §301.27 (1969).

Irrevocable Proxies

The parties to a shareholders' agreement, instead of binding themselves to vote their shares as a unit or in accordance with a predetermined plan, sometimes relinquish their power to vote, and confer it, in the form of an irrevocable proxy, upon one or more of their number or upon some person not a party to the agreement. A proxy may facilitate the implementation of a voting agreement and 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.

Some modern statutes, like the ones in New York and Michigan, state in detail the circumstances and the procedure whereby a proxy can be made irrevocable. In other jurisdictions, the law has retained all the uncertainties and subtleties of the proxy-coupled-with-an-interest concept, the interpretation of which has resulted in so much litigation.

According to the conventional view, the "interest" which the proxy holder must have in order for the proxy to be irrevocable is either a charge, lien, or some property right in the shares themselves, or a security interest given to protect the proxy holder for money advanced or obligations incurred. Under this view, a "recognizable property or financial interest in the stock in respect of which the voting power is to be exercised," which renders the proxy irrevocable, is said to be distinguishable from "an interest in the corporation generally" and from "an interest in the bare voting power or the results to be accomplished by the use of it," neither of which suffices to make a proxy irrevocable. See *In re Chilson,* 19 Del. Ch. 398, 168 A. 82 (Ch. 1933). Cf. *Smith v. Biggs Boiler Works Co.,* 32 Del. Ch. 147, 82 A.2d 372 (Ch. 1951).

Many decisions—perhaps in recent years, most decisions—have held irrevocable proxies that would have been revocable under the traditional concept. See F. O'Neal, CLOSE CORPORATIONS: LAW AND PRACTICE, §5.36 (Callaghan, Chicago, 2d ed. 1971). The courts have achieved this result either by departing from the "coupled with an interest" requirement or by broadening that concept, sometimes to such an extent that it is hardly recognizable. Language in a number of modern opinions indicates that an irrevocable proxy may be sustained if:

- It is supported by consideration moving from the proxy holder to the maker;
- The proxy holder has changed his position in reliance on the proxy; or
- The proxy was given to further or protect the interests of the proxy holder.

The new Michigan statute provides that a proxy that is entitled "irrevocable proxy" and states that it is irrevocable will not be revocable if it is held by a person designated by or under a shareholders' voting agreement, or by a person who has contracted to perform services as a director, officer, or employee of the corporation, if a proxy is required by his contract of employment. Mich. Bus. Corp. Act, §422(d)(f)(1972).

HOLDING COMPANIES AND PARTNERSHIPS

A group of majority shareholders in a close corporation can use a holding company, instead of a shareholders' voting agreement or a voting trust, to consolidate their voting power. In other words, the holders of a majority of the voting shares in company A can create another corporation, company B, and transfer their A shares to B in exchange for shares of B stock. Thereafter, the shares of A stock held by company B will be voted as a unit, pursuant to directions of B's board of directors or officers.

In a Nebraska case, four shareholders of a realty company, who together owned a bare majority of its stock, set up another company to hold their shares. The charter of the holding company provided, among other things, that it could not dispose of any stock it held in the realty company unless it disposed of all of its property, after approval of holders of at least two-thirds of its stock. By virtue of this holding company arrangement, an individual who held a majority of the holding company's stock was able to exercise complete control over both the holding company and the realty company, even though he had been only a minority shareholder in the realty company. In an action for a declaratory judgment to define the rights of the two corporations and their shareholders, the court sustained the arrangement and permitted the holding company to vote its shares of realty company stock. *Baum v. Baum Holding Co.*, 158 Neb. 197, 62 N.W. 2d 864 (1954).

A holding company can also be used in lieu of a voting trust temporarily to divest all, or a majority of, the shareholders of a corporation of their voting power and control. A corporation borrowing money might be required by a lending institution as a condition to its advancing funds to the corporation to set up a holding company that the lender can control. The shareholders to be temporarily disenfranchised would transfer their shares to a limited-life holding company in return for nonvoting holding company stock, while persons who were to acquire temporary control would purchase a few shares of holding company voting stock for a modest sum. When the holding company's stated life expired, its nonvoting shareholders would receive in liquidation the shares which they had formerly held in the operating company.

A holding company has a number of disadvantages, however, which will usually prevent its being used in setting up a control pattern for a closely held enterprise. In the first place, the use of a holding company entails the expense of organizing and maintaining an additional corporation. Further, both the holding company and the operating company would be disqualified to elect the tax status provided by Subchapter S, IRC §1371(a)(2).

