

The Rise of the Close Corporation and the Making of Corporation Law

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ABSTRACT: *Who makes corporation law? The study of corporation lawmaking has been a lively area in recent years, but scholars have limited their studies by focusing on only one kind of corporation law, the law of the public corporation. This article takes a new approach to the question through a legal historical case study of the law of the close corporation. Corporation statutes in the first half of the twentieth century were crafted by legislatures to fit public, not close, corporations. Close corporation participants found the standard-issue mechanisms provided by these statutes unsatisfactory, however, and sought instead to organize their firms through private agreements among themselves. Such agreements were common, but courts would void them if they diverged too far from corporation law's "statutory norms." This gave rise to a process in which close corporations adopted, and judges later approved (or disapproved) a range of agreements and arrangements designed to privately order the close corporation. In the end, this incremental back-and-forth produced a common law of close corporations. Only after the development of this common law of close corporations did legislators change corporation statutes to further legitimize close corporations' special agreements. This account challenges our understandings of how corporate law is made, for it shows that close corporation law was made not only by legislators, courts, and interest groups, but by close corporation participants themselves. This Article thus not only illuminates understudied areas of corporation law and legal history, it provides us a new account of the production of a vital area of modern American law.*

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I. INTRODUCTION

In the United States today, there are different kinds of corporation law for different kinds of corporations.¹ Large publicly traded corporations are governed by state and Federal laws and regulations designed for firms with many dispersed shareholders,² while smaller corporations can take advantage of separate bodies of law and doctrine crafted for firms without publicly traded securities, whose few shareholders usually play a role in managing their firm.³ So accustomed are we to a flexible legal landscape in which firms can do business as corporations, partnerships, limited liability partnerships (“LLPs”), limited liability companies (“LLCs”), or other more exotic organizational forms, that this seems hardly worth noting.⁴

Except that this was not always the case. Corporation law in the United States was once remarkably rigid, drawing a sharp line between the corporation, whose form and management structure were fixed by statute, and the partnership, which offered firms greater flexibility but required them to forego the major advantages of incorporation: limited liability and unlimited life for the business entity.⁵ Corporation statutes were written with large, publicly traded corporations in mind, and they made little allowance for other kinds of businesses which might also seek to incorporate.⁶ The statutes seemed to work well for large corporations, as the corporate structure mandated in statute—with an active Board of Directors overseeing the corporation’s affairs and shareholders playing little role in governance beyond electing those

1. The complex nature of corporate law has long been apparent to some observers. See Joseph L. Weiner, *Legislative Recognition of the Close Corporation*, 27 MICH. L. REV. 273, 278 (1928) (calling for statutory recognition of the close corporation); William O. Douglas, *Directors Who Do Not Direct*, 47 HARV. L. REV. 1305, 1306-07 (1934) (noting difference between large and small companies, and laws that govern each); Wiley B. Rutledge, Jr., *Significant Trends in Modern Incorporation Statutes*, 22 WASH. U. L.Q. 305, 328-29 (1937) (same); Abram Chayes, *Madame Wagner and the Close Corporation*, 73 HARV. L. REV. 1532, 1533 (1959). See also Frank H. Easterbrook & Daniel R. Fischel, *Close Corporations and Agency Costs*, 38 STAN. L. REV. 271, 271-72 (1985) (providing an economic analysis of the difference between public and close corporations); Henry G. Manne, *Our Two Corporation Systems: Law and Economics*, 53 VA. L. REV. 259, 259-60 (1967) (same). In recent years, of course, the development and widespread adoption of the Limited Liability Company (LLC) has further broadened the spectrum of business organization law. See generally F. HODGE O’NEAL & ROBERT B. THOMPSON, O’NEAL AND THOMPSON’S CLOSE CORPORATIONS AND LLCs: LAW AND PRACTICE (3d. ed. 2007) [hereafter O’NEAL AND THOMPSON’S CLOSE CORPORATIONS AND LLCs].

2. See STEPHEN M. BAINBRIDGE, CORPORATION LAW AND ECONOMICS 3 (2002).

3. See generally O’NEAL AND THOMPSON’S CLOSE CORPORATIONS AND LLCs, *supra* note 1.

4. One recent casebook, for instance, devotes separate discussions to the partnership, the corporation, the limited partnership, the limited liability partnership, the limited liability limited partnership, the limited liability company, the professional corporation, the business trust, the joint stock company, and the limited partnership association. ROBERT A. RAGAZZO & DOUGLAS K. MOLL, CLOSELY HELD BUSINESS ORGANIZATIONS: CASES, MATERIALS, AND PROBLEMS ix-x (2006).

5. See *infra* Part III.

6. See *infra* Part III.B.

directors—mirrored the way most large corporations actually operated.⁷ This structure did not fit, however, the actual workings of the other kind of corporation, the “close corporation,” where ownership and control were not divorced and where the firm’s few shareholders also served as its directors and managers.⁸ Although the modern giant public corporation only appeared in American law in the late nineteenth century,⁹ within a brief span its needs and operations came to dominate corporation law, both case and statute. Only well into the twentieth century did the law begin to change and accommodate the close corporation.¹⁰

The growth of close corporation law tells us much not only about an under-studied area of legal history,¹¹ but also about how corporation law is made. Accounts of the making of corporation law generally focus on the making of law for public corporations.¹² To simplify, in these accounts the “makers” of corporation law are usually the legislatures that adopt corporation statutes and the judges who interpret them. Other groups, notably the organized bar, influence corporation law either by helping to write the statutes, or by training and acculturating the judges who will eventually be called on to interpret

7. ADOLF A. BERLE JR. & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* 47-124, *passim* (1932).

8. See *infra* Part II.

9. Some form of corporation law can be traced all the way back to the Roman Empire, HENRY WINTHROP BALLANTINE, *BALLANTINE ON CORPORATIONS* § 1, at 2-5 (1927) [hereafter *BALLANTINE ON CORPORATIONS*], but the law of the modern business American corporation took shape in the mid- to late-nineteenth century, LAWRENCE M. FRIEDMAN, *A HISTORY OF AMERICAN LAW* 390-398 (3d ed. 2005). See also Pauline Maier, *The Revolutionary Origins of the American Corporation*, 50 WM. & MARY Q. 51 (1993); Oscar Handlin & Mary F. Handlin, *Origins of the American Business Corporation*, 5 J. ECON. HIST. 1 (1945).

10. The distinction between a close and a public corporation is addressed in Part III, *infra*.

11. The history of corporation law is in general under-studied, and in that area the close corporation has gained very little attention. Only two other authors appear to have examined the growth of close corporation law in recent years. Robert W. Hillman provides a brief but useful overview of the development of the close corporation in *The Bargain in the Firm: Partnership Law, Corporate Law, and Private Ordering within Closely-Held Business Organizations*, 2005 U. ILL. L. REV. 171, 174-77 (2005). Naomi Lamoreaux has also addressed the growth of the close corporation in the context of the sharp division American law made between corporations and partnerships in articles discussed in Part III *infra*. See Naomi R. Lamoreaux & Jean-Laurent Rosenthal, *Legal Regime and Contractual Flexibility: A Comparison of Business Organizational Choices in France and the United States During the Era of Industrialization*, 7 AM. L. & ECON. REV. 28 (2005); Naomi R. Lamoreaux, *Partnerships, Corporations, and Limits on Contractual Freedom in U.S. History: An Essay in Economics, Law, and Culture, in CONSTRUCTING CORPORATE AMERICA: HISTORY, POLITICS, CULTURE* 29 (Kenneth Lipartito & David B. Sicilia eds., 2004). The history of close corporations is also briefly addressed in one classic work. See JAMES WILLARD HURST, *THE LEGITIMACY OF THE BUSINESS CORPORATION IN THE LAW OF THE UNITED STATES, 1780-1970* 72-78 (The University Press of Virginia 1970). The neglect of the close corporation in legal history is paralleled by the neglect of small business in business and economic history. See MANSEL G. BLACKFORD, *A HISTORY OF SMALL BUSINESS IN AMERICA* 5-7 (William H. Becker ed., The University of North Carolina Press 2d ed. 2003). This author is aware of only one article specifically addressing the legal history of small business, and that article does not deal with the close corporation. See Lawrence M. Friedman, *Law and Small Business in American Life: One Hundred Years of Struggle and Accommodation*, in *SMALL BUSINESS IN AMERICAN LIFE* 305, 305-18 (Stuart W. Bruchey ed., Columbia University Press 1980).

12. The rest of this paragraph briefly summarizes a discussion in Part I. See *infra* Part I.

them.¹³ While every state has its own corporation law, the state that stars in these accounts is Delaware, as it is legal home for most of the nation's largest corporations.¹⁴ Other states appear in such accounts as Delaware's competitors, acting to attract incorporation away from Delaware, or at least keep in-state corporations.¹⁵ The Federal government, when it does appear, is usually depicted as a check on state corporate lawmaking.¹⁶

This Article presents a different account of the making of corporation law by focusing on the close corporation. Because close corporations rarely incorporated in other states, this account does not center on Delaware but has a wider focus. Legislatures and judges are again present as makers of corporation law, but they are joined by other sets of actors: the close corporation participants themselves. It was these participants who entered into informal or formal agreements setting out how the close corporation was to be structured and managed, agreements that often ran counter to the mandates of corporation law. Because the nature of close corporations discouraged litigation, it appears that most of these agreements never wound up in court.¹⁷ For many close corporations the "law" that governed their operations was, therefore, not the law set out in statute but rather the rules recorded in their private agreements. A body of close corporation law did eventually develop through the slow workings of common-law adjudication—that's the big story told in this Article—but it grew out of the myriad agreements crafted to govern individual close corporations. By showing that close corporation law was made through a different process than public corporation law, this Article not only addresses the growth of close corporation law, but also sheds new light on the development of corporation law generally.

After this Introduction, Part I of this Article sketches out the main currents of debates over the production of corporation law. Part II examines the difference between close corporations and publicly traded corporations, discusses how the needs of close corporations diverge from those of large, publicly traded firms, and takes a side glance at the larger issues of rigidity and flexibility in business organization law. Part III recounts the development of modern corporation law, and explains how the explosive growth of public corporations in the late nineteenth and early twentieth century produced a corporation law whose "statutory norms" simultaneously overlooked and hemmed in the close corporation. Part IV then shows how, in spite of this, a separate body of close corporation law developed in the first half of the twentieth century, not through changes in statute but rather through the

13. *See infra* Part II.

14. *See infra* Part II.

15. *Id.*

16. *Id.*

17. *See infra* Part VI.B.2.

everyday activities of close corporation participants, corporation lawyers, and judges, as attempts to contract around the strict requirements of corporation law, and judicial review of those attempts, eventually produced a common law for the close corporation. Part IV also briefly summarizes later changes made to corporation statutes that further legitimized this new body of law.

II. THE MAKERS OF CORPORATION LAW

Who makes corporation law? Over the past forty years this question has provoked a series of ongoing debates, as scholars have sparred over who influences the production of corporation law and who corporation law has been intended to benefit.¹⁸ Disputes have raged over, among other things, whether states produce distinctive brands of corporate law to attract out-of-state incorporators,¹⁹ if so, whether states compete in the production of that law, whether this competition produces a law favorable to managers or to shareholders,²⁰ which interest groups in a state wield most influence over corporation law-making,²¹ and how the presence of Federal corporation law and regulation influences state lawmaking.²² Rather than attempt to survey this entire debate, here I wish to highlight one facet: scholars who vigorously

18. The literature is extensive, but a good brief overview is in Brett H. McDonnell, *Two Cheers for Corporate Law Federalism*, 30 J. CORP. L. 99, 102-108 (2004). See generally ROBERTA ROMANO, THE GENIUS OF AMERICAN CORPORATE LAW (Christopher C. DeMuth & Jonathon R. Macey eds., The AEI Press 1983); Lucian Arye Bebchuk & Assaf Hamdani, *Vigorous Race or Leisurely Walk: Reconsidering the Competition over Corporate Charters*, 112 YALE L.J. 553 (2002); William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663 (1974); William J. Carney, *The Production of Corporate Law*, 71 S. CAL. L. REV. 715 (1998); Melvin Aron Eisenberg, *The Architecture of American Corporate Law: Facilitation and Regulation*, 2 BERKELEY BUS. L.J. 167 (2005); Jill Fisch, *The Peculiar Role of the Delaware Courts in the Competition for Corporate Charters*, 68 U. CIN. L. REV. 1061 (2000); Daniel Fischel, *The "Race to the Bottom" Revisited: Reflections on Recent Developments in Delaware's Corporate Law*, 76 NW. U. L. REV. 913 (1982); Lawrence A. Hamermesh, *The Policy Foundations of Delaware Corporate Law*, 106 COLUM. L. REV. 1749 (2006); Marcel Kahan & Ehud Kamar, *The Myth of State Competition in Corporate Law*, 55 STAN. L. REV. 679 (2002); Marcel Kahan & Edward B. Rock, *Symbiotic Federalism and the Structure of Corporate Law*, 58 VAND. L. REV. 1573 (2005); Ehud Kamar, *A Regulatory Competition Theory of Indeterminacy in Corporate Law*, 98 COLUM. L. REV. 1908 (1998); Jonathan R. Macey & Geoffrey P. Miller, *Toward an Interest-Group Theory of Delaware Corporate Law*, 65 TEX. L. REV. 469 (1987); Edward B. Rock, *Saints and Sinners: How Does Delaware Corporate Law Work?*, 44 UCLA L. REV. 1009 (1997); Mark J. Roe, *Delaware's Politics*, 118 HARV. L. REV. 2491 (2005); Mark J. Roe, *Delaware's Competition*, 117 HARV. L. REV. 590 (2003) [hereinafter Roe, *Delaware's Competition*]; Roberta Romano, *The State as a Laboratory: Legal Innovation and State Competition for Corporate Charters*, 23 YALE J. ON REG. 209 (2006) [hereinafter Romano, *The State as a Laboratory*]; Roberta Romano, *The State Competition Debate in Corporate Law*, 8 CARDOZO L. REV. 709 (1987) [hereinafter Romano, *The State Competition Debate*]; Robert B. Thompson, *Delaware, the Feds, and the Stock Exchange: Challenges to the First State as First in Corporate Law*, 29 DEL. J. CORP. L. 779 (2004); Ralph K. Winter, *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251 (1977).

19. See, e.g., Bebchuk & Hamdani, *supra* note 18; Romano, *The State as a Laboratory*, *supra* note 18, at 3.

20. Compare Cary, *supra* note 18, at 663 (arguing that states "race to the bottom" to offer manager-favoring corporation laws) with Winter, *supra* note 18, at 251 (arguing for a "race to the top").

21. E.g., Macey & Miller, *supra* note 18, at 472.

22. E.g., Roe, *Delaware's Competition*, *supra* note 18.

debate the making of corporation law have identified a fairly limited set of actors who, they contend, have power to create corporation law.

It should be noted at the outset that these debates focus on how corporate law governs the large, publicly traded corporation,²³ and that law is produced at only a few sites. The most important site is Delaware. The majority of large public corporations is now incorporated in Delaware and is thus governed by Delaware's corporation law.²⁴ Corporation law is also made in other states, and as one aspect of the debates over corporation lawmaking concerns whether states compete with Delaware for corporate charters, scholars sometimes look to other states' corporation codes to see whether they have been crafted to attract incorporators away from Delaware.²⁵ A third site for corporation lawmaking is Washington, D.C., where Congress and Federal agencies can and sometimes have adopted laws or regulations that supplant state corporation law.²⁶ Thus, scholars will often speak of "Delaware," other states (e.g., "Maryland"), or the "Federal government" as makers of corporation law. This makes sense; abstraction is necessary to analyze complex problems, and it is useful analytically to speak of, say, a competition for corporate charters between Nevada and Delaware.

Scholars know, of course, that lawmaking is complicated, and that saying that "Delaware" creates law does not exhaust the analysis.²⁷ So, depending on the questions they wish to answer they may take a more fine-grained approach and examine the different entities within a state that influence corporate law. When discussing Delaware corporate law, for instance, scholars have identified the legislature, the state bar, and the courts as the primary "makers" of the law.²⁸ Similar actors are active in other states, and the list of creators can also include national organizations that promulgate standards and influence state lawmaking such as the ABA and the American Law Institute,²⁹ as well as such bodies of rules as the listings requirements of the New York Stock Exchange and NASDAQ.³⁰ Other scholars have identified additional actors with significant influence over the law, including the shareholders and managers of

23. E.g., Eisenberg, *supra* note 18, at 169 n.2 ("I will use the term corporations to mean publicly held corporations (by which I mean corporations whose shareholder populations are sufficiently large that they are likely to involve a separation of ownership and control)").

24. Delaware is home to more than fifty percent of all U.S. publicly traded companies and sixty percent of the Fortune 500. State of Delaware: The Official Website for the First State, <http://www.corp.delaware.gov/> (last visited Feb. 22, 2008).

25. See, e.g., Romano, *The State as a Laboratory*, *supra* note 18, at 214-16.

26. See, e.g., Roe, *Delaware's Competition*, *supra* note 18, at 600-05.

27. See, e.g., Carney, *supra* note 18, at 718 ("A. States or Interest Groups as Producers of Corporate Law?").

28. E.g., Hamermesh, *supra* note 18, at 1751.

29. See, e.g., JAMES D. COX & THOMAS LEE HAZEN, CORPORATIONS § 2.08 (Aspen Publishers 2d ed. 2003) (on American Law Institute's Corporate Governance Project). See also David V. Snyder, *Private Lawmaking*, 64 OHIO ST. L.J. 371 (2003) (on private lawmaking generally).

30. *Id.*

the corporations who are deciding where to incorporate.³¹ Federal corporation law can also be depicted as the product of interactions among different actors (e.g., Congress, the SEC, the stock exchanges),³² and corporation law as a whole can even be conceptualized as the product of ongoing relationships between states and the Federal government.³³

Merely identifying actors who create corporation law does not, of course, resolve disputes over how and why the law is made. Vital questions persist as to which actors have the most power to influence the lawmaking process and to what ends they use that power. For instance, a number of scholars identify the Delaware bar as an important maker of Delaware corporation law, inasmuch as the Corporation Law Section of the Delaware State Bar Association is responsible for identifying and drafting proposed changes to the state corporation law and the state's judges are drawn, of course, from the state bar.³⁴ Yet scholars disagree over the effect this has on the law. In the 1970s, William Cary argued that this led to legal rules that encouraged lawsuits in Delaware courts,³⁵ a decade later, Jonathan Macey and Geoffrey Miller similarly hypothesized that Delaware's bar helped produce rules that would "maximize revenues to the bar, and more particularly to an elite cadre of Wilmington lawyers who practice corporate law in the state";³⁶ while more recently Lawrence Hamermesh has put forward a more benign account in which the bar members drafting changes to the law act not chiefly to benefit themselves but to conserve the present state (and attractiveness) of Delaware corporate law.³⁷ Though these scholars have identified the same actors making corporation law, their accounts of its making differ in major ways.