Participants in a closely held corporation sometimes organize a partnership to hold the shares representing their interests in the corporation. Some or all of the share certificates representing the ownership of the corporation can be issued to a partnership composed of key participants in the business; and voting of the shares probably can be controlled by a provision in the firm's articles of partnership authorizing, for example, a particular partner to vote the shares, or directing that they be voted pursuant to the decision of a majority of the partners. However, a partnership is seldom used, perhaps because of uncertainty as to the validity of a provision in the articles of partnership controlling the voting of the shares, or reluctance to enter into a control arrangement that can be terminated at any time by one of the partners exercising his right to dissolve the partnership.

Management Contracts

To be distinguished from control agreements among some or all of the shareholders are contracts executed by the corporation itself under which its management or the control over certain aspects of its operations is entrusted to a creditor or 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 considerable management powers in another corporation or individual, particularly if a substantial fee is to be paid for these management services.

A distinction also should be made between management agreements and the common resolutions under which the directors temporarily delegate part of their functions to an executive committee or to corporate officers. An arrangement giving authority to an executive committee or the corporation's officers is always subject to the supervision and overriding jurisdiction of the directors, who can modify or terminate the prerogative of such a committee or officer at any time. A management agreement, on the other hand, divests the board of its functions for the term provided in the contract.

Judicial opinions dealing with the validity and effect of management agreements and other corporate contracts that vest control of a corporation in managers other than its duly selected directors and officers are few in number and rather unsatisfactory. In particular, there seems to be a tendency in the decisions to lump together indiscriminately cases dealing with management contracts and those relating to shareholders' agreements. The decisions indicate, however, that a management contract may be subject to attack on the following two grounds:

- The contract violates a statute which provides that the affairs of a corporation shall be managed by its board of directors; and

- The directors of a corporation, in view of their limited term of office, do not have the capacity to enter into long-term contracts that will bind future boards for long or indefinite periods on basic policy or management matters.

Taking the decisions as a whole, the validity of a contract by which a corporation vests direction 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 they are to be held, and perhaps the purpose of the contract or the situation out of which it arose.

Management contracts that delegate substantially all management decisions to outsiders for indefinite or extended periods of time are usually held invalid. Thus, a court struck down a contract between two insurance companies that gave one the "underwriting and executive management" of the other for a period of 20 years. 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. *Sherman & Ellis, Inc. v. Indiana Mut. Cas. Co.*, 41 F.2d 588, 591 (7th Cir.), *cert. denied,* 282 U.S. 893 (1930).

Similarly, the Supreme Court of Michigan refused to specifically enforce an agreement by a corporation giving the purchaser of some of its five-year convertible bonds the right 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. The court declared the contract to be against public policy and thus unenforceable. *Marvin v. Solventol Chem. Products, Inc.*, 298 Mich. 296, 298 N.W. 782 (1941).

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. 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 for a period of five years was held to be valid. *Jones v. Williams,* 139 Mo. 1, 40 S.W. 353 (1897) (all of the shareholders and directors approved the contract; in fact, thc dissenting judges viewed it as an agreement of the individual shareholders rather than as a corporate contract). Further, a contract among manufacturing companies establishing a joint committee with exclusive authority to represent the parties in negotiations with employees was sustained against a claim that it constituted an unlawful delegation of the discretionary functions of the directors. *Dyers Bros. Golden West Iron Works v. Central Iron Works,* 182 Cal. 588, 189 P. 445 (1920).

CONCLUSION

In states that have completely reworked their corporation acts in recent years, such as Delaware, New York, and Michigan, the control devices discussed here are clearly sanctioned by statute, and the procedures to be followed in using the devices are carefully spelled out. In those states, a lawyer can proceed with assurance that the control patterns he is setting up for a corporation will not be struck down by the courts.

In other states, useful control devices, such as high vote requirements for shareholder and director action, are of doubtful validity. Nevertheless, in spite of an unfavorable statute, 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 that can be anticipated easily.

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 eorporation should be individually developed. 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; and the business skills, the personalities, and the preferences of the participants.

The stability of a control pattern, once established, can sometimes be affected by the transfer of shares, buy-and-sell agreements, and various types of buy-out arrangements. Furthermore, thought must be given to provisions for avoiding dissension, settling disputes, and breaking deadlocks that 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 important business, tax, or legal advantages. Inflexible control arrangements may make if difficult for an enterprise to meet unforeseen contingencies or take advantage of unexpected opportunities. Furthermore, use of some control deviccs, such as classification of shares, may preclude the corporation's election of the favorable tax status authorized by Subchapter S of the IRC. 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 being made in establishing an enterprise.