Even so, most scholars studying the making of corporation law seem to share a view of how state corporation law is produced. First, corporation statutes are adopted by a legislature with active input from the state bar and other interest groups. The statutes are then interpreted by the judiciary as cases arise.³⁸ Once passed, the law changes either through the accretion of judicial decisions, or when an external event (e.g., a business scandal or Federal action) provokes further statutory modification.³⁹ In this view, interest groups, be they

31. See, e.g., Kahan & Rock, *supra* note 18, at 1586.

32. E.g., Roe, *Delaware's Competition*, *supra* note 18, at 598-600.

33. E.g., Kahan & Rock, *supra* note 18, at 1600.

34. Hamermesh, *supra* note 18, at 1755-56.

35. Cary, *supra* note 18, at 687-88.

36. Macey & Miller, *supra* note 18, at 472.

37. Hamermesh, *supra* note 18, at 1752.

38. The degree to which state court judges can be said to "make" corporate law probably varies from state to state; in Delaware judges had significant power to make corporation law through common-law rulemaking that emphasizes the fiduciary duties of corporate actors. See Kahan & Rock, *supra* note 18, at 1593.

39. The most recent example being the adoption of the Sarbanes-Oxley Act following the Enron and WorldCom fiascos. See Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 Yale L.J. 1521, 1523 (2005).

the bar, corporate managers, or anyone else, influence the law when it is being drafted; that moment of drafting is when groups other than the judiciary can “make” corporation law. This may be an entirely correct account of the making of public corporation law; but this Article will argue that such a model does not capture how close corporation law was made in the first half of the century.

Specifically, this Article will contend that other actors can play an important role in the manufacture of corporation law, particularly if we broaden our perspective as to where corporation law is made. If corporation law is made chiefly in the statehouse and courthouse, then we will conceive of it as the product of legislators, judges, and interest groups. If we think of it being made in the day-to-day operations of corporations, however, a different picture may emerge.⁴⁰ For one example of a broader perspective on the manufacture of corporation law, in his article *Saints and Sinners: How Does Delaware Corporate Law Work?*, Edward Rock posits a more active role for corporate lawyers in making corporate law by focusing on interactions between lawyers and clients. Rock points out that Delaware’s corporation statute does not always provide clear rules for corporate managers and that Delaware’s judges, when drafting opinions, also do not give clear guidance, preferring instead to make general statements of the legal norms to which directors and officers are nonetheless expected to adhere.⁴¹ As he puts it, Delaware judicial opinions are often “fact-intensive, normatively saturated descriptions of manager, director, and lawyerly conduct, and of process—descriptions that are not reducible to rules.”⁴² Despite this, the law seems to function reasonably well; lawyers are able to advise directors and officers as to what actions will be allowed by the courts.⁴³ In this account, lawyers have an active and indeed crucial role in making corporate law, for the essence of the “law” lies not in the “corporate law sermons”⁴⁴ that the Delaware courts deliver but rather in the lawyers’ subsequent distillation of the sermons into useful advice for clients. “[I]n a world of vaguely defined norms and rapidly evolving transactional forms, what the business lawyer tells the client—rather than what the judge announces to the world—is the ‘law.’ . . . [T]he core of this body of law resides in the firms

40. I discuss Rock’s article here because I think his discussion of how law firms can be said to “create” corporation law has illuminating similarities to my contention that close corporations can be said to have “created” close corporation law. He is not the only scholar, however, to have identified other actors as makers of corporation law. See, e.g., Roberta Romano, *Law as a Product: Some Pieces of the Incorporation Puzzle*, 1 J. L. ECON. & ORG. 225, 279-80 (1985) (identifying Delaware’s legal system as a whole, including its case law and judges, as important factors in the “production” of corporation law); Eisenberg, *supra* note 18, at 182 (describing as “soft corporation law” various “bodies of standards, principles, or rules that are promulgated by private institutions, and that have force of some sort although they are not directly backed by state sanctions”).

41. See Rock, *supra* note 18, at 1062.

42. *Id.* at 1015.

43. *Id.* at 1010.

44. *Id.* at 1016.

and in the advice given to clients in confidence.”⁴⁵

This Article similarly attempts to point our attention in a new direction and to add to our list of actors who make corporation law and places where it is made. In one sense, corporation law in this period was of course the law set out in statutes and opinions. This law was, however, crafted to meet the needs of public corporations; it was made by legislatures and courts that were unaware of the needs of the close corporations to which the law would also apply. Close corporation participants thus often devised their own rules for the operation of their corporations, entering into agreements and arrangements that allowed close corporations to operate, even if the legality of those agreements and arrangements were questioned when they reached a courtroom. A more formal and public body of close corporation law formed as courts were called upon to pass on the legality of those private agreements. The close corporation law that eventually took public shape was thus the creation of all those parties—legislators and judges, to be sure, but close corporation participants as well, and close corporations often operated not according to the requirements of the statutory and case law governing corporations, but according to the private agreements entered into by the close corporation participants. In some sense, then, the private agreements of those participants were close corporation law in this era.

III. “THE ORPHAN OF CORPORATE LAW”

In 1959 the legal scholar Abram Chayes declared that the “close corporation, long the orphan of corporate law, has . . . begun to come into its own.”⁴⁶ The remainder of this Article will show why the close corporation was the orphan of corporate law, and how over the first half of the twentieth century it indeed came into its own. Before that, however, an overview of the close corporation is required.

A. The Close Corporation: A Brief Primer

The term “close corporation” originated in English local government law. In England before 1835, a close corporation was the municipal corporation governing a town or city.⁴⁷ Dating from Medieval times, these bodies were not democratically elected governments but rather self-perpetuating oligarchies that dominated town political and, often, economic life.⁴⁸ Although English close

45. *Id.* at 1096.

46. *See* Chayes, *supra* note 1, at 1532.

47. *See generally* SIDNEY & BEATRICE WEBB, 2 ENGLISH LOCAL GOVERNMENT FROM THE REVOLUTION TO THE MUNICIPAL CORPORATIONS ACT: THE MANOR AND THE BOROUGH (Longmans, Green & Co. 1908).

48. *Id.* at 405-93.

corporations were abolished by the Municipal Corporations Bill of 1835,⁴⁹ the term survived in the United States and was used during much of the nineteenth century to denote any self-perpetuating body.⁵⁰ Only towards the end of the century do we find it being used in its more modern sense, to mean a closely held business corporation with only a few shareholders who are also involved in firm management.⁵¹

The distinctive legal nature of the modern “close corporation” is easy to grasp but hard to define.⁵² Although a bundle of special features can be cited as marks of a close corporation, the close corporation is most easily understood as a legal entity when contrasted to what it is not—the large corporation whose shares are publicly traded (the “public corporation”).⁵³

Large, integrated corporations appeared in late nineteenth-century America and rapidly grew to wield unprecedented economic power and dominate broad sectors of industry.⁵⁴ A hallmark of many large corporations was the

49. *Id.* at 748-49.

50. *See, e.g.,* *Brown v. Keener*, 74 N.C. 714 (1876); *Hatch v. City Bank of New Orleans*, 1 Rob. (LA) 470, 1842 WL 1537 at *6 (1842).

51. *See, e.g.,* *Jones v. Brown*, 50 N.E. 648, 649 (Mass. 1898) (“The underlying idea of the agreement is that there was to be a close corporation, and that the ownership of the shares was to be, as far as possible, in the hands of those who might from time to time be actively engaged in the business of the company”); *Levins v. W. O. Peebles Grocery Co.*, 38 S.W. 733, 735 (Tenn.Ch. 1896) (“while there were other small stockholders of the grocery company, W. O. Peebles and D. M. Peebles owned nearly all of its stock, and had absolute control of its affairs, and did control it as a close corporation”). By the early twentieth century the term “close corporation” was in common circulation. *See Jackson v. Hooper*, 75 A. 568, 571 (N.J. 1910) (discussing the “innumerable . . . ‘close corporations,’ in which all the stock is held by a few persons, who are at one in the conduct and policy of corporate action”). The term “close corporation” apparently predated its synonym, “closely held corporation.” Late nineteenth century cases can be found using the term “close corporation” in its modern sense, *see supra*. A search of Westlaw’s ALLCASES database shows the first use of “closely held corporation” only in 1922, *see In re Wirth’s Estate*, 119 N.Y.S. 365, 366 (1922), though a reference to stock being closely held dates to 1895, *see Schweitzer v. Bonn*, 31 A. 24, 25 (N.J.Ch. 1985).

52. O’NEAL AND THOMPSON’S *CLOSE CORPORATIONS AND LLCs*, *supra* note 1, at § 1:2. As late as 1948 one author complained that “no satisfactory all-purpose definition of a close corporation appears ever to have been worked out,” *id.* at n.1 (quoting Carlos Israels, *The Close Corporation and the Law*, 33 CORNELL L.Q. 488, 491 (1948)), while five years later the convenor of a symposium on the close corporation had to admit that it was difficult to determine what the term meant, *see* Foreward, *The Close Corporation*, 18 LAW & CONTEMP. PROB. 433, 433 (1953) [hereinafter Foreward, *The Close Corporation*]. Since the 1960s, a number of states have provided a corporation the option of registering as a “close corporation,” so long as the corporation meets the statutory definition of “close corporation.” *See* DEL. GEN. CORP. LAW. § 342(a) (2008); *see also infra* Part IV.D.

53. “Public corporation” can cover any corporation whose shares are publicly traded, here it will be applied to the typical large public corporations. In the nineteenth century, the term “public corporation” was sometimes used to refer to a corporation “which exist only for public purposes, such as towns, cities, etc”—not the usage here. *Dartmouth College v. Woodward*, 17 U.S. (4 Wheat) 519, 663 (1819).

54. *See* ALFRED D. CHANDLER, JR., *THE VISIBLE HAND: THE MANAGERIAL REVOLUTION IN AMERICAN BUSINESS* 1 (1977), for the standard treatment of the growth of large-scale business enterprise, which Chandler defines as an enterprise containing many distinctive operating units and managed by a hierarchy of salaried executives. Chandler’s account should be supplemented by, among others, PHILIP SCRANTON, *ENDLESS NOVELTY: SPECIALTY PRODUCTION AND AMERICAN INDUSTRIALIZATION, 1865-1925* (1999) and Naomi R. Lamoreaux et. al., *Beyond Markets and Hierarchies: Toward a New Synthesis of American Business History*, 108 AM. HIST. REV. 404 (2003).

“separation of ownership from control” produced by dispersed public ownership of their stock.⁵⁵ While legal ownership of such corporation rested with thousands of shareholders scattered across the country, actual power rested with managers who owned, at best, a relatively small percentage of the firm’s shares.⁵⁶ The bulk of twentieth century corporation law focuses on large public corporations,⁵⁷ and specifically on balancing the legal relationships among the distinct constituencies created by the separation of ownership from its control: shareholders, directors, and officers.⁵⁸

The close corporation’s distinguishing features sharply differentiate it from the public corporation. It is usually smaller than the public corporation, though size alone does not always mark a close corporation.⁵⁹ Its shares are not freely traded; indeed, the standard treatise on the close corporation defines a “close corporation” as a corporation whose shares are not generally traded in the securities markets.⁶⁰ Equally important, the close corporation does not suffer from the separation of ownership and control. A close corporation has only a few owners, and these are usually its managers as well; several scholars have identified this unity of ownership and control as the distinctive feature of the close corporation.⁶¹ These two features—the lack of a public market for shares, and the unity of ownership and control—are interrelated; owners who have a significant percentage of their wealth in shares of a firm, and cannot sell those shares on a public market, have a strong incentive to become active in management of the firm.⁶² When used in this article, “close corporation” covers corporations whose shares are not publicly traded and whose owners are typically also their managers, and “close corporation participants” shall apply to those individuals who are both the major shareholders and managers of a

55. See BERLE & MEANS, *supra* note 7, at 84-89.

56. See *id.* Control by management was a perennial concern, but it should be noted that, during the earlier part of the twentieth century, control by a minority “control group” of shareholders or bankers was also a concern. See Dalia Tsuk Mitchell, *Shareholders as Proxies: The Contours of Shareholder Democracy*, 63 WASH. & LEE L. REV. 1503, 1525-26 (2006).

57. While public corporations have always been at the center of corporation law, the close corporation received almost no scholarly attention before the 1930s. See, e.g., HURST, *supra* note 11, at 76-77; Chester Rohrich, *The New Deal in Corporation Law*, 35 COLUM. L. REV. 1167, 1167-69 (1935); Henry Winthrop Ballantine, *Questions of Policy in Drafting a Modern Corporation Law*, 19 CAL. L. REV. 465, 466 (1931). In addition, small corporation law remains under-studied. See, e.g., Hillman, *supra* note 11, at 172; Easterbrook & Fischel, *supra* note 1, at 271.

58. Indeed, to some this appears the whole of corporation law. See WILLIAM A. KLEIN & JOHN C. COFFEE, JR., BUSINESS ORGANIZATION AND FINANCE: LEGAL AND ECONOMIC PRINCIPLES 122-23 (10th ed. 2007) (“The formal structure for control and operation of a corporation can best be described by reference to three basic groups—shareholders, directors, and officers”).

59. Though not always; for instance, the Ford Motor Company was closely held until 1956. Thomas K. McCraw & Richard S. Tedlow, *Henry Ford, Alfred Sloan, and the Three Phases of Marketing*, in CREATING MODERN CAPITALISM 289 (Thomas K. McCraw ed., 1997).

60. O’NEAL AND THOMPSON’S CLOSE CORPORATIONS AND LLCs, *supra* note 1, at § 1:2.

61. See Foreword, *The Close Corporation*, *supra* note 52, at 433-34; F. Hodge O’Neal, *Restrictions on Transfer of Stock in Closely-Held Corporations: Planning and Drafting*, 65 HARV. L. REV. 773, 773 (1952).

62. Easterbrook & Fischel, *supra* note 1, at 273-74.

close corporation.⁶³

Close corporations face organizational and managerial problems different from those of public corporations.⁶⁴ Public corporations can be owned by thousands of shareholders, so free transferability of shares is the norm and desirable. Close corporations, however, are typically formed by individuals who know one another well and who also work together at the corporation; thus, close corporation shareholders will seek restrictions on transfer of stock so they can control who they have to work with.⁶⁵ Public corporation shareholders are rarely employees of their companies (or, when they are, their employment does not rest on share ownership). Close corporation shareholders usually work for the close corporation, and in many cases their salaries from the corporation are their main source of income and return on their investment; thus, they may seek employment agreements or income guarantees from the corporation.⁶⁶ In public corporations, important decisions are usually made by a majority of shareholders or the Board of directors, and unhappy shareholders can simply follow the “Wall Street Rule” and sell their shares.⁶⁷ In close corporations, shareholders can’t easily sell their stakes, so majority rule opens up the possibility that a minority shareholder could lose control over what is perhaps his or her major investment and even be frozen out of the firm altogether.⁶⁸ Minority shareholders will thus seek veto powers over corporate decisions.⁶⁹ Such veto powers, however, make it more likely that a minority shareholder can block important corporate actions, and even deadlock all decision-making; in response, other shareholders may seek the power to, *in extremis*, dissolve the corporation (or at least overrule or buy out the recalcitrant shareholder).⁷⁰ In all these ways, close corporations present special problems for legal and business planners.

63. O’NEAL AND THOMPSON’S *CLOSE CORPORATIONS AND LLCs*, *supra* note 1, at § 1:13. These definitions are imperfect; there are close corporations with shares are owned by a passive investor, or whose participants inherited their shares and are not involved in management.

64. O’NEAL AND THOMPSON’S *CLOSE CORPORATIONS AND LLCs*, *supra* note 1, at § 1:13.

65. *Id.* In general, close corporation members only want to work with individuals they trust. See Margaret M. Blair & Lynn A. Stout, *Trust, Trustworthiness, and the Behavioral Foundations of Corporate Law*, 148 U. PA. L. REV. 1735, 1799-1807 (2001).

66. O’NEAL AND THOMPSON’S *CLOSE CORPORATIONS AND LLCs*, *supra* note 1, at § 1:13. Because dividends are generally taxable to a corporation while employee salaries are deductible, close corporation participants usually prefer to be paid a salary as a return on their investment.

67. Which group getting to decide which questions depending on the state statute and the question presented. BAINBRIDGE, *supra* note 2, at §§ 5.1, 10.2.

68. Douglas K. Moll, *Shareholder Oppression & Reasonable Expectations: Of Change, Gifts, and Inheritances in Close Corporation Disputes*, 86 MINN. L. REV. 717, 723-27 (2002).

69. O’NEAL AND THOMPSON’S *CLOSE CORPORATIONS AND LLCs*, *supra* note 1, at § 1:13.

70. *Id.*

B. Corporation and Partnership

The close corporation exists at an odd intersection of American law.⁷¹ Law in the United States traditionally provided two organizational forms for business: the partnership and, beginning in the mid-nineteenth century, the corporation.⁷² The partnership offered participants maximum organizational flexibility; no formal agreement was required to form a partnership, and partners were free to arrange the internal operation of the partnership as they wished, usually through a written partnership agreement.⁷³ Yet a partnership also had significant drawbacks: it was impermanent, as it could be dissolved by any partner on demand (and was in any event dissolved on a partner's death); the act of any partner for the partnership bound all the partners; it was more difficult for an easily-dissolvable partnership to raise capital;⁷⁴ and, perhaps most significant, partners were individually responsible for the debts of the partnership.⁷⁵

Incorporation fixed many of a partnership's flaws. A corporation had a lifespan apart from its shareholders, and could not be dissolved by a shareholder; management was vested in a Board, so a mere shareholder lacked the power to bind the corporation or other shareholders; and, most significant, shareholders in a corporation were not, absent more, liable for the corporation's debts.⁷⁶ Yet the corporate form had drawbacks as well; in particular, the corporate form lacked the partnership's organizational flexibility.⁷⁷ Courts often demanded that corporations strictly follow the structural and managerial

71. Unless otherwise noted, this paragraph and the next two rely on Lamoreaux, *supra* note 11. Lamoreaux examines the development of corporate and partnership law in the nineteenth and twentieth century, emphasizing the sharp lines drawn between the two organizational forms in the twentieth century and the difficulties that faced business organizers who sought an intermediate form between the two (*i.e.*, the close corporation). She argues that, until the passage of close corporation statutes in the late twentieth century, business organizers were severely restricted in their organizational options. *Id.* at 51-52. I do not dispute her main conclusions, but I believe that the common law was more flexible than may have been assumed, and that even before statutory reforms it had evolved significantly to accommodate the close corporation.

72. Some states also offered a limited partnership, but this proved unpopular to firm organizers for a variety of reasons. Naomi Lamoreaux, *Partnerships, Corporations, and the Theory of the Firm*, 88 AM. ECON. REV. 66, 67 (1998).

73. HENRY O. TAYLOR, A TREATISE ON THE LAW OF PRIVATE CORPORATIONS §§ 59, 36 (4th ed. 1898) (distinguishing partnerships and corporations); *see also* UNIFORM PARTNERSHIP ACT (1916).

74. EDWARD H. WARREN, CORPORATE ADVANTAGES WITHOUT PARTNERSHIP 18-25 (1929). A partner could even dissolve a partnership contrary to a partnership agreement, but might be liable for damages.

75. *Id.* at 19-25.

76. Though the corporate form may have been more flexible in the nineteenth century, it was rigid by the turn of the century. *See* Lamoreaux, *supra* note 11, at 49-51.

77. HURST, *supra* note 11, at 78-79; *see also* Lamoreaux, *supra* note 11, at 49-50 (citing *Jackson*, 75 A. at 568); Note, *Validity of Variations from the Norm in Corporate Structure*, 28 COLUM. L. REV. 366 (1928).

requirements of corporation statutes—the “statutory norms” —most notably the norm that lodged responsibility for a corporation’s management in its Board.⁷⁸ This left little opening for businessmen who wanted to join with others to form a corporation, but who also wanted to, say, alter the charter to give themselves further protection, or significantly limit the power of the Board. American law offered them a choice between the flexible partnership and the safe-but-inflexible corporation. It did not allow them to “mix[] and match[] attributes of the partnership and corporate form as it suited to their needs, combining, for example, limited liability with governance rules based on consensus and ability to exit.”⁷⁹

This is odd, because other nations’ laws did provide such organizational flexibility. By the mid-nineteenth century, for instance, as the historians Naomi Lamoreaux and Jean-Laurent Rosenthal have shown, French law offered business organizers a spectrum of choices ranging from the ordinary partnership (*societe en nom collectif*), through the limited partnership (*commandite simple*), to the public corporation (*societe anonyme*), and also gave organizers “considerable freedom to modify [these] basic forms to suit their needs.”⁸⁰ At the end of the century, Britain and Germany also provided business forms combining limited liability with organizational flexibility, the Private Company in Great Britain and the *Gesellschaft mit Beschraenkter Haftung* (G.m.b.H.) in Germany. When we examine the slow development of the close corporation in American law, then, we should keep in mind how American law diverged from that of other industrial nations.⁸¹

78. Lamoreaux, *supra* note 11, at 30.

79. It does not appear that scholars have systematically examined how the existence of business forms in other nations influenced the development of American business law, though some have noted the existence of such an influence. See, e.g., William J. Carney, *Limited Liability Companies: Origins and Antecedents*, 66 U. COLO. L. REV. 855, 860-72 (1995) (European and Latin American antecedents to the LLC); L. C. B. Gower, *Some Contrasts Between American and British Corporation Law*, 69 HARV. L. REV. 1369, 1375-76, *passim* (1956) (comparing British and American law); Weiner, *supra* note 1, at 281-82 (comparing Private Corporation and GmbH to close corporation).

80. Lamoreaux & Rosenthal, *supra* note 11, at 34; see also Timothy Guinnane et al., *Putting the Corporation in its Place*, 8 ENTERPRISE & SOC. 687 (2007) (examining the evolution of business forms in several industrialized nations).

81. Lamoreaux, *supra* note 11, at 30.

IV. THE RISE OF THE MODERN CORPORATION (AND THE PROBLEM OF THE CLOSE CORPORATION)

A. The Origins of the American Business Corporation

The first American work on corporation law defined a “corporation” as “an intellectual body, created by law, composed of individuals united under a common name, the members of which succeed each other, so that the body remains the same, notwithstanding the change of the individuals who compose it, and which for certain purposes is considered as a natural person.”⁸² In this sense, America has always had corporations. Before 1800, however, most corporations were not *business* corporations. The term “corporation” was applied instead to stare-chartered artificial bodies ranging from colonial governments to colleges to, more rarely, private enterprises.⁸³ Most corporations performed public functions – initially towns, boroughs, and cities, then later corporations established for “ecclesiastical, educational, [and] charitable . . . purposes.”⁸⁴ After the American Revolution, more corporations engaged in private business appeared; one study found that 328 entities organized for private gain received charters between the end of the Revolution and 1800.⁸⁵ Yet these business corporations differed from modern-day corporations; each was created through a separate legislative act and provided some public service (e.g., a bank or turnpike company).⁸⁶ Furthermore, a corporation’s charter was not merely a license to do business but often constituted the grant of a quasi-monopoly.⁸⁷

Modern corporate law only gained its distinctive, recognizable form in the nineteenth century.⁸⁸ The most important step was probably the adoption of general incorporation laws. Into the early nineteenth century, each organization

82. JOSEPH K. ANGELL & SAMUEL AMES, A TREATISE ON THE LAW OF PRIVATE CORPORATIONS AGGREGATE 1 (1832).

83. See JOSEPH STANCLIFFE DAVIS, 1 ESSAYS IN THE EARLIER HISTORY OF AMERICAN CORPORATIONS 4 (1917).

84. *Id.* The *Dartmouth College* case, for instance, concerned a corporate charter, but the corporation in question was not a business corporation but a college. See *Dartmouth College*, 17 U.S. (4 Wheat) at 519. Generalizations about early corporations are difficult; as Hendrik Hartog has pointed out, each was created by a charter specially adopted by the legislature and “[t]here was no general categorization of different corporate entities.” HENRIK HARTOG, PUBLIC PROPERTY AND PRIVATE POWER: THE CORPORATION OF THE CITY OF NEW YORK IN AMERICAN LAW, 1730-1870 22-23 (1983).

85. DAVIS, *supra* note 83, at 22-23. Davis found seven charters granted to for-profit corporation in the colonial period.

86. *Id.*

87. FRIEDMAN, *supra* note 9, at 131-32.

88. HERBERT HOVENKAMP, ENTERPRISE AND AMERICAN LAW, 1836-1937 2 (1991) (the modern corporation is a “distinctively Jacksonian product.”); BALLANTINE ON CORPORATIONS, *supra* note 9, at § 1, at 2 (“The modern business corporation is differently regarded than the business corporation prior to the 19th century”).

of a corporation required the legislature to pass a special act.⁸⁹ As the century progressed, such “special incorporation” came under fire. The granting of special privileges to businessmen clashed with the Jacksonian era’s democratic ethos, and allegations of corruption in corporate chartering further soured the public on special incorporation.⁹⁰ By the mid-nineteenth century, some states had abandoned special incorporation altogether, and a majority had adopted general incorporation statutes that offered the corporate form to all comers without need for specific legislative approval.⁹¹ Together with related developments such as the development of modern share voting systems giving each share one vote,⁹² and the widespread grant of limited liability to shareholders,⁹³ this marked the emergence of the recognizably modern business corporation in American law.⁹⁴

As the corporate form became more easily available, it also became more popular. Although exact numbers are lacking, it is clear that many firms adopted the corporate form in the nineteenth century, and incorporation became more common as the century progressed.⁹⁵ For instance, between “1800 and 1817, the New England states chartered about 850 corporations under special laws; between 1844 and 1862, they chartered more than 3500.”⁹⁶ Between 1826 and 1835, New Jersey chartered approximately eleven corporations a year; between 1876 and 1885, it chartered 202 annually.⁹⁷ By the early twentieth century, the corporate form was almost completely dominant in many sectors; in 1904, for instance, corporations produced two-thirds of the nation’s

89. See FRIEDMAN, *supra* note 9, at 131-35; WILLIAM J. NOVAK, *THE PEOPLE’S WELFARE: LAW AND REGULATION IN NINETEENTH CENTURY AMERICA* 105 (1996) (“The right of incorporation as practiced in early America was a special gift (accompanied by special privileges) bestowed by the polity upon select associations as quid pro quo for the performance of special duties and obligations”).

90. FRIEDMAN, *supra* note 9, at 134-35; see also Susan Pace Hamill, *From Special Privilege to General Utility: A Continuation of Willard Hurst’s Study of Corporations*, 45 AM. U. L. REV. 81, 86-88 (1999).

91. Hamill, *supra* note 90, at 100-102. Some states banned special charters outright, where others created a two-track system for incorporation, involving either general incorporation or a special charter. HURST, *supra* note 11, at 21; see also NOVAK, *supra* note 89, at 108-09. Despite its widespread availability, general incorporation only appears to have surpassed special incorporation in the 1870s. Naomi Lamoreaux, *Business Organization*, in 3 HISTORICAL STATISTICS OF THE UNITED STATES: EARLIEST TIMES TO THE PRESENT MILLENNIAL EDITION 483 (Susan B. Carter et al. eds., 2006) (data from New Jersey and New England) [hereinafter *HISTORICAL STATISTICS*].

92. See generally Colleen Dunlavy, *From Citizens to Plutocrats: Nineteenth Century Shareholder Voting Rights and Theories of the Corporation*, in *CONSTRUCTING CORPORATE AMERICA* 66, 66 (explaining the evolution of shareholder voting rights in the nineteenth century).

93. Historians disagree over the importance of limited liability to the early development of the corporation. Compare Blair & Stout, *supra* note 65, at 437-441 (downplaying the centrality of limited liability) with HOVENKAMP, *supra* note 88, at 49-50 (emphasizing it). Limited liability for shareholders not a universal feature of corporation law until the early twentieth century. See Mark I. Weinstein, *Limited Liability in California, 1928-1931: It’s the Lawyers*, 7 AM. L. & ECON. REV. 439, 441 (2005).

94. This does not mean the business corporation took on any fixed form in the mid-nineteenth century; merely that it took on recognizable shape.

95. See Maier, *supra* note 9, at 52.

96. *HISTORICAL STATISTICS*, *supra* note 92, at 3.

97. *Id.*

manufactured product, and by 1927, 97.6 percent of it.⁹⁸

Adoption of the corporation as a legal form did not, however, transform firms into the large, diversified, public corporation we associate with the industrial economy. Into the 1880s corporations with publicly traded stock were common in only two industrial sectors: railroads and textiles.⁹⁹ Manufacturing firms rarely had publicly traded stock and were often not even corporations.¹⁰⁰ In the 1880s, manufacturing enterprises tended to be small (*i.e.*, worth less than \$2 million), and “[t]he partnership form of organization predominated Where enterprises were incorporated and, therefore, had outstanding securities, these were generally held by a small group of persons and were infrequently offered for sale to the public.”¹⁰¹

The growth of larger enterprises accelerated in the 1890s. Between 1895 and 1904, the “Great Merger Movement”¹⁰² swept through American manufacturing, as small manufacturing firms in many industries engaged in a series of horizontal consolidations to produce “a single, giant enterprise” intended to dominate their respective fields.¹⁰³ Over 1800 small manufacturing firms combined in this period to form 147 large corporations.¹⁰⁴ Not all the new enterprises succeeded, but those that did often dominated their industries for decades.¹⁰⁵

The Great Merger Movement had two notable consequences. First, by consolidating many small manufacturers into a relatively few giant enterprises, it helped produce an American economy whose core was occupied by a limited number of large, bureaucratically managed, multi-divisional, publicly traded “center firms.”¹⁰⁶ Second, it created a significant public market for industrial securities, as owners of the smaller industrial firms that were consolidated received, in exchange for their ownership interests, securities in the new giant enterprises—securities which in turn found new buyers, as investors who would have shied away from the securities of a small manufacturer proved

98. MORTON KELLER, *REGULATING A NEW ECONOMY: PUBLIC POLICY AND ECONOMIC CHANGE IN AMERICA, 1900-1933* 86 (1990).

99. Thomas R. Navin & Marian V. Sears, *The Rise of a Market for Industrial Securities*, 29 *BUS. HIST. REV.* 1900-1933 105, 110 (1955).

100. *Id.* at 109.

101. *Id.*; see also CHANDLER, *supra* note 54, at 331-32 (discussing changes in securities markets in the 1890s).

102. NAOMI LAMOREAUX, *THE GREAT MERGER MOVEMENT IN AMERICAN BUSINESS, 1895-1904* 2 (1985); see also CHANDLER, *supra* note 54, at 320-344.

103. LAMOREAUX, *supra* note 102, at 1.

104. *Id.* at 1-4.

105. See CHANDLER, *supra* note 54, at 334-338. Not all mergers succeeded; they tended to succeed in industries where production methods produced additional efficiencies after consolidation, and fail in “labor intensive industries where the concentration of production did not significantly reduce costs and where distribution did not involve high-volume flows or did not require special services.” *Id.* at 337.

106. WALTER LICHT, *INDUSTRIALIZING AMERICA: THE NINETEENTH CENTURY* 133 (1995).

willing to buy the securities of the big corporations.¹⁰⁷ By the first decade of the twentieth century, the modern economy centered around large public corporations had emerged.¹⁰⁸

B. Legislating for the Large Firm: Corporations and Corporate Statutes in the Early Twentieth Century

For most of the nineteenth century, corporation law provided for large and small firms alike.¹⁰⁹ If anything, the law may have been written with smaller firms in mind because there weren't many large, publicly traded firms; almost all corporations, excepting railroads, were smaller than their twentieth-century counterparts.¹¹⁰ "In part," one scholar has speculated, "lawmakers were simply legislating based on what they saw: until the railroads, large-scale private corporations were scarce, so it was only natural that the concerns of small enterprises would occupy the attention of lawmakers."¹¹¹ As the new century opened, however, the legal needs of the new giant public corporations began to diverge from those of smaller, closely held firms. Public corporations had distinctive legal requirements which required distinctive legal remedies, and corporate law changed to accommodate these firms. Close corporations were left behind.¹¹²

A law specially suited for public corporation began to develop at the end of the late nineteenth century when some states started to compete for corporate charters.¹¹³ Toward the end of the century, corporations seeking to combine with competitors to reduce competition found themselves hemmed in by an inflexible rule: one corporation could not own the stock of another.¹¹⁴ This

107. Navin & Sears, *supra* note 99, at 127.

108. LICHT, *supra* note 106, at 133.

109. There were special categories in corporation law for certain corporations with a particular public influence (e.g., public utilities). See generally WILLIAM W. COOK, CORPORATIONS (1889) [hereinafter *CORPORATIONS*] (examining particular state corporation statutes); see also 1 WILLIAM W. COOK, A TREATISE ON THE LAW OF CORPORATIONS § 7, at 41-43 (8th ed. 1923) (discussing "quasi-public corporations" such as railroads) [hereinafter *COOK ON CORPORATIONS*].

110. See Rutledge, *supra* note 1, at 307 ("The general incorporation laws of the nineteenth century were designed primarily to extend the privilege of limited liability to what may be termed 'incorporated partnerships' and relatively local 'joint-stock companies' rather than for the creation of institutions national in the spread of their securities and activities"); E. Merrick Dodd, *Statutory Developments in Business Corporation Law, 1886-1936*, 50 HARV. L. REV. 29 (1936) ("The industrial corporations which were operating under the statutes of fifty years ago were nearly all of rather small size, judged by big-business standards of today").

111. DAVID SKEEL, ICARUS IN THE BOARDROOM: THE FUNDAMENTAL FLAWS IN CORPORATE AMERICA AND WHERE THEY CAME FROM 52 (2005).

112. Corporation law was thus not crafted to meet the real needs of existing close corporations. The approach of its drafters stands in sharp contrast to that of the drafters of the Uniform Commercial Code ("UCC"), who professed to study actual business practices when drafting the Code. See LAWRENCE M. FRIEDMAN, AMERICAN LAW IN THE 20TH CENTURY 379-81 (2002).

113. See generally Charles M. Yablon, *The Historical Race: Competition for Corporate Charters and the Rise and Decline of New Jersey: 1880-1910*, 32 J. CORP. L. 323 (2007).

114. See OLIVIER ROY, SOCIALIZING CAPITAL: THE RISE OF THE LARGE INDUSTRIAL

requirement limited corporate combinations and corporate size.¹¹⁵ Attorneys initially attempted to get around this by establishing trusts to hold the shares of several corporations and coordinate their operations (hence "Antitrust" law). Such arrangements were however open to a variety of legal challenges.¹¹⁶ In 1889, therefore, New Jersey changed its corporation law to allow corporations incorporated in the state to own shares of other companies.¹¹⁷ The "internal affairs" doctrine, already well-established, allowed a corporation based in one state to incorporate in a different ("foreign") state and have its internal operations governed by that state's corporation laws; taking advantage of the doctrine, many corporations based elsewhere soon re-incorporated in New Jersey.¹¹⁸ New Jersey profited from the moves; following the adoption of the new corporation law, corporations moved to re-incorporate in New Jersey and incorporation fees and corporate franchise taxes "combined to dominate New Jersey's receipts."¹¹⁹

Other states, notably Delaware,¹²⁰ also changed their corporation laws to attract out-of-state corporations, creating a competition among states to provide favorable corporate law.¹²¹ These changes appear to have come in two waves; one, around the turn of the century, involving New Jersey, Delaware, and a few other states angling for out-of-state corporate business; another, beginning in the 1920s, drawing in a wider array of states that changed their corporation laws chiefly to retain domestic corporations.¹²²

New Jersey, Delaware, and their followers changed their corporation laws not only to allow holding companies but also to reduce state involvement in

CORPORATION IN AMERICA 148-155 (1997); HOVENKAMP, *supra* note 89, at 257-58.

115. CHRISTOPHER GRANDY, NEW JERSEY AND THE FISCAL ORIGINS OF MODERN AMERICAN CORPORATION LAW 42-43 (1993).

116. Such trusts were governed by the common law, and so were vulnerable to challenges under common-law prohibitions on trade restraints. HOVENKAMP, *supra* note 88, at 250-51. In contrast, it was not clear that the antitrust laws applied to holding companies until the Supreme Court's *Northern Securities* decision in 1904. *See id.* at 264 (citing *Northern Securities Co. v. United States*, 193 U.S. 197 (1904)).

117. 1889 N.J. Laws 414 (quoted and cited in Yablon, *supra* note 113, at 340, n.76).

118. The internal affairs doctrine broadly allows a corporation's internal operations to be governed by the corporation law of its state of incorporation. *See* Frederick Tung, *Before Competition: Origins of the Internal Affairs Doctrine*, 32 J. CORP. L. 33, 39-41, 65-68 (2006).

119. GRANDY, *supra* note 115, at 46.

120. Delaware eventually won the competition, starting in 1913 when New Jersey Governor Woodrow Wilson changed New Jersey's corporation law and provoked a mass corporate migration to Delaware. ROY, *supra* note 114, at 166.

121. Care should be taken to distinguish the historical debate over state competition, which examines competition around the turn of the century, from more recent debates over whether such competition between states is still ongoing, and if so where the "race" is headed. It appears that states did compete for corporate charters early in the century. Yablon, *supra* note 113, at 358-367; GRANDY, *supra* note 115, at 75-83; *Louis K. Liggett Co. v. Lee*, 288 U.S. 517, 553-56 (1933) (Brandeis, J., dissenting in part). For the contemporary debates, *see supra* Part I.

122. *See* Yablon, *supra* note 113, at 358-367 (discussing the initial wave of competition); Rutledge, *supra* note 1, at 309-14 & n.14 (discussing further changes in other states beginning in the 1920s); Dodd, *supra* note 110, at 39-44 (same).

corporate affairs and provide a new range of freedom for the managers of public corporations. Although general incorporation had marked a significant moment in the liberalization of corporation law, even at the end of the nineteenth century corporation law significantly limited corporations' actions.¹²³ The *Ultra Vires* doctrine limited a corporation's activities to those explicitly or impliedly authorized by its charter.¹²⁴ Limits on capitalization or the amount of assets a corporation could own restricted growth.¹²⁵ Doctrines depicting shareholders as possessing "vested rights" made it difficult to amend the corporation's charter if the result would be a reorganization of capital structure unfavorable to some shareholders.¹²⁶ Requirements for stock to have "par value" required the corporation to maintain capital to serve as payment to creditors in case of insolvency.¹²⁷ Shareholders were given a veto over major corporate decisions; unanimous approval was for instance required for a merger or other fundamental corporate change.¹²⁸ And the existence of broad shareholder rights to inspect the corporate books provided another check on managerial power.¹²⁹ Although these restrictions applied to large and small corporations alike, they collectively acted to restrict the scope of large corporations.¹³⁰

Each of these limits on corporate action was eroded or swept away after 1900 as states eased their restrictions on corporations to attract or keep incorporations.¹³¹ *Ultra Vires* was fading by the end of the nineteenth century,

123. HURST, *supra* note 11, at 45; see also MORTON J. HOROWITZ, *THE TRANSFORMATION OF AMERICAN LAW 1870-1960: THE CRISIS OF LEGAL ORTHODOXY* 73 (1992).

124. TAYLOR, *supra* note 73, at §§ 264-65; see also HOVENKAMP, *supra* note 88, at 59-62; KENT GREENFIELD, *THE FAILURE OF CORPORATE LAW: FUNDAMENTAL FLAWS AND PROGRESSIVE POSSIBILITIES* 77-79 (2006).

125. In Massachusetts, for instance, the capital of a "mining or manufacturing" corporation was to be not less than \$5,000 nor more than \$1,000,000, while in Illinois the capital stock of "miscellaneous corporations" was limited to \$1,000,000. *CORPORATIONS*, *supra* note 109, at 90.

126. See Rutledge, *supra* note 1, at 324-25; see also BERLE & MEANS, *supra* note 7, at 213-19.

127. "Par value" mandated that every purchaser of stock pay a "par value" for shares, and that this sum then constitute a reserve to satisfy claims of the firm's creditors. See BERLE & MEANS, *supra* note 7, at 155-58; see also LAWRENCE MITCHELL, *THE SPECULATION ECONOMY: HOW FINANCE TRIUMPHED OVER INDUSTRY* 64-66 (2007).

128. David Millon, *Theories of the Corporation*, 1990 DUKE L.J. 201, 215 (1990).

129. Adam Winkler, "Other People's Money": *Corporations, Agency Costs, and Campaign Finance Law*, 92 GEO. L.J. 873, 908, n.253 (2004).

130. Such restrictions demonstrate that even at the end of the nineteenth century corporate chartering was seen as a distinctively *public* activity, the granting of circumscribed privileges by the state in exchange for the benefit of the charter. Although general incorporation certainly marked a loosening of state supervision of corporations, even general incorporation statutes performed significant regulatory functions. See NOVAK, *supra* note 89, at 105-11. In this light, it is worth noting that the one significant attempt to restrict corporate activities through corporation law in the twentieth century was the early twentieth century push for *federal* incorporation of large corporations, and this failed. See MARTIN J. SKLAR, *THE CORPORATE RECONSTRUCTION OF AMERICAN CAPITALISM 1890-1916: THE MARKET, THE LAW, AND POLITICS* 201-03 (1988).

131. See GRANDY, *supra* note 115, at 42-43; Rutledge, *supra* note 1, at 310-11; Dodd, *supra* note 110, at 38-39.

and had almost disappeared by the 1920s;¹³² limits on capitalization largely disappeared;¹³³ courts gave majority shareholders new freedom to approve fundamental corporate changes,¹³⁴ or to amend corporate charters, even if the result was a change in shareholders' relative position in the capital structure;¹³⁵ par value requirements either disappeared or were so watered down as to become meaningless;¹³⁶ and shareholders lost their once-sweeping rights to inspect corporate documents.¹³⁷

To a great extent, these legal changes made economic and organizational sense. The corporations that arose around the turn of the century were the kind now dubbed "Berle-Means" corporations, gigantic firms often "owned" by a large number of shareholders scattered across the country but actually controlled by managers with comparatively little ownership interest in the corporation.¹³⁸ Many of the corporate law innovations of this period were intended to give managers of these corporation free rein to organize their firms as they saw fit; for instance, the changes in the securities laws mentioned above gave managers more power to alter the corporation's capital structure and change relationships among shareholders.¹³⁹

A corollary to the strengthening of managers was the weakening of shareholders.¹⁴⁰ In legal terms, this meant that power in the corporation moved away from shareholders and towards the Board of Directors.¹⁴¹ Although the Board had always in fact wielded a great deal of power, nineteenth century principles of corporation law "had vested ultimate managerial power in the shareholders, with directors enjoying only such responsibility as was actually delegated. During the early twentieth century, [however,] legal doctrine instead came to lodge managerial power in the directors as a matter of law."¹⁴² To a great extent, this merely aligned corporate law with the facts of the public corporation. The only way to efficiently run a large corporation was to lodge power in full-time managers, and to limit shareholders' ability to directly

132. The corporations scholar William W. Cook declared *Ultra Vires* a dead doctrine as early as 1898, HOVENKAMP, *supra* note 88, at 60, though its complete abolition was apparently still being mulled in the 1920s, see GREENFIELD, *supra* note 124, at 254 n.25.

133. Rutledge, *supra* note 1, at 333-34.

134. Millon, *supra* note 128, at 215.

135. BERLE & MEANS, *supra* note 7, at 213-19.

136. See Dodd, *supra* note 110, at 38, n.48; BERLE & MEANS, *supra* note 7, at 157-59.

137. Winkler, *supra* note 129, at 908 n.253.

138. See Mark J. Roe, *A Political Theory of American Corporate Finance*, 91 COLUM. L. REV. 10, 12-16 (1991) (discussing BERLE & MEANS, *supra* note 7).

139. See BERLE & MEANS, *supra* note 7, at 207-219.

140. See Dodd, *supra* note 110, at 51; Millon, *supra* note 128, at 214-15 ("[o]ne of the most salient features of this development was the prevention of active participation by shareholders in the management of the business").

141. See Millon, *supra* note 128, at 214-15; ROY, *supra* note 114, at 155-56; HOROWITZ, *supra* note 123, at 98-100; Note, *Control of Directors of a Corporation under a Partnership Agreement Between Stockholders*, 23 HARV. L. REV. 551 (1909).

142. Millon, *supra* note 128, at 215.

influence corporate management to the periodic election of directors.¹⁴³ In passing, it should be noted that this gave the Board something of a double role: the Board was part of the corporation's "management" along with its officers, inasmuch as the Board had oversight of the corporation's day-to-day operations, but the Board was also charged with supervising those officers and ensuring they did not deviate from their duty to serve shareholders.

Observers at the time had little question but that the change in laws were directed towards helping big business. Writing in 1936 Wiley Rutledge, then Dean of the University of Iowa Law School, credited many of the corporation law changes of the last few decades to the "local big business community," and more generally ascribed the new corporate codes to the desire to "adjust the statutory provisions to the requirements of the large scale mass production enterprise."¹⁴⁴ In some instances there was even evidence that the new laws were drafted not by legislatures but by attorneys working directly for public corporations.¹⁴⁵ In contrast, close corporations, which rarely incorporated in foreign jurisdictions and which were not a large source of incorporation fee and franchise tax revenues, were far from drafters' main concern when the new corporation statutes were written.¹⁴⁶

C. The "Statutory Norms" and the Close Corporations

If the corporation laws of this era were written for the public corporation, where did that leave the close corporation? The place of the close corporation in corporation law between the late nineteenth century and the 1950s presents a paradox. As described above, the broad trend in corporate law was towards granting incorporators and managers more leeway in corporate organization; between 1890 and 1930, states "created a new frame of policy within which [they] gave businessmen a free hand in adapting the corporate instrument to their will."¹⁴⁷ Yet these changes did not benefit close corporations. For close corporations, the early twentieth century was a time when the law proved particularly *inflexible*, inasmuch as it did not allow close corporation

143. BALLANTINE ON CORPORATIONS, *supra* note 9, at 325 ("Shareholders are too numerous, too scattered and too unfamiliar with the business of the corporation to conduct its business directly. It is accordingly the plan of corporate organization that the stockholders shall choose directors who shall control and supervise the conduct of the business").

144. Rutledge, *supra* note 1, at 312, 337.

145. The New Jersey law of 1889 was, for instance, likely drafted by William Cromwell of Sullivan & Cromwell, whose clients included several trusts, Yablon, *supra* note 113, at 340, while Adolf A. Berle similarly claimed that New York law firms drafted major changes to Delaware's corporation law in the 1920s. A. A. Berle, Jr., *Investors and the Revised Delaware Corporation Act*, 29 COLUM. L. REV. 563, 563-64 (1929).

146. See Ian Ayres, *Judging Close Corporations in an Age of Statutes*, 70 WASH. U. L.Q. 364, 374-78 (1992) (discussing close corporations' tendency to incorporate in their state of residency); see also ROMANO, *supra* note 18, at 24-25 (speculating that states may have other incentives to craft favorable close corporation laws).

147. HURST, *supra* note 11, at 13.

participants to deviate from the “new frame” provided for corporate governance. The centralization of power in the Board created significant (if apparently unintended) problems for the close corporation, chiefly because of a perceived corollary to the rule of Board dominance: if the power to control a corporation reposed in the Board, then it could not be lodged anywhere else. The close corporation found itself hemmed in by corporation law’s “statutory norms.”¹⁴⁸

The “statutory norms” were the mandatory structural and organizational provisions of a state’s corporation law, most important corporation law’s commandment that “the business of a corporation shall be managed by its directors.”¹⁴⁹ Although changes in corporation law had provided managers with much greater flexibility in certain areas, established doctrine still demanded that corporation statutes be strictly construed,¹⁵⁰ and most courts held to this, regarding “the corporation pattern with its advantage of limited liability as a grant from the legislature to be accepted *in toto* or not at all.”¹⁵¹ The statutory norms were not problems for public corporations, because the norms themselves mirrored the governance structures favored by public corporations. They were, however, a problem for the close corporation participants who desired to change those governance mechanisms.

To understand why the norms posed a problem for the close corporation, we must review the close corporation’s defining features.¹⁵² The typical close corporation consists of several individuals who serve simultaneously as shareholders, directors, and employees of the firm; ownership in the firm represents much of a participant’s wealth (no diversified portfolio here), and employment by the firm may be her main source of income. The participant’s dependence on the close corporation is exacerbated by lack of a public market for its shares; a participant may not be able to sell her stake in the company even if she wants out. Minority ownership of a close corporation thus comes with risk, perhaps most notably the risk a majority shareholder (or a coalition of shareholders) will “oppress” a minority shareholder by freezing her out of

148. The “statutory” or “corporate norms” were often invoked during the decades when close corporation law took shape. *See, e.g.,* Clark v. Dodge, 199 N.E. 641, 642 (N.Y. 1936) (“The business of a corporation shall be managed by its board of directors. . . . That is the statutory norm”); George D. Hornstein, *Stockholders’ Agreements in the Closely Held Corporation*, 59 YALE L.J. 1040 (1950). (“To what extent does the corporate form necessitate these corporate ‘norms?’”); Chayes, *supra* note 1, at 1532 (“The villains of the close-corporation piece have always been the ‘corporate norms,’ standard structural and organizational arrangements set out in general corporation acts”).

149. N.Y. CONSOL. LAW ch. 23 § 27 (1948) (cited in Long Park v. Trenton-New Brunswick Theaters Co., 77 N.E.2d 663, 663 (N.Y. 1948)). Most states’ corporation laws contained near-identical provisions. *See* John F. Meck, Jr., *Employment of Corporate Executives by Majority Stockholders*, 47 YALE L.J. 1079, 1079, n.2 (1938).

150. Leonard M. Wallstein, *Issue of Corporate Stock for Property Purchased: A New Phase*, 15 YALE L.J. 111, 125, n.40 (1906) (citing Oregon Ry. & Nav. Co. v. Oregon Ry., 130 U.S. 1, 20 (1889)).

151. Note, *supra* note 77, at 366.

152. *See supra* Part III.A.

control and employment at the corporation.¹⁵³

Most of these problems would not arise were the participants in the close corporation instead partners in a partnership. Partnership law provided partners significant discretion in ordering the internal operations of their firms. Partners could enter into a written Partnership Agreement which could, for instance, provide each partner a guaranteed slice of profits, or give each partner a veto over major partnership decisions.¹⁵⁴ Partnership law even gave each partner a valuable bargaining chip: the right to dissolve the partnership.¹⁵⁵ Partnership law did not, however, provide partners the main advantages of the corporation, separate existence and limited liability.¹⁵⁶

The best solution for close corporation participants would have been an organizational form which combined the benefits of a corporation (e.g., limited liability) with partnership-like flexibility, allowing close incorporators to contract among themselves for additional protections (e.g., a veto over major corporate decisions).¹⁵⁷ There was even a name for this type of flexible corporate form: the “incorporated partnership.”¹⁵⁸

Yet attempts to deviate from Board dominance, to lodge power with shareholders or limit the scope of the Board’s autonomy through private agreement, were regularly struck down as violations of the statutory norms of corporation law. The leading case of *Jackson v. Hooper* illustrates both close corporations’ attempts to deviate from the statutory norms, and courts’ decisive rejection of such deviations.¹⁵⁹ In 1902 Jackson and Hooper, formerly partners, organized a corporation to publish the *Encyclopedia Britannica*.¹⁶⁰ When organizing the corporation, they structured it as the law required, dividing the

153. Minority oppression is an ubiquitous problem for close corporations; it even has its own treatise. See generally F. HODGE O’NEAL & ROBERT B. THOMPSON, O’NEAL AND THOMPSON’S OPPRESSION OF MINORITY SHAREHOLDERS AND LLC MEMBERS (2d ed. 2004).

154. See FLOYD MECHEM, ELEMENTS OF PARTNERSHIP §§ 113-19, at 100-105 (2d ed. 1920); see also UNIFORM PARTNERSHIP ACT §§ 9, 18.

155. See MECHEM, *supra* note 154, at § 344, at 304; UNIFORM PARTNERSHIP ACT § 31. A partner who dissolved a partnership without cause would be liable for damages. See *id.*

156. Nor could other unincorporated business forms. See WARREN, *supra* note 74, at 403 (concluding that neither joint-stock companies nor the business trust offered corporation-like limited liability). It is not clear to what extent limited liability was a spur to forming close corporations. Although many writers about close corporations identified limited liability as a particularly attractive feature, see, e.g., Warner Fuller, *The Incorporated Individual: A Study of the One-Man Company*, 51 HARV. L. REV. 1373, 1374 (1937-1938); Weiner, *supra* note 1, at 273. This advantage may have been overstated, as close corporation participants were also often required to make personal pledges for their firms’ debts. See HURST, *supra* note 11, at 28.

157. See, e.g., Rutledge, *supra* note 1, at 338, n.153; Weiner, *supra* note 1, at 278.

158. Use of this term was actually a little confusing, as sometimes it referred to the ideal—a corporation with a partnership’s flexibility—while at other times it was just a synonym for “close corporation.” See Hornstein, *supra* note 148. For these reasons, while it was often used in discussions of close corporations, I have avoided it here.

159. *Jackson*, 75 A. at 568.

160. See *id.* at 568-69. Their business was organized in different states but their dispute was eventually heard in New Jersey.

shares between themselves and forming a Board of directors consisting of themselves and three other men expected to function as “dummy” directors.¹⁶¹ (Almost all corporation statutes demanded at least three directors.) However, Jackson claimed that while “the business was conducted in the names of corporations . . . [it was] always [run] in accordance with the original [partnership] agreement as to equal ownership, interest, authority, and control” between Jackson and Hooper, with the dummy directors merely voting as the two principals directed.¹⁶²

In 1908 the two “partners” fell out, and Hooper and the other directors expelled Jackson from management of the firm.¹⁶³ Jackson then sued Hooper and the other directors, alleging that their acts “constituted a breach of the so-called partnership agreement that Jackson and Hooper should have equal control and equal voice in the management of the companies.”¹⁶⁴

New Jersey’s highest court rejected Jackson’s suit. A corporation must be operated in accordance with the requirements of corporation law, it stated. Incorporators could not establish a corporation and then attempt to ignore the law by managing the corporation in accord with a private arrangement. It made no difference that the corporation was a “so-called ‘close corporations’ in which all the stock is held by a few persons, who are at one in the conduct and policy of corporate action.”¹⁶⁵ An attempted deviation from statute could not be tolerated “upon grounds of public policy . . . as it renders nugatory and void the authority of the Legislature . . . established by the Constitution, in respect to the creation, supervision, and winding up of corporations.”¹⁶⁶ “If they adopt the corporate form,” the court stated, “with the corporate shield extended over them to protect them against personal liability, they cease to be partners, and have only the rights, duties, and obligations of stockholders. They cannot be partners *inter sese* and a corporation as to the rest of the world.”¹⁶⁷

Particularly troubling, in the court’s eyes, was the alleged attempt to circumvent the Board. Directors had to act independently for the good of the entire corporation, and any agreement the “dummy” directors may have made to follow the original partners’ commands was unenforceable as both a violation of the corporation law and, incidentally, *ultra vires*.¹⁶⁸ The directors “must act on behalf of the corporation . . . and cannot enter into agreements,

161. *See id.* at 569-70.

162. *Id.* at 570. It should be noted that Hooper vigorously denied the existence of any such agreement. *See Jackson v. Hooper*, 74 A. 130, 133 (N.J. Ch. 1909), *rev’d* 75 A. 568.

163. *Id.*

164. *Id.*

165. *Id.* at 570.

166. *Id.*

167. *Id.* The Court traced the rule that stockholders in a corporation cannot operate a corporation as partners to *Russell v. McLellan*, 31 Mass. [14 Pick.] 63 (1832).

168. *See id.* at 573.

either among themselves or with stockholders, by which they abdicate their independent judgment.”¹⁶⁹

Jackson v. Hooper forcefully summarized the doctrines that were stumbling blocks to the development of a separate law for close corporations: corporation law was to be strictly construed, corporations were to be managed by their Boards, and neither shareholders nor directors could contract out of or evade these requirements.¹⁷⁰ So long as these norms held sway, close corporation participants who desired to enter into private agreements to gain different protections than were provided in standard-issue corporation law, were out of luck.

D. Explaining Rigidity: Economics, Politics, Theory

Why, in an era when states removed many limits on corporate activities, were restrictions that impinged particularly on close corporations not similarly loosened?¹⁷¹ No single answer completely resolves the question, but three developments surely contributed to legislators’ and, to a lesser extent, courts’ reluctance to provide close corporations significant relief.

The first development was discussed above: the growth of the public corporation and the concomitant separation of ownership from control.¹⁷² Although it seems certain that close corporations have always outnumbered public corporations, beginning in the late nineteenth century it was the public corporations that came to dominate the economy and loom over the public and legal imagination.¹⁷³ Shareholders in these firms lacked both ability and incentive to manage them, so corporation law fixed management of the corporation in its directors.¹⁷⁴ Given the centrality of the Board in this scheme, it is not surprising that attempts to weaken or circumvent the Board through private agreements met with deep skepticism. This is especially understandable if we keep in mind that the Board was not only charged with overseeing the

169. *Id.*

170. See *Sun River Stock & Land Co. v. Montana Trust & Savings Bank*, 262 P. 1039, 1044 (Mont. 1928) (describing *Jackson* as a “leading case”); see also, e.g., *Creed v. Copps*, 152 A. 369, 370 (Vt. 1930) (following *Jackson*); *Seitz v. Mitchell*, 181 N.W. 102, 103-04 (Minn. 1921) (same); *Manson v. Curtis*, 119 N.E. 559, 562 (N.Y. 1918) (“Clearly the law does not permit the stockholders to create a sterilized board of directors. Corporations are the creatures of the state and must comply with the exactions and regulations it imposes.”); *BALLANTINE ON CORPORATIONS*, *supra* note 9, at 324-25; 4 WILLIAM W. COOK, *A TREATISE ON THE LAW OF CORPORATIONS* 2954 (8th ed. 1923).

171. Courts slowly allowed minor deviations from the statutory norms, but not major deviations, and no legislature changed its laws to accommodate the close corporation until the late 1940s. See Recent Statute, *Corporations—Voting Requirements—New York Statute Permits Corporations to Require Unanimity of Greater than Majority Vote for Director or Shareholder Action*, 62 HARV. L. REV. 526, 526 (1949).

172. See *supra* Part IV.

173. On the legal impact of the corporation, see KELLER, *supra* note 98, at 86-91; on its economic dominance, see generally CHANDLER, *supra* note 54; on its social impact, see generally OLIVIER ZUNZ, *MAKING AMERICA CORPORATE 1870-1920* (1990).

174. See *supra* Part IV.B.

corporation, but also with keeping an eye on the officers who managed it so that those officers could not line their pockets at shareholders' expense.¹⁷⁵

A second development was political, a consequence of state competition for corporation charters.¹⁷⁶ As Ian Ayres has noted, states competed for corporation charters during this period because of the income those states could earn from incorporation fees and franchise taxes.¹⁷⁷ This gave legislators good reasons to change corporation law to accommodate public corporations. But for several reasons, including convenience, close corporations nearly always incorporated in their home state.¹⁷⁸ Even if some close corporations did seek to re-incorporate in another state, that state would likely earn little additional in taxes or fees, as such taxes and fees are often based to a corporation's assets and outstanding shares.¹⁷⁹ Thus, while state legislators had significant incentives to alter their statutes to favor public corporations, they had much less incentive to alter their statutes to meet the distinctive needs of close corporations. The demands of state fiscal politics dictated that corporation law serve large public corporations, not close ones.

A final reason why legislatures and courts may have been reluctant to countenance deviations from the statutory norms lay in legal theory, specifically the theory of the corporation. In the decades surrounding the turn of the twentieth century, academics warred over the idea of "corporate personhood" and more generally over what, exactly, the modern corporation was.¹⁸⁰ Along one axis of this debate¹⁸¹ lay the question of whether the corporation was an "aggregate" or an "entity;" that is, whether it was best seen as merely the aggregate interactions of its members, and so akin to a partnership, or instead as an entity existing apart from its shareholders.¹⁸² For a time, in the late nineteenth century, the aggregate theory enjoyed significant support.¹⁸³ When most corporations were still small-scale and run by their owners, it was plausible to maintain that they, like partnerships, were best

175. See Douglas, *supra* note 1, at 1305-1317.

176. I take this argument from Ayres, *supra* note 146, at 374-78.

177. *Id.* at 373-74; see also GRANDY, *supra* note 115, at 50 (discussing income New Jersey earned from incorporation fees).

178. Ayers, *supra* note 146, at 374 (citing F. HODGE O'NEAL & ROBERT THOMPSON, O'NEAL'S CLOSE CORPORATIONS § 2.11, at 55 (3d. ed. 1987) [hereinafter O'NEAL'S CLOSE CORPORATIONS]). One scholar noted in the 1930s that close corporations rarely incorporated in other states. Rutledge, *supra* note 1, at 340. Nevada now apparently competes for close corporation charters. Kahan & Kamar, *supra* note 18, at 716-20.

179. Ayers, *supra* note 146, at 377.

180. See Millon, *supra* note 128, at 211-20; Gregory A. Mark, *The Personification of the Business Corporation in American Law*, 54 U. CHI. L. REV. 1441, 1455-78 (1987); HOROWITZ, *supra* note 123, at 65-107; Lamoreaux, *supra* note 11, at 43-47.

181. The debates dealt with at least two conceptually distinct issues, whether the corporation was a natural or artificial entity, and whether it was an aggregate or an entity. See generally Millon, *supra* note 128. For this Article, the second debate is more relevant.

182. HOROWITZ, *supra* note 123, at 213-215.

183. HOROWITZ, *supra* note 123, at 73-75.

conceptualized as the collective interactions of the members.¹⁸⁴ The aggregate theory was also popular among corporations that wished to claim certain Constitutional rights; Attorneys could thus maintain the corporations were merely asserting the rights of the shareholders who comprised the corporation.¹⁸⁵

By the early twentieth century, however, the aggregate theory lost out in favor of the entity theory.¹⁸⁶ The growth of giant corporations, the rise of professional non-owner management, and the dispersion of share ownership made it impossible to see a corporation as merely the sum of its shareholders; it was instead a separate entity run by professional managers.¹⁸⁷ This drove home the conclusion that active power in a corporation rested not with shareholders but with a Board. As the theorist Ernst Freund put it, “where the whole sum of corporate powers is vested by law in a board of directors . . . such an organization . . . allows us to see in a large railroad, banking or insurance corporation rather an aggregation of capital than an association of persons.”¹⁸⁸ Thus, the entity theory’s rejection of an analogy between shareholder and partner made it more difficult for courts to entertain the possibility that shareholders could wield partner-like powers within a corporation.¹⁸⁹

All these developments—the growth of large corporations, their disproportionate influence on state lawmaking, and a conceptual framework sharply differentiating the partnership from the corporation—served as major impediments to the development of a law for close corporations from the 1890s through the 1940s. The surprising thing, indeed, is that a close corporation law developed at all.

V. MAKING CLOSE CORPORATION LAW

A. *The Roots of Close Corporation Law*

Despite the statutory norms, the first half of the twentieth century saw the slow evolution of a body of law for close corporations. This was not, however, a product of legislative action; before mid-century the corporation statutes, framed to accommodate public corporations, remained silent on the close corporation.¹⁹⁰ Rather, close corporation law developed as part of the common

184. *See id.*

185. Mark, *supra* note 180, at 1459-64 (discussing *The Railroad Tax Cases*, 13 F. 722 (C.C.D.Cal. 1882), *app. dismissed as moot*, *San Mateo County v. Southern Pac. R.R.Co.*, 116 U.S. 318 (1885), and *Santa Clara County v. Southern Pac. R.R.Co.*, 118 U.S. 394 (1886)).

186. Millon, *supra* note 128, at 214-15.

187. *Id.* at 214.

188. *Id.* (quoting ERNST FREUND, *THE LEGAL NATURE OF CORPORATIONS* 58 (1897)).

189. *See id.*; *see also* Lamoreaux, *supra* note 11, at 44-46.

190. The first statutory change directed specifically at close corporations was New York’s 1948 amendment of its corporation law, discussed *infra*.

law. Its starting-point was the private agreements that close corporation participants made with one another regarding how to operate their corporations and in the adjustments to the corporate form these participants engineered, typically out of sight of the courts. In one sense, these agreements and adjustments were for a time “close corporation law,” inasmuch as they determined how close corporations were run.¹⁹¹ Then a close corporation common law began to develop as courts passed on the validity of these agreements and arrangements. While the statutes remained silent when it came to close corporations, some courts were willing to accept small deviations from the norms to accommodate them. As judges sifted through these arrangements, they developed a body of doctrine which approved some legal arrangements tried by close corporation participants and invalidated (many) others.¹⁹² As one mid-century observer put it, “[n]ot the legislature, but the judges (who must deal with lawyers) and the lawyers (who must deal with clients) have quickened into life a type of business organization needed to meet the exigencies of the market place.”¹⁹³

The result of this incremental growth was less an elegantly unified body of law than a set of judicial imprimaturs on certain kinds of arrangements, including shareholder agreements, special charter and by-law provisions, and stock transfer restrictions, that allowed close corporation members to adopt control mechanisms that deviated from the norms. In general, Courts were likely to approve agreements that they believed infringed little or not at all on the statutory norms, while voiding those that infringed more blatantly on the norms and especially on the independence and authority of the Board.

The development of the common law of the close corporation was uneven; arrangements allowed in one state might be disapproved in another, and a court might uphold one shareholder agreement yet hold another that seemed very similar void as an infringement on the statutory norms.¹⁹⁴ Furthermore, while some experts, as early as the 1930s, claimed that with proper planning a “reasonable degree of safety [could] be achieved for the minority stockholder in a close corporation by the skillful use of all or some of the devices [approved

191. See *infra* Part V.A.2.

192. See *Israels*, *supra* note 52, at 488 (“Litigation . . . centered about the attempts of participants in close corporations generally occupying not only the capacity of shareholder but also those of director and officer to induce the courts to recognize private agreements between them which are in derogation of the statutory scheme of corporate government”).

193. George D. Hornstein, *Judicial Tolerance of the Incorporated Partnership*, 18 L. & CONTEMP. PROBS. 435, 435 (1953); see also *Fuller*, *supra* note 156, at 1374 (“It is encouraging to note . . . the relatively more sympathetic judicial treatment accorded the small incorporate enterprise. The courts have been comparatively alive to its problems and alert to find a practical solution for them.”).

194. Compare, for example, *Benintendi v. Kenton Hotel, Inc.*, 60 N.E.2d 829 (N.Y. 1945) (declining to enforce shareholders’ agreement) with *Clark*, 199 N.E. at 641 (upholding shareholders’ agreement) and with *McQuade v. Stoncham*, 189 N.E. 234 (N.Y. 1934) (declining to enforce shareholders’ agreement).

by courts] . . . supplemented by contracts,”¹⁹⁵ such planning typically required complex drafting and contracting, and the results were still shadowed by the possibility of subsequent court disapproval.¹⁹⁶

1. Private Agreements and/as Corporation Law

Close corporation participants attempted to modify the corporate form through private agreements long before such agreements won a safe harbor in the law. Every such agreement was an attempt, one way or another, to bend corporate law to the specific needs of the participants.¹⁹⁷ Agreements could attempt to control who would participate in the close corporation by limiting or forbidding transfer of shares;¹⁹⁸ they might give minority shareholders greater power by providing them a veto over shareholder or director action,¹⁹⁹ or by giving them the power to dissolve the corporation;²⁰⁰ they might guarantee participants' employment and salary as insurance against a potential shift in relations among participants;²⁰¹ or they might guarantee all signatories a seat on the Board.²⁰² Although these agreements appear most often as private contracts between close corporation participants, their provisions could also be lodged in a corporation's charter or by-laws.²⁰³

It is not surprising that participants entered into such agreements. While the law sharply distinguished corporations from partnerships, many close corporations had partnership-like features (e.g., active involvement of owners) and some had started out as partnerships before seeking the advantages of incorporation (hence “incorporated partnership”).²⁰⁴ Businessmen moving from partnership to corporate form, and looking for ways to guarantee their positions in the new firms, already had a model agreement at hand, the Partnership Agreement.²⁰⁵ Many of the agreements entered into by close corporation

195. CHESTER ROHRlich, *LAW AND PRACTICE IN CORPORATE CONTROL* 214 (1933).

196. Hence growing calls for statutes specifically drafted for close corporations that would legitimize these devices. See *infra* Part IV.C.

197. See generally *infra* Part V.B.

198. E.g., *Mason v. Mallard Tel. Co.*, 240 N.W. 671, 672-73 (Iowa 1932).

199. E.g., *Manson*, 119 N.E. at 562.

200. See Note, *Statutory Assistance for Closely Held Corporations*, 71 HARV. L. REV. 1498, 1501-02 (1958) (discussing cases on involuntary dissolution).

201. E.g., *McQuade*, 189 N.E. at 234.

202. E.g., *Ringling Bros—Barnum & Bailey Combined Shows, Inc. v. Ringling*, 53 A.2d 441 (Del. Ch. 1947).

203. See *infra* Part III.B. Although there are important legal distinctions between agreements recorded in a separate contract and those placed in the charter or by-laws, each should also be seen as a private agreement among participants susceptible of judicial scrutiny.

204. See, e.g., Hornstein, *supra* note 193, at 435; JAMES WILLARD HURST, *LAW AND ECONOMIC GROWTH: THE LEGAL HISTORY OF THE LUMBER INDUSTRY IN WISCONSIN, 1836-1915* 413-14 (1964) (move from partnership to corporation in the lumber industry).

205. Although no writing was required to form a partnership, it was business custom for partners to enter into and operate under a formal agreement. See MECHEM, *supra* note 154, at §§ 113-14, at 101-102; UNIFORM PARTNERSHIP ACT.

shareholders, then, appear to be no more than quasi-Partnership Agreements, intended to do what Partnership Agreements did: privately order the management of a firm. It was only their translation from partnership to corporation law that changed these agreements from well-understood and enforceable contracts to more legally uncertain documents.

There is no way to measure the number of such agreements, but the available evidence suggests they were fairly common.²⁰⁶ In the well-known 1934 case of *McQuaid v. Stoneham*, which turned on the enforceability of a shareholder agreement, New York's Court of Appeals admitted that "such agreements, tacitly or openly arrived at, are not uncommon, especially in close corporations where the stockholders are doing business for convenience under a corporate organization."²⁰⁷ In 1950, one scholar spoke of the "many instances" in which control in small corporations was divided up by agreements, "such agreements [sometimes]. . . committing the board of directors in advance as to the choice of officers, salaries, of even particular corporate policies."²⁰⁸ Case law also abounded in disputes over such shareholders' agreements.²⁰⁹ Furthermore, the agreements that appear in case law were likely only a small slice of the universe of such agreements, as close corporation participants had strong incentives against testing these agreements in court. First, it could not easily be predicted whether a particular agreement would be upheld, such that a plaintiff seeking to enforce an agreement ran the risk that the agreement would be voided.²¹⁰ Second, such a suit would signal that relationships in the corporation were irretrievably broken; thus, close corporation participants who wanted to continue in the business, or believed there were other options left to them, would probably not sue.²¹¹

206. *Accord* *Galler v. Galler*, 203 N.E.2d 577, 581-583 (Ill. 1964) (reciting Illinois cases dating from the late nineteenth century in which shareholder agreements appeared); Note, *supra* note 77, at 372 (speaking of "a vast field untouched, that of contracts between incorporators which are not a part of the charter but which the organization of the corporation has been rested upon"); Meck, *supra* note 149, at 1080 (noting judicial disapproval of shareholder agreements guaranteeing a corporate office, and that, "[d]espite such judicial disapproval, attempts constantly are being made to use such agreements").

207. *McQuade*, 189 N.E. at 236.

208. Edmund T. Delaney, *The Corporate Director: Can His Hands Be Tied in Advance*, 50 COLUM. L. REV. 50, 52 (1950).

209. See generally O'NEAL'S CLOSE CORPORATIONS, *supra* note 178.

210. Of course, a plaintiff could also be seeking to void an agreement, but such cases were less common because most plaintiffs were minority shareholders seeking to have an agreement enforced.

211. As others have pointed out, close corporation agreements are one kind of relational contract, as they involve long-term agreements among participants not all of whose exact terms can be fixed in advance. Moll, *supra* note 68, at 756-58; see also Robert Thompson, *The Law's Limits on Contracts in a Corporation*, 15 J. CORP. L. 377, 394 (1990). Adjustments of disputes in relational contracts tend to occur outside the courtroom, as participants prefer to use less adversarial "means for dispute avoidance and settlement," not the least because a litigated dispute could tie up significant assets and destroy a valuable long-term relationship. Stewart Macaulay, *Elegant Models, Empirical Pictures, and the Complexities of Contract*, 11 L. & SOC'Y REV. 507 (1976-1977). This aversion to litigation in relational contracts may explain why so many of the cases discussed in this Article involve freeze-outs in which a plaintiff has effectively been deprived of all economic benefit from a close corporation; in such a situation, litigation as the only way left to realize a return.

What was the relationship between these agreements and corporation law? In one sense, the answer is that it was tenuous and unhappy. As discussed below, for the first half of the twentieth century it was likely that many of these agreements violated corporation law. When challenged in court, some agreements might be upheld, but others were held void, and *ex ante* it was not clear whether a particular agreement would be enforced.²¹² In this view, these agreements predated and were at best the raw material for true “close corporation law,” which only developed as these agreements were passed upon by judges and as a body of case law developed showing which agreements would be upheld and which would not.

But there is another way to think about shareholders’ agreements and corporation law. The corporation scholar Melvin Eisenberg has argued that there are several kinds of corporation law, including “soft corporation law” consisting of “bodies of standards, principles, or rules that are promulgated by private institutions, and that have force of some sort although they are not directly backed by state sanction.”²¹³ In this sense, the shareholders agreements crafted for close corporations were a kind of corporation law, albeit “soft corporation law.” They structured the operations of the close corporations that adopted them and were adhered to by close corporation participants who looked to them as recording the ground rules of the corporation. The agreements determined who were elected as directors, who were the corporation’s officers, who managed the corporation, and even what they were paid. Some number, at least, were drafted by the individuals whom close corporation participants looked to for legal advice: their lawyers.²¹⁴ Thus, although the agreements may have lacked the force of law, inasmuch as their violation might not have called forth state action, they structured the internal operations of the corporation as surely as did any other kind of corporation law.²¹⁵

2. *A Straw in the Wind: The One-Man Corporation*

Although courts generally enforced the statutory norms, there was already one sign during this era that they might be amenable to limited corporate innovations: the one-man corporation.²¹⁶ Corporation statutes depicted

212. See *infra* Part V.

213. Eisenberg, *supra* note 18, at 182. Eisenberg’s examples include the ALI’s *Principles of Corporate Governance* and the listing rules of the stock exchanges. *Id.* at 182-183.

214. See, e.g., *Galler*, 203 N.E.2d at 579.

215. It would be stretch to say this focus on close corporation participants and their agreements is an attempt to depict “corporate law from the bottom up,” but it is an attempt to illustrate how, at least in the close corporation, both were active participants in the making of corporation law. For an analogous project, see ZUNZ, *supra* note 173, at 4-9, *passim*.

216. See I. MAURICE WORMSER, *FRANKENSTEIN INCORPORATED* 95-98 (1931); Fuller, *supra* note 156, at 1373; Note, *One Man Corporations—Scope and Limitations*, 100 U. PA. L. REV. 853 (1952) [hereinafter Note, *One Man Corporations—Scope and Limitations*]; Note, *Judicial Supervision of the*

incorporation as a collective act, the coming together of several individuals to create an entity—the corporation—separate from its creators. Almost all statutes, for example, mandated three incorporators for a new corporation and thereafter three directors.²¹⁷ They did not contemplate a situation where one individual created a corporation, owned all its shares, and controlled its operations.²¹⁸ Under the statutes, forming a one-man corporation required subterfuge;²¹⁹ the “real” owner of the would-be corporation had to recruit individuals to act as “dummy” incorporators and “dummy” directors and, in states where directors had to be shareholders, give them token shares in the corporation.²²⁰ All real power and ownership, however, remained with the individual behind the corporation.

Despite its departures from the statutory norm, the one-man corporation won fairly quick acceptance in American law. A leading case concerning one-man corporations—actually an English case²²¹—dated from 1896, when the House of Lords held, in *Broderip v. Salomon*, that a one-man corporation had been validly incorporated even though all but one of its seven required stockholders was a “straw man” lacking any “real and independent interest in the business.”²²² While a few early cases questioned the propriety of a corporation with only one stockholder,²²³ by the 1930s the one-man corporation was common.²²⁴ Even its deceptive aspects were tolerated; by 1938, “the use of dummy incorporators and dummy directors [was] a common technique

One Man Corporation, 45 HARV. L. REV. 1084 (1931-1932) [hereinafter Note, *Judicial Supervision of the One Man Corporation*]; Comment, *One-Man Corporations*, 10 HARV. L. REV. 304 (1896). The term used was “one man” corporation, though there may have been a few women incorporators, too.

217. By the 1930s, Michigan and Iowa allowed incorporation by a single individual. Rutledge, *supra* note 1, at 314-15. One-man corporations remained invalid in Louisiana. Hornstein, *supra* note 193, at 442, n.28.

218. Fuller, *supra* note 156, at 1374 (“With rare exception the one-man corporation has not been expressly authorized under the general incorporation statutes, and if the language of the statutes is to be given its fair import, none would seem even to be contemplated”).

219. One should distinguish between subterfuge in setting up a one-man corporation, which the courts seemed to accept, with later fraudulent behavior. Note, *Judicial Supervision of the One Man Corporation*, *supra* note 216, at 1085-87.

220. See Fuller, *supra* note 156, at 1375-76; Note, *Judicial Supervision of the One Man Corporation*, *supra* note 216, at 1084 n.3.

221. In the early part of the century English business law was often treated as valid authority in American sources for corporation law. See, e.g., EUGENE ALLEN GILMORE, HANDBOOK ON THE LAW OF PARTNERSHIPS §§ 1-3, *passim* (1911); TAYLOR, *supra* note 73, at § 1, *passim*.

222. Comment, *supra* note 216, at 304-305 (discussing *Broderip v. Salomon*, [1895] 2 Ch. 233); see also WORMSER, *supra* note 216, at 97-98 (criticizing *Broderip* and one-man corporations generally).

223. A few early cases suggested that a corporation with only one stockholder would “suspend” the corporation, but this seems to have faded by the early twentieth century. Fuller, *supra* note 156, at 1375 n.8.

224. One extraordinary case should be mentioned. In 1956, the North Carolina Supreme Court dissolved a corporation all of whose shares had been transferred to a single purchaser, reasoning that a one-man corporation was not allowed by statute. *Park Terrace Inc. v. Phoenix Indem. Co.*, 91 S.E.2d 584 (N.C. 1956). The ruling was promptly overturned by the legislature. Manne, *supra* note 1, at 259 n.19.

employed in the formation of corporations, large and small.”²²⁵

According to one commentator, the acceptance of the one-man corporation illustrated “the flexibility and adaptability of the common law and its ability to dispense with technical doctrine in the interests of results dictated by justice and common sense.”²²⁶ Although courts were not willing to abandon the statutory norms, the case of the one-man corporation did show that some courts would accept slight variations from the corporation statutes when benefit was promised and no harm threatened. A similar process of acceptance would occur with close corporations.

B. Close Corporation Law, 1900-1960

1. Incorporators Propose, Judges Dispose

A common law of close corporations developed incrementally over the first half of the twentieth century as courts were called upon to enforce, or invalidate, the techniques devised by close corporation participants to maintain control of the corporation. Each technique was an attempt to evade the mandates of the statutory norms in order to meet the close corporation participants’ needs. Rather than deal encyclopedically with every technique,²²⁷ this section examines the evolution and judicial acceptance of three tools of close corporation governance: shareholder agreements, voting requirements for shareholders and directors set out in the charter and by-laws, and stock transfer restrictions.

a. Shareholder Agreements

The most contentious and far-reaching legal tool for operating a close corporation was the Shareholders’ Agreement, a contract entered into by some or all of the shareholders of a close corporation that provided for the corporation’s management.²²⁸ Such agreements varied enormously, with some

225. Fuller, *supra* note 156, at 1375. This presents an interesting contrast to contemporary corporation law, where an individual serving as a corporation’s director while taking on no real interest in the firm would likely be violating the fiduciary duties she owed to the corporation.

226. *Id.* at 1406.

227. Thus, the following does not comprehensively address other legal tools that were also tried, with varying degrees of success, in close corporations, including voting trusts, see Henry W. Ballantine, *Voting Trusts, Their Abuses and Regulation*, 21 TEX. L. REV. 139, 142-44 (1942-43); employment contracts among shareholders, see Meck, *supra* note 149, at 1079-84; arbitration agreements, see F. Hodge O’Neal, *Resolving Disputes in Closely Held Corporations: Intra-Institutional Arbitration*, 67 HARV. L. REV. 786 (1954); and agreements providing for dissolution of the corporation, see Carlos Israels, *The Sacred Cow of Corporate Existence, Problems of Deadlock and Dissolution*, 19 U. CHI. L. REV. 778 (1952).

228. See I F. HODGE O’NEAL, CLOSE CORPORATIONS: LAW AND PRACTICE §§ 5.01-.39, at 223-331 (1st ed. 1958) [hereinafter O’NEAL’S CLOSE CORPORATIONS (1958)]; Comment, “Shareholders’ Agreements” and the Statutory Norm, 43 CORNELL L.Q. 68 (1957) [hereinafter Comment, “Shareholders’ Agreements” and the Statutory Norm]; Delaney, *supra* note 208; Hornstein, *supra* note

merely touching on peripheral matters and others covering almost every major aspect of a close corporation's operations. Signatories might agree to vote for one another as directors,²²⁹ to appoint one another as officers once elected directors,²³⁰ to pay one another fixed salaries,²³¹ to hand over management of the company to a third party,²³² or to buy or sell shares when a member wished to exit the corporation.²³³ However, shareholders' agreements were not voting trusts; shares in a voting trust were lodged with a trustee empowered to vote them, whereas shareholder agreements were instead agreements among shareholders to vote the same way, with each shareholder retaining ownership of his or her shares.²³⁴

As is to be expected, courts' willingness to enforce shareholder agreements varied enormously across time and jurisdiction. In a few states with atypically flexible corporation statutes, agreements were usually enforced, even if they transgressed the norms by, for instance, allowing shareholders to elect officers directly.²³⁵ In most states, though, shareholders' agreements were more closely scrutinized by the courts, which over the years developed a core of close corporation law by winnowing acceptable provisions in shareholder agreements from provisions that transgressed too far on the statutory norms.²³⁶

In the nineteenth century, it appears shareholder agreements were not in such clear disfavor. Nineteenth-century common law held that shareholders could do collectively what they could do individually; thus, shareholders could enter into agreements coordinating their votes.²³⁷ Some late nineteenth-century

148, at 1040; Comment, *Corporations—Validity of Stockholders' Voting Control Agreement*, 47 MICH. L. REV. 580 (1948) [hereinafter Comment, *Corporations—Validity of Stockholders' Voting Control Agreement*]; Note, *Specific Enforcement of Shareholder Voting Agreements*, 15 U. CHI. L. REV. 738 (1947); Meck, *supra* note 149, at 1079-84; Comment, *Corporations—Contracts—Validity of Contracts Binding Directors to Prescribed Course of Corporate Management*, 21 MINN. L. REV. 103 (1936) [hereinafter Comment, *Corporations—Contracts—Validity of Contracts Binding Directors*]; Note, *The Validity of Stockholders' Voting Agreements in Illinois*, 3 U. CHI. L. REV. 640 (1935-36) [hereinafter Note, *The Validity of Stockholders' Voting Agreements in Illinois*]; Comment, *Validity of Contracts Among Stockholders to Control a Corporation*, 44 YALE L.J. 873 (1935).

229. O'NEAL'S CLOSE CORPORATIONS (1958), *supra* note 228, at § 5.12, at 251-52.

230. *Id.* at § 5.17, at 267-69.

231. *E.g.*, McQuade, 189 N.E. at 265.

232. *E.g.*, Long Park, 77 N.E.2d at 663.

233. The legality of transfer restrictions is discussed in Part V.B.1 *infra*.

234. See ROHRICH, *supra* note 195, at 40 (close incorporators disliked voting trusts); *see also* Ballantine, *supra* note 227, at 139.

235. *See* Hornstein, *supra* note 193, at 444.

236. This section pays particular attention to New York, as it probably had the most developed close corporation law during the first half of the twentieth century. Comment, *"Shareholder Agreements" and the Statutory Norm*, *supra* note 228, at 70-74.

237. 5 FLETCHER, CYCLOPEDIA OF CORPORATIONS § 2064 (1931), cited in Comment, *Corporations—Validity of Stockholders' Voting Control Agreement*, *supra* note 228, at 580. It should be noted, though, that the nineteenth-century theory that shareholders owed duties to one another, and thus could not contract away their votes, reared its head even into the twentieth century. In 1946 the Supreme Judicial Court of Massachusetts stated in dicta that a contract "which takes away even some of stockholders freedom to use their judgment as to the best interests of the corporation" was void. Delaney, *supra* note 208, at 54. (citing *Odman v. Oleson*, 64 N.E.2d 439 (Mass. 1946)).

cases extended this principle to allow shareholders to enter into agreements concerning corporate management, essentially validating proto-shareholders agreements. In *Faulds v. Yates*, an 1871 case, the Illinois Supreme Court upheld an agreement between shareholders of a coal company to choose the corporation's officers and managers, stating that absent fraud or injury to minority shareholders "[t]he co-operation, then, of these parties in the election of the officers of the company . . . cannot properly be characterized as dishonest and violative of the rights of others, [or] in contravention of public policy."²³⁸ Ten years later, in *Lorillard v. Clyde*, the New York Court of Appeals upheld a contract made by two incorporators and later shareholders that assigned one, Clyde, management of the corporation and the other, Lorillard, regular dividends.²³⁹ Lorillard sued to have the agreement enforced after Clyde stopped paying the dividends.²⁴⁰ The Court upheld the agreement, stating that it could "see no objection on the score of public policy, to an agreement between parties about to form a corporation, agreeing upon the general plan upon which it is to be organized and conducted, so long as nothing is provided for inconsistent with the provisions of the statute, or immoral in itself."²⁴¹ The Court's opinion also, however, included an important caveat: though the agreement was not itself illegal, it "might not be binding upon the trustees of the corporation when organized," thus leaving open whether an incorporators' agreement concerning a corporation's management could subsequently bind its Board.²⁴²

These two opinions were, however, more a relic of the nineteenth century's emphasis on shareholder power than a harbinger of new law.²⁴³ They were handed down years before the explosive growth of public corporations, and in a period when there was still perceived overlap between corporation and partnership law.²⁴⁴ The U.S. Supreme Court in 1890's *West v. Camden* decisively set the modern trend against shareholders' agreements.²⁴⁵ At issue in *West* was a contract between a majority shareholder and director of a company, and its vice-president, in which the director promised to keep the vice-president

238. 420 Ill. 416, 420 (Ill. 1870).

239. 86 N.Y. 384, 384-87 (1881).

240. *See id.*

241. *Id.* at 389.

242. *Id.* Lorillard was suing on an executory contract; query whether a suit brought by the other party to guarantee his right to manage the corporation's affairs would have been enforced.

243. Although neither case was overturned, each was subsequently read narrowly or inconsistently. After the turn of the century, both states courts' refused to enforce shareholder agreements that would bind directors' discretion. *See Teich v. Kaufman*, 174 Ill. App. 306 (1912) (declining to enforce an agreement committing directors to a course of action and to pay fixed salaries); *Flaherty v. Cary*, 70 N.Y.S. 951 (1901). It should be noted, though, that Illinois law in this area remained inconsistent, with some apparently broad shareholders' agreements being upheld by the courts. *See, e.g., Fitzgerald v. Christy*, 242 Ill. App. 343 (1926); *Kantler v. Benzinger*, 73 N.E. 874, 878 (Ill. 1905).

244. *See HOROWITZ, supra* note 123, at 73.

245. 135 U.S. 507 (1890).

employed at the company.²⁴⁶ The court held that the agreement was void as against public policy, reasoning that a director or officer owed duties to the corporation and its stockholders, and the contract, if enforced, would force the director to violate those duties.²⁴⁷ From this decision a general rule was soon distilled, summed up in a standard treatise of the period: “[A]ny contract between a director and an outsider the tendency of which is to influence a director’s official conduct by circumstances other than the good of the company is void.”²⁴⁸ This essentially restates the statutory norm of corporation law which places power in an autonomous Board.

Various explanations were offered for this rule, but a prominent one cited the plight of minority shareholders. If directors were able to enter into agreements locking them into a course of action, the reasoning went, shareholders would be deprived of their judgment, and those who would suffer the most would be the individuals who did not sign on to the agreement and were most dependent on the directors’ independence: the minority shareholders.²⁴⁹ Several cases striking down shareholders’ agreements noted either the threat such agreements posed to minority shareholders, or the fact that the agreement at issue had not been signed by all shareholders.²⁵⁰ This provided another reason for supporting an autonomous and powerful Board of Directors. Not only was such a Board necessary to manage a large public corporation, it also served as protection for the minority shareholders of a smaller corporation.

Yet the emphasis on protecting minority shareholders’ rights raised a question: what if an agreement impinging on the Board’s powers was reached by all shareholders? This issue was raised in *Manson v. Curtis*, decided in 1918 by New York’s Court of Appeals.²⁵¹ *Manson* concerned an agreement promising a shareholder management of a steamship corporation.²⁵² When organizing the corporation, Manson and several fellow-shareholders had agreed that his candidates would be elected to the Board and that he would run the

246. *Id.* at 509-10.

247. *Id.* at 521.

248. ARTHUR W. MACHEN, A TREATISE ON THE MODERN LAW OF CORPORATIONS § 1632, at 1347 (1908). See *Seitz v. Mitchell*, 181 N.W. 102, 104 (Minn. 1921); *Lothrop v. Goudeau*, 76 So. 794, 798 (La. 1917); *Haldeman v. Haldeman*, 197 S.W. 376, 380 (Ky. Ct. App. 1917); *Scripps v. Sweeney*, 125 N.W. 72, 77-78 (Mich. 1910); *Cone’s Ex’rs v. Russell*, 21 A. 847, 849 (N.J.Ch. 1891); *Gage v. Fisher*, 65 N.W. 809, 814 (N.D. 1895); *Validity of Individual Contract by Director to Put or Maintain a Designated Person in Office*, 12 A.L.R. 1070 (1921).

249. E.g., BALLANTINE ON CORPORATIONS, *supra* note 9, at § 174, at 579.

250. See, e.g., *Creed*, 152 A. at 416 (“None of [the other shareholders] knew of any understanding between the plaintiff and said Copps until the bringing of this proceeding.”); *Scripps*, 125 N.W. at 79 (noting that agreement was not signed by all shareholders); *West*, 35 U.S. at 513 (noting agreement was not made between all the shareholders). See also *Faulds*, 420 Ill. at 57 (upholding agreement after observing that “[t]here was nothing in [the agreement] which necessarily affected the rights and interests of the minority”).

251. *Manson*, 119 N.E. at 559.

252. *Id.*

corporation.²⁵³ After the customary falling-out, the defendants broke their promise, firing Manson and refusing to elect his candidates to the Board.²⁵⁴ When Manson sued, the defendants claimed that the agreement was void as against public policy.²⁵⁵

The Court of Appeals agreed. It began by noting that one part of the agreement clearly was legal, the agreement by the shareholders to pool their votes to elect directors.²⁵⁶ In this, the Court merely followed the widely accepted rule that shareholder agreements to elect directors were valid.²⁵⁷ But the agreement also promised Manson management of the corporation. Here the court balked, stating that such a provision would create a “sterilized board of directors” without power over the corporation, and so violate corporate law’s command that the “affairs of every corporation . . . be managed by its board of directors.”²⁵⁸ The court held the parts of the agreement giving management to Manson to be void, and because the provision for electing directors was inextricably bound up with the management provisions, it was also invalidated.²⁵⁹

Manson could be read two ways. On its face, it apparently was just another case prohibiting agreements that limited the power of the directors. Yet in *dicta* the Court seemed to send a different message: “The rule that all stockholders by their universal consent may do as they choose with the corporation concerns and assets, provided the interests of creditors are not affected, because they are the complete owners of the shares, cannot be invoked here.”²⁶⁰ The *dicta* implied that the problem for Manson was that his agreement was not entered into by “all stockholders.”²⁶¹ By implication, *Manson* distinguished between unanimous shareholder agreements, which might be given some leeway to intrude on the board’s managerial prerogatives, and non-unanimous shareholder agreements, which would not.

After *Manson*, a few unanimous shareholders’ agreements were upheld by the New York courts.²⁶² Yet the permissible scope of such agreements was

253. *Id.* at 560.

254. *Id.*

255. *Id.*

256. *Id.* at 561.

257. *O’NEAL’S CLOSE CORPORATIONS* (1958), *supra* note 228, at § 5.12, at 251-52, n.8.

258. *Manson*, 119 N.E. at 562.

259. *Id.*

260. *Id.* at 562-3.

261. *Id.* at 562; *see also* *In re Burr’s Estate*, 175 Misc. 725, 726 (N.Y. 1941).

262. *See* *Harris v. Magrill*, 226 N.Y.S. 621 (1928) (upholding shareholders’ agreement promising plaintiff officer position, citing *Manson* in support). This reading of *Manson* was also bolstered by a 1931 case, *Fells v. Katz*, 175 N.E. 516 (N.Y. 1931). In *Fells* the court was asked to invalidate a unanimous shareholder agreement that guaranteed all signatories jobs as officers at the corporation. *Id.* One signer later started a competing company and, unsurprisingly, was fired. *Id.* The Court refused to uphold the employment agreement, but not because the whole shareholder agreement was void; rather, the Court held that shareholders could not so intrude on directors’ powers as to prevent the directors

only made clearer in two cases appearing a number of years later, one striking down a shareholders agreement, another upholding one.²⁶³ In *McQuade v. Stoneham*, the Court of Appeals refused to enforce a shareholders' agreement signed by a majority of the shareholders of the New York Giants which guaranteed McQuade a job as the Giants' Treasurer at a fixed salary.²⁶⁴ The Court stated that the contract was "illegal and void so far as it preclude[d] the board of directors . . . from changing officers, salaries or policies or retaining individuals in office."²⁶⁵ *McQuade* left the status of expansive shareholder agreements in doubt, not because of its holding, which merely repeated *Manson's* rule that less-than-unanimous shareholder agreements could not intrude on directors' managerial authority, but because of dicta that appeared to throw into doubt *any* shareholder agreements which limited director discretion.²⁶⁶

A clearer rule was laid down two years later in *Clark v. Dodge*, a case that was, not incidentally, authored by Judge Crouch, who had dissented from the holding in *McQuade*.²⁶⁷ *Clark* involved a classic close corporation shareholder agreement between the two shareholders of a pharmaceutical firm.²⁶⁸ The minority shareholder, Clark, was promised employment as a director and the firm's general manager so long as he was "faithful, efficient, and competent," and was to receive one-fourth of the corporation's net income as either salary or dividends.²⁶⁹ Later Dodge, the majority shareholder, attempted to break the agreement and freeze Clark out.²⁷⁰ The only question facing the court was whether the agreement was illegal.

The Court of Appeals began by noting that the agreement, and many others like it, apparently violated the statutory norm set down in New York's corporation law: "The business of a corporation shall be managed by its board of directors."²⁷¹ But, the Court asked, was that an absolute rule? "Are we committed by the *McQuade* case to the doctrine that there may be no variation, however slight or innocuous, from the norm, where salaries or policies or the

from firing an officer for cause. *Id.* at 517. "An agreement to continue a man as president is dependent upon his continued loyalty to the interests of the corporation." *Id.* By implication, the opinion suggested that shareholder agreements guaranteeing shareholders officers' positions were acceptable, so long as they could still be dismissed for cause by the Board. See Comment, "Shareholder Agreements" and the Statutory Norm, *supra* note 228, at 72-74.

263. For a good discussion of the following two cases, see Delaney, *supra* note 208, at 57-58.

264. *McQuade*, 189 N.E. at 235.

265. *Id.* at 237.

266. See Comment, "Shareholder Agreements" and the Statutory Norm, *supra* note 228, at 72-74.

267. *Clark*, 199 N.E. at 641. To be precise, Crouch concurred to the extent that he believed the contract unenforceable, but on the grounds that McQuaid had been a public employee at the time the agreement was entered into. He did not join the majority opinion in *McQuaid* that such agreements were generally unenforceable.

268. *Id.* at 641-42.

269. *Id.* at 642.

270. See *id.*

271. *Id.*

retention of individuals in office are concerned?”²⁷² The Court concluded it was not:

“If the enforcement of a particular contract damages nobody—not even, in any perceptible degree, the public—one sees no reason for holding it illegal, even though it impinges slightly upon the broad provisions of section 27 [of the New York Stock Corporation Law]. Damage suffered or threatened is a logical and practical test, and had come to be the one generally adopted by the courts. Where the directors are the sole stockholders, there seems to be no objection to enforcing an agreement among them to vote for certain people as officers.”²⁷³

The Court upheld the agreement, concluding that, while it impinged on the statutory norms, the impingement was slight. “If there was any invasion of the powers of the directorate under that agreement, it is so slight as to be negligible; and certainly there is no damage suffered by or threatened to any body.”²⁷⁴

Clark attempted to reconcile the mandates of corporation law with the needs of the close corporation. Under the rule of the case, the statutory norms still had force; an agreement could infringe on them only if the infringement were “slight” or “negligible” and did not threaten any harm.²⁷⁵ This rule had teeth. In 1945 the Court struck down, in *Benintendi v. Kenton Hotel, Inc.*, provisions in a corporation’s bylaws requiring unanimity for either stockholder or director action.²⁷⁶ Even though the provisions had been approved by all the corporations’ shareholders, they infringed too deeply on the corporate model as set out in statute.²⁷⁷ And in 1948’s *Long Park, Inc. v. Trenton-New Brunswick Theatres Co.*, the court invalidated a shareholder agreement giving a shareholder complete managerial power over the corporation’s theaters for nineteen years.²⁷⁸ In each case, the Court found that the agreement was more than a “slight” or “negligible” infringement on the statutory norms. Close corporation participants now had greater leeway to enter into shareholder agreements slightly infringing on the statutory norms, but they could not disregard the norms altogether.²⁷⁹

272. *Id.*

273. *Id.* (citations omitted).

274. *Id.* at 643.

275. Delaney, *supra* note 208, at 57 (quoting *In the Matter of Buckley*, 50 N.Y.S.2d 54 (N.Y. 1944)). It should be noted that New York’s courts were even willing to uphold some non-unanimous shareholders’ agreements, so long as they did not infringe on the statutory norms. *Buckley*, 50 N.Y.S.2d at 57.

276. *Benintendi*, 60 N.E.2d at 829. The infringing provision here was placed in the bylaws, and so is also discussed *infra* Part IV. In general, provisions placed in the bylaws or charter of a corporation could be treated by courts as a shareholder agreement even if the charter provision or bylaw were invalid. *Corporations—Restrictions on Managerial Functions of Directors*, 23 N.Y.U. L. REV. at 155 & n.30.

277. See *Benintendi*, 60 N.E.2d at 829-30.

278. *Id.*

279. Comment, “Shareholder Agreements” and the Statutory Norm, *supra* note 228, at 75-76.

By the late 1930s, New York's courts had shown themselves willing to bend the corporate norms to accommodate the needs of close corporations. Close corporation shareholders who sought to protect themselves from oppression and to guarantee themselves a voice in corporate deliberations, could enter into agreements guaranteeing their election as directors, appointment as officers, and even salaries. They knew that their agreements were likely to be enforced, at least so long as they did not overly infringe on the statutory norms or threaten harm to other shareholders or creditors.²⁸⁰ Shareholders' agreements had won their place in the corporation law.²⁸¹

b. Voting Requirements

Close corporation participants also sought to protect themselves by changing the voting requirements for shareholder or director actions. The modern rule was that a majority of shareholders attending a valid shareholders' meeting could act for all shareholders,²⁸² and a majority of directors voting at a valid meeting could act for the Board.²⁸³ These rules, of course, left minority participants vulnerable to majority overreach. By changing the rules to require approval of more than a bare majority, a minority shareholder could guarantee herself leverage, and possibly veto power, over fundamental corporate changes or the election of directors (at the shareholder level), or over the management of the corporation (at the director level).²⁸⁴ For instance, a requirement that three-quarters of shareholders approve major corporate transactions would give a thirty percent shareholder an effective veto over those transactions, and a requirement for director unanimity when electing officers would help protect a minority participant against being frozen out of the corporation.²⁸⁵

Close corporation lawyers drafting supermajority requirements had to navigate both statutory provisions concerning shareholder and director voting

280. Though as one observer noted, "the distinction between slight and substantial impingements [was] not always clear." *Id.*

281. Similar developments occurred in other states. See Note, *The Validity of Stockholders' Voting Agreements in Illinois*, *supra* note 228; Comment, *Corporations—Contracts—Validity of Contracts Binding Directors*, *supra* note 228, at 103-104 (noting that most courts did not uphold agreements binding directors to a specific course of action); Hornstein, *supra* note 148, at 1043 (most states "have sustained composite agreements of all stockholders to elect certain of their number as directors, and then as directors to appoint certain designated persons . . . to particular offices at stated salaries"). A court's refusal to void a shareholder agreement did not mean it would order specific performance; in the well-known *Ringling* case, for instance, the court upheld a voting agreement, but in the absence of a proxy refused to order specific performance, thus frustrating the winning party's attempt to retain seats on the Board. *Ringling Bros.*, 49 A.2d at 603.

282. *COOK ON CORPORATIONS*, *supra* note 109, at § 607, at 2117-18.

283. *Id.* at § 713a, at 2956.

284. See F. Hodge O'Neal, *Giving Shareholders Power to Veto Corporate Decisions: Use of Special Charter and By-law Provisions*, 18 L. & CONTEMP. PROBS. 451, 451 (1953). Shareholders could also obtain a veto over corporate actions by setting high quorum requirements; if, say, eighty percent of shares were required for a shareholder meeting to have a valid quorum, a thirty percent shareholder could stymie action by just not showing up. *Id.* at 464.

285. *Id.* at 455

and courts policing the statutory norms. Most state statutes actually posed little problem for close corporations wishing to insert supermajority requirements in either the corporation's official formation and governing document (its charter) or the rules governing its day-to-day operations (the by-laws). By mid-century, many "modern corporation acts expressly authorize[d] charter provisions requiring a high vote for shareholder actions."²⁸⁶ Delaware law, for instance, stated that a corporation's charter could include "provisions requiring for any corporate action the vote of a larger proportion of the stock or of any class thereof than is required by this Chapter."²⁸⁷ Supermajorities for Board action were also usually allowed; as one expert noted, even where statute did not explicitly provide for a supermajority requirement, "a charter provision requiring a high director vote would probably be given effect."²⁸⁸ However, such changes were not allowed everywhere; New Jersey's corporation statute, for instance, specified the percentage of shares voting needed to approve certain major transactions, and New Jersey courts had held such requirements could not be varied by private agreement.²⁸⁹ A provision's validity could also depend on where it was placed; some courts were more willing to sustain supermajority provisions located in the charter rather than in the by-laws, while others held that that charter could contain only statutorily required provisions and that the proper location for supermajority requirements was the by-laws.²⁹⁰

Yet some courts warned that supermajority or veto provisions still could not intrude too far on the statutory norms. In 1944's *Kaplan v. Block*, the Virginia Supreme Court of Appeals struck down by-law and charter provisions which required unanimous shareholder ratification before any action taken by a corporation's Board was given effect.²⁹¹ The court rejected this not only as a violation of Virginia statute, but as utterly incompatible with the concept of a corporation governed by a Board Because the agreement required shareholders to ratify every Board action, "[f]or all practical purposes there might as well be no board at all. A private business corporation without a board of directors is an impossible concept."²⁹² A year later, in *Benintendi v. Kenton Hotel*, the New York Court of Appeals likewise held invalid by-law provisions which required unanimous votes before stockholders or directors could take

286. *Id.* at 458.

287. *Id.* (citing DEL. GEN. CORP. LAW § 5(11)).

288. *Id.* at 459.

289. *Id.* at 460.

290. *Id.* at 465-66. The particular cases seemed to turn chiefly on specific wording of a state's corporation statutes, though a court's greater willingness to uphold a close corporation provisions located in the charter may also have turned on the more "public" nature of a charter, as charters were filed with a state's Secretary of State and presumably received that official's approval. *See* O'Neal, *supra* note 61, at 785-86.

291. 31 S.E.2d 893, 894 (Va. 1945).

292. *Id.* at 896.

any corporate actions.²⁹³ According to the Court, these by-laws violated the “statutory scheme for stock corporation management,” which had fixed certain percentages votes for approval of various transactions, and which set limits on the percentage of directors sufficient to constitute a quorum for Board action.²⁹⁴ The Virginia and New York courts seemed, however, in a minority on the question of supermajority requirements.²⁹⁵ Perhaps a sign of the acceptance of small incursions into the statutory norms, shortly after the *Benintendi* decision, New York’s legislature overruled it by statute, giving New York close corporations the power close corporations already enjoyed in most states—to adopt charter provisions requiring supermajorities for shareholder and director action.²⁹⁶

c. Stock Transfer Restrictions

Close corporation participants also wanted to control who held stock in their corporation. Some, having formed the corporation with trusted friends or colleagues, wanted to ensure that any new shareholders and potential co-workers were collegial and would not disrupt operations; others, planning succession, wanted to keep ownership of the corporation within a family.²⁹⁷ Restrictions could also help ensure that a corporation did not come under the Federal or state securities laws²⁹⁸ or, later, lose tax benefits that it may have acquired as an “S Corporation.”²⁹⁹

Under Partnership law, restricting sale of an interest was not a problem, for a partnership was a contract between the partners and not freely transferable.³⁰⁰

293. *Benintendi*, 60 N.E.2d at 829. Compare *In re Boulevard Theatre & Realty Co.*, 186 N.Y.S. 430 (N.Y. App. Div. 1921) (invalidating a charter provision requiring unanimous vote of all stockholders to elect a director) with *Ripin v. Atlantic Merc. Co.*, 89 N.E. 855, 856-57 (N.Y. 1912) (allowing a charter provision requiring a unanimous shareholder vote before the number of directors could be changed).

294. See *Benintendi*, 60 N.E.2d at 831-32. The Court was particularly offended by the fact that unanimity was required for all actions; it cautioned that “[w]e do not hold that an arrangement would necessarily be invalid, which, for particular decisions, would require unanimous consent of all stockholders.” *Id.*

295. O’Neal, *supra* note 284, at 462 (citing 1948 N.Y. LAWS ch. 862 § 1).

296. See O’NEAL’S CLOSE CORPORATIONS (1958), *supra* note 228, at § 7.02, at 2-4; Bernard F. Cataldo, *Stock Transfer Restrictions and the Close Corporation*, 37 VA. L. REV. 229 (1951).

297. The Securities Act of 1933 made it unlawful to make a public issue of stock without registering it with the Securities and Exchange Commission, but exempted from registration any sale “not involving a public offering.” SECURITIES ACT OF 1933 § 4; see also O’NEAL’S CLOSE CORPORATIONS (1958), *supra* note 228, at § 1.16, at 33-35; Rohlich, *supra* note 57, at 1174.

298. In 1958 Congress passed legislation creating the so-called “S Corporation,” which initially allowed certain small corporations with 10 or fewer shareholders to elect to have their income taxed to shareholders rather than the corporation. See William P. Cunningham, *Subchapter S Corporations: Uses, Abuses, and Some Pitfalls*, 20 MD. L. REV. 195, 197 (1960).

299. See UNIFORM PARTNERSHIP ACT § 27. Interest in a partnership was transferable, but the recipient would not become a partner or be entitled to management; rather, she would merely received the profits the partner would have been entitled to. *Id.*

300. See *In re Petition of Klaus*, 29 N.W. 582, 585 (Wisc. 1886) (“When the law makes stock personal property, it clothes it with all the incidents of personal property, and the owner has full dominion over it, and may dispose of it at will”).

Restricting sale of stock, however, was more difficult. Stock in a corporation was the private property of the stockholder, and Anglo-American law strongly favored the free transferability of property.³⁰¹ One of the base assumptions of corporation law was therefore that stock was freely transferable unless a statute provided otherwise,³⁰² and even when a statute provided a limitation courts disfavored it.³⁰³ Absolute restrictions on alienation were invariably struck down.³⁰⁴

Lawyers seeking to draft enforceable transfer restrictions, therefore, had to plan around earlier court decisions, corporate law doctrine, and the peculiarities of their jurisdiction. Courts generally imposed a test of “reasonableness” on transfer restrictions, but only slowly did sufficient cases accrete to show what this meant.³⁰⁵ In the decades around the turn of the twentieth century, courts appeared reluctant to uphold any restriction on share transfers. As courts became more sympathetic to the special needs of close corporations, certain restrictions were more often allowed. Restrictions requiring a shareholder to get consent to sell from other shareholders or the Board are a case in point. Before 1920, courts “almost without exception held that any restriction conditioning the power of a shareholder to dispose of his shares on the consent of some other person was an invalid restraint on the alienability of shares . . . [but after 1920 most] cases uphold consent restraints,” so long as consent was not unreasonably withheld.³⁰⁶ Similarly, “first option” agreements, which gave other shareholders or the corporation itself an option to purchase shares when a shareholder decided to sell, were generally held invalid in the 1890s, but were usually upheld after the turn of the century.³⁰⁷ Courts were also willing to uphold buy-out arrangements in which shareholders agreed that, at their death, their shares would be offered first to the other shareholders or the corporation itself.³⁰⁸

As court decisions shaped what restrictions would be attempted, they also shaped where the restrictions would be placed. Early transfer restrictions often appeared in by-laws, but courts sometimes invalidated these on the grounds that by-laws were intended to regulate a corporation’s operations and that transfer

301. See 1 VICTOR MORAWETZ, TREATISE ON THE LAW OF PRIVATE CORPORATIONS §§ 164, 165, at 166-68 (2d ed. 1886).

302. See Annot., *Validity of Restrictions by Corporation on alienation or transfer of corporation stock*, 30 A.L.R. 1159 (1930).

303. O’Neal, *supra* note 61, at 777-78.

304. *Id.* (“The underlying test seems to be whether the restraint is sufficiently needed by the particular enterprise to justify overriding the general policy against restraints on alienation”).

305. *Id.* at 780. See also Comment, *Corporations—Articles of Incorporation—Restrictions on Transfer of Stock*, 18 IOWA L. REV. 88 (1932). But see Cataldo, *supra* note 296, at 241 (stating that consent restrictions contained in by-laws are generally held unreasonable).

306. O’Neal, *supra* note 61, at 780-81.

307. O’NEAL’S CLOSE CORPORATIONS (1958), *supra* note 228, at § 7.10, at 1-16.

308. O’Neal, *supra* note 61, at 779.

restrictions were beyond their scope.³⁰⁹ Courts were more willing to uphold restrictions located in a charter or separate shareholders' agreement; so, by the 1950s, authorities recommended placing the desired transfer restrictions in both.³¹⁰ When a shareholder agreement was used, a best practice was to have as signatories both the shareholders and the corporation itself.³¹¹ Statute also helped determine the form transfer restrictions took; the Uniform Stock Transfer Act, proposed in 1909 and widely adopted, stated that a transfer restriction, whether recorded in the by-laws or elsewhere, would be unenforceable unless the "restriction is stated upon the certificate."³¹²

By mid-century close corporation law had evolved to provide reliable procedures for imposing restrictions on share transfers. The slow judicial weighing of restrictions had produced a clear body of law allowing close corporation stockholders to impose limits on the sale of shares, providing them a dependable tool for controlling ownership of their firms. As one group of observers noted, "[i]t is in the area of stock transfer restrictions, perhaps more than in any other area, that the judges have been able to serve effectively the peculiar needs of the close corporation."³¹³

d. Explaining Flexibility

Why, after spending so much time invoking the statutory norms, were courts willing to uphold agreements that did not adhere to them? What explains the growth of a judge-made close corporation law? Part of the explanation must lie in judges' and commentators' growing familiarity with close corporations, and their realization that a slight loosening of the statutory norms, limited to situations involving close corporations, was no threat to the general structure of corporate law.³¹⁴ Part may lie as well in changing notions of the corporation, and a slow acceptance of the view that the corporation was not so much an artificial creation of the state as the creation of its incorporators, who should therefore be given greater flexibility in arranging its workings as they saw fit.³¹⁵ Much of the reason, however, lies in the particular mechanisms that were developed to govern the close corporation. Through their decisions, courts had signaled that they would treat harshly any attempt to trample the statutory norms, while they looked more favorably on mechanisms that either avoided

309. *Id.* at 785-86.

310. *Id.* at 789.

311. UNIFORM STOCK TRANSFER ACT § 15; *see also* Hornstein, *supra* note 148, at 1048 (all forty-eight states adopted the Uniform Stock Transfer Act).

312. Note, *A Plea for Separate Statutory Treatment of the Close Corporation*, 33 N.Y.U. L. REV. 700, 721-21 (1958). This Note was co-authored by ten students.

313. *E.g.*, *Buckley*, 50 N.Y.S.2d at 54 (allowing "negligible" infringement of norms).

314. *See* Millon, *supra* note 128, at 202 ("the notion of the corporation as a natural creation of private initiative and market forces replaced the idea that the corporation was artificial" by the early 20th century).

315. Hornstein, *supra* note 193, at 435.

impinging on Board predominance (e.g., supermajority requirements) or guaranteed that no harm would come to shareholders when the norms were trespassed (e.g., unanimous shareholder agreements). The close corporation law that resulted from these interactions was a law that acknowledged the statutory norms, even though it allowed the norms to occasionally be “slightly” overstepped. It was not just that courts had learned to live with close corporations, but close corporations had learned to live with the statutory norms.

2. Mid-Century: Planning for the Close Corporation

By mid-century, courts, lawyers, and close corporation participants in many states had developed a common law for the close corporation. Planning for the close corporation had become part of the day-to-day work of some corporate lawyers and courts; the field’s vitality “conclusively demonstrated by flourishing practices, office files, and judicial decisions.”³¹⁶ Close corporation law was more reliable; writing of New York, one expert estimated that a carefully drafted shareholders’ agreement would rarely result in litigation, and estimated that, in Manhattan, only about 10 cases involving shareholder agreements would be litigated in a year, “less than one percent of the number of stockholders’ agreements actually signed.”³¹⁷ The close corporation was also beginning to draw sustained academic attention³¹⁸ and, while close corporation law was still nearly all common law, statutes were just starting to be rewritten to accommodate the close corporation.³¹⁹ While close corporation law was certainly not free of disputes and uncertainties—then or now—it had taken on substance in a way it had not possessed thirty years before.³²⁰

An attorney planning for a close corporation could turn to articles and secondary sources aimed at helping him or her draft the needed shareholder agreements, transfer restrictions, by-laws and corporate charters.³²¹ In 1951, a Pennsylvania attorney seeking to organize a close corporation could refer to

316. Hornstein, *supra* note 148, at 1055, n.51.

317. In 1953, for instance, the journal *Law & Contemporary Problems* devoted an issue to a symposium on the close corporation. See Foreward, *Close Corporations*, *supra* note 52.

318. See *infra* Part V.B.

319. Some problems of close corporation law remained long unresolved. Thus, while the 1950s may have seen the development of tools to restrict ownership in a corporation and give power to minority shareholders *ex ante*, in the 1970s courts were still wrestling with issues related to minority oppression and, especially, problems relating to dissolution and exit options for minority shareholders. See, e.g., Charles W. Murdock, *The Evolution of Effective Remedies for Minority Shareholders and Its Impact Upon Valuation of Minority Shares*, 65 NOTRE DAME L. REV. 425, 429-440 (1990); J.A.C. Hetherington & Michael P. Dooley, *Illiquidity and Exploitation: A Proposed Statutory Solution to the Remaining Close Corporation Problem*, 43 VA. L. REV. 1, 3-6 (1977).

320. I have found only one pre-1945 discussion of close corporations in a work aimed at practitioners. See ROHRICH, *supra* note 195, at 210-16.

321. Warren M. Ballard, *Arrangements for Participation in Corporate Management Under the Pennsylvania Business Corporation Law*, 25 TEMP. L.Q. 131 (1951).

“Arrangements for Participation in Corporate Management Under the Pennsylvania Business Corporation Law,” which appeared in the *Temple Law Quarterly*,³²² while Illinois lawyers could soon resort to “How Illinois Corporations May Enjoy Partnership Advantages: Planning for the Closely Held Firm,” published in the 1953 *Northwestern University Law Review*.³²³ Presentations to lawyers were also available; in 1949, a continuing legal education presentation was given to the New York Bar on “Stockholders Agreements in Closely Held Corporations,”³²⁴ and the ABA’s section on corporation, banking, and business law featured a round table on “Problems of Closely Held Corporation” at its 1954 meeting.³²⁵

It was also during this period that the close corporation gained significant academic attention, most notably through the work of Hodge O’Neal. Although earlier scholars had occasionally discussed the close corporation, beginning with his 1952 *Harvard Law Review* article on *Restrictions on Transfer of Stock in Closely Held Corporations*,³²⁶ O’Neal is generally identified as the first scholar to identify it as a distinct field “worthy of study and of separate attention.”³²⁷ O’Neal’s landmark treatise *Close Corporations: Law and Practice* appeared in 1958, and provided readers aiming to plan for close corporations not only an overview of the emerging field but a wealth of sample shareholder agreements, charter amendments, and by-law provisions.³²⁸

Although many close corporations undoubtedly used these new tools, it is not easy to determine how many did so.³²⁹ Were shareholder agreements, transfer restrictions, and other mechanisms used chiefly by larger close corporations in commercial hubs, or was their use more widespread? No data appears available to answer this question, but one signal that many close corporations did use some of these tools appears in a 1952 study of incorporation in Iowa.³³⁰ Of the 229 corporations first incorporated during the first half of that year, nearly fifty percent included a stock transfer restriction in their articles, and since restrictions could also have been located in by-laws or a

322. William L. Cary, *How Illinois Corporations May Enjoy Partnership Advantages: Planning for the Closely Held Firm*, 48 NW. U. L. REV. 427 (1953).

323. Hornstein, *supra* note 148, at † (describing the article as originally a talk given at the “Association of the Bar of the City of New York, under the auspices of the Committee on Post Admissions Legal Education”).

324. *See Panel Discussion: Problems of Closely Held Corporations*, 10 BUS. LAW. 9 (1954).

325. O’Neal, *supra* note 61.

326. O’NeDorsey D. Ellis, Jr., *In Memoriam: F. Hodge O’Neal*, 69 WASH U. L.Q. 369, 370 (1991).

327. *See O’NEAL, CLOSE CORPORATIONS* (1958), *supra* note 228, at §§ 10.01-.39, at 240-334.

328. Some experts apparently believed not enough did so. *See O’Neal, supra* note 284, at 471 (“Lawyers have too seldom taken advantage of the flexibility permitted by modern corporation statutes to mold the corporate device to the needs of closely held enterprises”).

329. *See* Edward R. Hayes, *Iowa Incorporation Practices—A Study: Introduction and Part I*, 39 IOWA L. REV. 409, 409-10 (1954).

330. *See* Edward R. Hayes, *Corporation Cake with Partnership Frosting (Part III of A Study of Iowa Incorporation Practices)*, 40 IOWA L. REV. 157, 158-59 (1954).

shareholders' agreement, the authors of the study concluded that "probably many more" than half of the corporations had such restrictions. This suggests that at least one close corporation planning tool was in wide use by the early 1950s, and also suggests that shareholder agreements were not uncommon in Iowa.³³¹

To say that close corporation law was well established by the 1950s is not to say it was perfected. Drafting special documents for a close corporation was difficult. Practicing lawyers called on to draft these special documents found it a more exacting task than drafting documents for the "default" public corporation.³³² To meet these demands "within the framework of most existing corporation laws [was] a task that often challeng[ed] the ingenuity of competent and well-trained lawyers to the utmost."³³³ In particular, the lack of statutory sanction for the close corporation led lawyers to "resort to more detailed and complex instruments and to more exhaustive examination of the applicable law than would otherwise be required."³³⁴ And even after careful research and drafting, attorneys were still left with a residual worry that their best efforts might be struck down by a court.³³⁵ Many believed that the solution to the problems of complexity and uncertainty was to overturn the statutory norms, and win explicit recognition of the close corporation in statute.

C. The Legislature Catches Up: Statutes

The logical conclusion to the development of close corporation law would seem to be recognition of the close corporation in statute.³³⁶ This would harmonize statute and case law, and dispel residual uncertainties that hung over many of the tools used by close corporations. The varying success of bids for statutory legitimacy, however, illustrates the degree to which the close corporation was already established in corporation law.

Although occasional calls for statutory recognition of the close corporation

331. The appearance of O'Neal's treatise may have eased this problem.

332. Miguel de Capriles, *Fifteen-Year Survey of Corporate Developments, 1944-1959*, 13 VAND. L. REV. 1, 5 (1959); see also O'Neal, *supra* note 284, at 458 n.1 (stating that drafting "taxes the ingenuity" of close corporation lawyers).

333. Willard P. Scott, *The Close Corporation in Contemporary Business*, 13 BUS. LAW. 741, 743 (1958).

334. *Id.*; see also Israels, *supra* note 52, at 496 ("Why then is not [a shareholder] agreement the simplest solution? Obviously it would be if it were clear that it is binding on the corporation and that an election at which votes were cast in breach of it would be set aside").

335. See Robert L. Oppenheim, *The Close Corporation in California—Necessity of Separate Treatment*, 12 HASTINGS L.J. 227, 227 (1961); Note, *Desirability of a Close Corporation Act*, 52 NW. U. L. REV. 397, 397 (1957); Note, *supra* note 312, at 721-21; Note, *supra* note 200, at 1498-99; E. R. Latty, *The Close Corporation and the New North Carolina Business Act*, 34 N.C. L. REV. 432, 438-39 (1956); Norman Winer, *Proposing a New York "Close Corporation" Law*, 28 CORNELL L.Q. 313 (1942); Rutledge, *supra* note 1, at 328-29; Weiner, *supra* note 1, at 278.

336. See, e.g., Winer, *supra* note 335, at 313; Rutledge, *supra* note 1, at 328-29; Weiner, *supra* note 1, at 278.

had appeared since the 1920s,³³⁷ such change did not come about until compelled by a court decision. In *Benintendi*, the New York Court of Appeals voided by-law provisions that required unanimity for shareholder or director action.³³⁸ Although the ruling itself was narrow, its dicta seemed to question almost all attempts to limit directorial power through charter or by-law provisions.³³⁹ In response, the legislature modified New York's corporation law in 1948 to allow a corporation's charter to require a supermajority for a quorum or for action by either directors or stockholders.³⁴⁰ The new provision was limited to close corporations by the additional requirement that all shareholders consent to the adoption of the provisions; it was the first statutory provision specially drafted for the close corporation.³⁴¹

Through the 1950s and 1960s, a number of other states would provide statutory recognition for the close corporation, beginning with North Carolina in 1955 when it adopted a new North Carolina Business Corporation Act.³⁴² Some of the North Carolina Act's provisions blessed close corporation mechanisms already in use; it permitted high vote and quorum requirements for director and shareholder action,³⁴³ allowed close incorporators to include provisions for liquidation in the charter or a separate written agreement,³⁴⁴ and further validated transfer restrictions.³⁴⁵

More significantly, the Act specifically rejected the statutory norms which limited use of partnership-like agreements in corporations. In what its drafter called the "basic philosophy provision," the Act stated that:

Except in cases where the shares of the corporation are at the time or subsequently become generally traded . . . no written agreement to which all of the shareholders have actually assented, whether embodied in the charter or bylaws or in any side agreement in writing and signed by all the parties thereto, and which relates to any phase of the affairs of the corporation . . . shall be invalid as between the parties thereto, on the ground that it is an attempt by the parties thereto to treat the corporation as if it were a partnership or to arrange their relationships in a manner that would be appropriate only between

337. *Benintendi*, 60 N.E. at 829.

338. The New York Attorney General interpreted *Benintendi* "to the effect that since requirements for unanimity in matters involving the stockholders' and directors' activities render it virtually impossible to conduct the normal operations of the corporation, they are, in the absence of specific statutory authority therefore violative of the public policy of this state." *Op. Atty Gen. (N.Y.) to Secretary of State (Dec. 14, 1948)* (quoted in *O'NEAL'S CLOSE CORPORATIONS (1958)*, *supra* note 228, at § 4.18, at 202).

339. N.Y. STOCK CORP. LAW § 9 (1948) (cited in Recent Statute, *supra* note 171, at 526).

340. *See id.*

341. *See* N.C. Sess. Laws 1955, C. 1371 (quoted in Latty, *supra* note 335, at 438).

342. Latty, *supra* note 335, at 446.

343. *Id.* at 449.

344. *Id.* at 451.

345. N.C. GEN. STAT. § 55-73(b) (1955) (quoted in Latty, *supra* note 335, at 438.).

partners.³⁴⁶

North Carolina's statute was an enabling statute for close corporations (which it broadly defined as corporations whose shares were not publicly traded). Rather than craft a separate statutory regime for close corporations, it merely inserted into its general incorporation law a series of benefits available to all corporations without publicly traded shares.³⁴⁷ This was the approach eventually taken in the Model Business Corporation Act, which was revised in 1969 to accommodate the needs of close corporations.³⁴⁸ The 1969 revisions gave close corporation shareholders remarkable freedom; under its provisions, shareholders of the close corporation could agree to dispense with a Board altogether, and govern themselves according to a shareholder agreement.³⁴⁹ Although not all states have adopted the Model Business Corporation Act, all now have some statutory provision allowing close corporation participants "to depart from the statutory norm and restrict the centralized control of directors."³⁵⁰

This enabling approach seems to fit most closely with the common law approach to close corporation law that preceded it, which attempted to slip by rigid statutory requirements and gave close corporation participants optional flexibility to order the internal workings of their corporations. This was not, however, the only approach tried. Beginning in the 1960s, several states took an "integrated" approach to close corporation law by creating separate bodies of law available only to close corporations and strictly defining "close corporations" for purposes of the new laws.³⁵¹

Delaware's approach was the best known and most copied.³⁵² It created a separate sub-chapter within the Delaware General Corporation Law available only to statutorily-defined close corporations and defined as a "close corporation" a corporation whose charter provides that its stock is held by not more than 30 people, its shares are subject to transfer restrictions, and it will

346. Dennis J. Karjala, *A Second Look at Special Close Corporation Legislation*, 58 TEX. L. REV. 1207, 1207-08 (1980).

347. Robert A. Kessler, *Hooray (?) for the Model Act—The 1969 Revision and the Close Corporation*, 38 FORDHAM L. REV. 743, 744-45 (1970) (discussing MODEL BUS. CORP. ACT (1969)).

348. This provision is now in the Model Business Corporation Act subsection 7.32(a) (2002). Its use is restricted to close corporations by the requirement that all shareholders approve the agreement, *id.* at subsection 7.32(b)(1), and that the agreement cease to be effective when shares are publicly traded, *id.* at subsection 7.32(d). In 1983, a further Statutory Close Corporation Supplement was added to the Model Act. Committee on Corporate Laws, *Statutory Close Corporation Supplement to the Model Business Corporation Act*, 38 BUS. LAW. 1031 (1983).

349. O'NEAL AND THOMPSON'S CLOSE CORPORATIONS AND LLCs, *supra* note 1, at § 1.16. Over thirty state statutes also give explicit authorization to various shareholder agreements, most following the language of Model Business Corporation Act section 7.32. *Id.*

350. F. Hodge O'Neal, *Close Corporations: Existing Legislation and Recommended Reforms*, 33 BUS. LAW. 873, 875 (1978).

351. F. Hodge O'Neal, *Close Corporation Legislation: A Survey and an Evaluation*, 1972 DUKE L.J. 867, 880.

352. DEL. CODE ANN. tit. 8, § 342 (2007). The sub-chapter is XIV.

make no public offering of stock as defined under the Securities Act of 1933.³⁵³ Close corporations that elected statutory close corporation status received certain legislative benefits; written agreements among a majority of shareholders to restrict the powers of directors were “not invalid,”³⁵⁴ and by unanimous consent shareholders could agree to manage the company without a Board of Directors.³⁵⁵ Yet the statutes’ utility had limits; lest adoption of an integrated statute throw doubt on the validity of agreements entered into by non-statutory close corporations, Delaware’s law made clear that the adoption of the new close corporation subchapter “shall not be deemed to repeal any statute or rule of law which is or would be applicable to any corporation which is organized under this chapter but is not a [defined] close corporation.”³⁵⁶

The integrated close corporation statutes seemed to be the solution towards which close corporation law had long tended. In the end, however, they failed. While fifteen states eventually adopted integrated statutes, remarkably few close corporations chose to take advantage of them.³⁵⁷ Empirical studies show that only a very small percentage of corporations ever registered as statutory close corporations. In Wisconsin, for instance, following passage of an integrated close corporation law only five percent of newly incorporated corporations elected statutory close corporation status; in Texas, only 4.65 percent of corporations chose to incorporate as statutory close corporations; and in Arizona, less than one percent of new corporations chose the new status.

While a number of reasons have been adduced for the failure of integrated close corporation statutes, including the statutes’ unnecessary complexity, fear that they would unduly restrict growing firms, and worries that separate treatment for close corporations might tend to isolate “giant companies politically (depriving them of their identification with politically potent small businesses),”³⁵⁸ a core reason must be that close corporations determined they did not need the statutes. Early in the century, when courts often looked with disfavor on anything that trespassed on the statutory norms, and when the validity of shareholder agreements and special charter and by-law provisions were uncertain, such statutory protection could have been attractive. However, when the close corporation was already well established, and when courts were loathe to strike down such private arrangements the statutory approval was no longer needed, but rather a potential stumbling block. Perhaps as well, the special statutory status, with its careful measure of who was a close corporation, carried a whiff of the rigid statutory norms that close corporations

353. *Id.* at § 350.

354. *Id.* at § 351.

355. *Id.* at § 356.

356. O’NEAL AND THOMPSON’S CLOSE CORPORATIONS AND LLCs, *supra* note 1, at §§ 1.20, 1.22.

357. Comment, *Assessing the Utility of Wisconsin’s Close Corporation Statute: An Empirical Study*, 1986 WISC. L. REV. 811, 825-26, n.90.

358. O’NEAL AND THOMPSON’S CLOSE CORPORATIONS AND LLCs, *supra* note 1, at § 1.14.

had fought so long to leave behind.

D. An Epilogue: The LLC Revolution

The corporation in all its forms remained the dominant business organizational form for both large and small firms throughout almost all of the twentieth century. Then, surprisingly swiftly, a new entity appeared to challenge the corporation: the limited liability company (the “LLC”).³⁵⁹ The evolution of the LLC differed in many ways from that of the close corporation; for one, the LLC was a creature of statute, whereas the close corporation first took shape in the business office and courtroom. Nonetheless, the LLC offered a structure whose flexibility proved attractive to many who would otherwise have opted for a close corporation.

The nation’s first LLC statute was adopted in Wyoming in 1977, but the form only became widely popular in 1988, when the Internal Revenue Service released a ruling that allowed the LLC to combine two usually incompatible features: limited liability and partnership taxation treatment (unlike in most corporations, members’ income was not taxed at the business entity level).³⁶⁰ Combining these features proved immensely attractive, and by 1995 every state had adopted an LLC statute.³⁶¹ Although its popularity was initially due to tax considerations, the LLC is also a business form combining the organizational flexibility of the partnership with a corporate form.³⁶² As one scholar explained it, LLC statutes “generally vest agency authority and governance rights in all members, as if they were partners in a general partnership. However, LLC members . . . can adopt a management structure resembling those of corporations or limited partnerships by appointing managers. The LLC’s managers . . . take on the roles held both by general partners of limited partnerships and by corporate officers and directors.”³⁶³ In most states, more LLCs are now organized annually than corporations, and it may be that the LLC eventually eclipses the close corporation as the preferred business form for small firms.³⁶⁴

359. Susan Pace Hamill, *The Origins Behind the Limited Liability Company*, 59 OHIO ST. L.J. 1459, 1463-78 (1998); see also Larry E. Ribstein, *The Emergence of the Limited Liability Company*, 51 BUS. LAW. 1, 3-4 (1995).

360. Hamill, *supra* note 359, at 1463-78.

361. *Id.*

362. O’NEAL AND THOMPSON’S *CLOSE CORPORATIONS AND LLCs*, *supra* note 1, at § 2.07 (the LLC “offers business participants a combination of limited liability as to outsiders, pass-through tax treatment as to the federal government, and a decentralized government structure among co-venturers”). Some corporations can approximate the LLC’s benefits, but only by taking several separate organizational steps, such as electing “S Corporation” tax treatment and entering into a shareholders’ agreement. *Id.*

363. Susan Pace Hamill, *The Limited Liability Company: A Catalyst Exposing the Corporate Integration Question*, 95 MICH. L. REV. 393, 395 (1996).

364. Howard M. Friedman, *The Silent LLC Revolution—The Social Cost of Academic Neglect*, 38 CREIGHTON L. REV. 35, 36 (2004) (“By 2003, the predominance of LLCs was unquestionable. In that year, more LLCs than corporations were formed in 29 states. In 11 other states where corporations

VI. CONCLUSION

Over the first half of the twentieth century close corporation law slowly came into its own. Despite the hurdle created by the rigid “statutory norms” of the era’s corporation law, techniques for ordering the close corporation, including shareholder agreements, special charter and by-law provisions, and transfer restrictions, first took shape in business and law offices and then won slow legal approval in case law and eventually statute. Close corporation law was the joint, and sometimes unintended, creation of close corporation members, lawyers, judges, and legislators. In place of a once standardized and rigid corporation law a flexible law emerged more suited for the diverse and variegated operations of modern American business.

In itself, this was an important episode in the growth of American corporate law. Yet we can also draw larger lessons from it. First, this episode is significant for the light it sheds on the making of corporation law generally. Close corporation law was made not only by the judges, legislatures, and interest groups that are typically cast as the actors in corporation law, but by close corporation incorporators and practicing lawyers, who through shareholders’ agreements and other management techniques produced a distinctive body of close corporation law. This episode should lead us to question whether the traditional narratives of the development of corporation law truly capture the complexity of its evolution, and the ways that actors left out of traditional accounts may still have influenced its growth. Second, as a chapter of legal history, this episode reminds us that, like the law, history too has its rigidities and blind spots. Despite the significance of small firms and close corporations, legal historians have overwhelmingly focused on the large public corporation, leaving us an incomplete picture of the growth and operation of business and corporation law. Finally, and more speculatively, this episode can expand our notion of what constitutes corporation law. Corporation law is generally depicted as constituted by statutes and cases interpreting them, perhaps supplemented by Federal regulations. For many close corporations of this period, however, the rules governing their operations, contained in the private agreements entered into by close corporation participants, were the “law” under which they functioned.

predominated, over 45% of new business filings were for LLCs”).