An Agricultural Law Research Article

Sole Proprietors' Quandry: Opening the Close Corporation

by

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Originally published in NEBRASKA LAW REVIEW
54 NEB. L. REV. 527 (1975)

Comment

Sole Proprietors' Quandry: Opening the Close Corporation

I. INTRODUCTION

Farm operators are generally accorded the luxury of being free to choose the form of business enterprise in which they wish to conduct their profession. The farm lends itself to a variety of business structures; principally, the sole proprietorship, partnership and close corporation.

The independent spirit of the farmer has generally dictated the use of the sole proprietorship.[1] Perhaps the popularity of the sole proprietorship can be attributed to a desire on the part of farm operators to avoid technical formalities and cumbersome statutory requirements which normally attend the incorporation process as well as other forms of business organization. Despite its ease of operation and practical facility, the proprietory farm has in many instances been replaced by the closely-held corporation. Owing to the increased complexity of the modern farming operation, planning factors which have previously been relatively unimportant have placed the incorporated farm in vogue.[2] Decisions to incorpo-

1. Nearly 90% of the eleven million businesses in the United States are individual proprietorships. HENN, AGENCY-PARTNERSHIP 160 (1972). The advantages of the individual proprietorship are several: there is little or no formal structure, the proprietor works for no one and is free to make his own decisions, reliance on the discretion of others is nil, the business need not formally qualify to trade in any given area, credit is extended to the business on the basis of both its own and its owners assets and there is no double taxation as there is likely to be in the incorporated business. Despite its flexibility, the individual proprietorship is also subject to unlimited personal liability and is unable to use numerous tax benefits available under the corporate form. *Id.* at 161-62.
2. While recent figures are not available, it would appear that as early as 1965, the number of farm corporations in America was 15,000 and growing. *See* Harl, *Public Policy Aspects of Farm Incorporation*, 20 BUS. LAW. 933 (1965). Professor Harl points out that measurement of farm corporation statistics is difficult since the Census of Agriculture does not identify farms by method of organization. *Id.* at 933. It would seem prudent to speculate that the number has substantially increased with the advent of qualified pension and profit sharing plans available to qualifying corporations. It is interesting to note that popu-

rate are often premised upon the assumed-advantages of favorable tax treatment, financial flexibility, continuity of the enterprise and limited liability. The need for increased capitalization in large farms and the necessity of allocating responsibility to more than one participant have also been prompting factors.

A caveat to incorporation of the farm is warranted, however, less the prospective incorporator assumes that such a procedure is a universal salve with which to soothe all of the modern farm's complexities. Wise counseling would seem to preclude a uniform recommendation of corporate form, but the enthymemantic nature of this platitude often falls on deaf ears.[3] It is submitted that incorporation should not necessarily be favored over other forms of organization unless it is intended to be used as an estate planning vehicle.[4]

Incorporating a proprietary farm, more often than not, contemplates the use of the closely-held corporate form,[5] a species of busi-

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larity of incorporating the family owned farm is accompanied by growing public disfavor of the large corporate farm. Kansas has adopted legislation which prohibits farm incorporation unless the shareholders number 10 or less.

Similar legislation was contemplated by the Nebraska legislature. NEB. REV. STAT. §§ 76-1501 to 1506 (Supp. 1975). L.B. 203 would have struck out vertically integrated farming corporations by limiting the acceptable number of shareholders to 10 or less who are related to one another no less than kindred of third degree.

Such limitations would have seriously impinged on the control aspects of the close corporation and made it difficult for the proprietor who contemplated incorporation to arrange the corporate hierarchy to fit his needs. However, these portions were deleted and the bill as passed provided that corporations holding agricultural lands must follow certain reporting procedures. *See* NEB. REV. STAT. §§ 76-1501 to 1506 (Supp. 1975).

3. Perhaps the decision to incorporate is often induced by overzealous counsel who are reluctant to explain fully the disadvantages of incorporation and difficulties of control in an effort to avoid "queering the deal." *See* Hetherington, *Special Characteristics, Problems, and Needs of the Close Corporation*, 1969 U. ILL. L.F. 1, 17.
4. For a complete discussion of the use of the corporation in estate plans, see Kelley, *The Farm Corporation as an Estate Planning Device*, 54 NEB. L. REV. 217 (1975).
5. Where the corporation has a single shareholder, many of the problems inherent in the typical close corporation dissipate; this article, however, does not consider the one man corporation and will be limited to discussing the propriety of incorporating the farm with a few closely-related shareholders.

There are myriad definitions which apply to close corporations (many of which define closeness in terms of numbers of shareholders and the fact that the stock is not publicly traded); this article adopts the definition of classifying a corporation as close whenever manage-ness organization which is far removed from the traditional concepts of a corporation. Close corporations are decidedly different from their publicly-held counterparts in terms of internal structure and practical operation,[6] yet traditional corporate statutes and numerous court decisions have tended to ignore these differences to the detriment of the close corporate shareholders.[7] Participants in the close corporation often find themselves bound by technical, expensive and time consuming formalities designed to satisfy ob-

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ment and ownership coalesce in a small related group of shareholders in addition to its non-publicly traded nature. *See* F. O'NEAL, CLOSE CORPORATIONS § 1.02 (1971) [hereinafter cited as O'NEAL].

6. Typically, the close corporation has the following attributes:
   (1) the shareholders are few in number, often only two or three;
   (2) they usually live in the same geographical area, know each other, and are well acquainted with each other's business skills;
   (3) all or most of the shareholders are active in the business, usually serving as directors or officers or as keymen in some managerial capacity; and
   (4) there is no established market for the corporate stock, the shares not being listed on a stock exchange or actively dealt in by brokers; little or no trading takes place in the shares.

7. Conventional statutes contemplate the traditional management structure of the public corporation and tend to ignore the fact that many of the formalities that lend themselves to bureaucratic structure are not practically feasible in the close corporation. The traditional view sees the corporation as a creature of the state and in exchange for the privilege of incorporation, it must pay tribute to statutory norms. Long Park, Inc. v. Trenton-New Brunswick Theatres Co., 297 N.Y. 174, 77 N.E.2d 633 (1948); Benintendi v. Kenton Hotel, Inc., 294 N.Y. 112, 60 N.E.2d 829 (1945); Kaplan v. Block, 183 Va. 327, 31 S.E.2d 893 (1944); Jackson v. Hooper, 76 N.J. Eq. 592, 75 A. 568 (Ct. Err. & App. 1910).

   Formal board meetings, minute documentation, formal shareholder meetings and other formalities of incorporation are not often palatable to the former sole proprietor who is used to buying a new piece of farm equipment without formal board action. Comfort can be found in recent court decisions, however. Courts have been more willing to recognize the uniqueness of close corporations than have legislatures.

   > In recent years, many courts have become aware of the distinctive characteristics of close corporations and have shown a somewhat greater readiness than formerly to treat such corporations differently than public-issue corporations. A California court, [Kauffman v. Meyberg, 59 Cal. App. 2d 730, 739, 140 P.2d 210, 215 (1943)] for instance, has frankly stated that it will not apply the technical rules commonly applied to corporations to "a close family corporation of two shareholders of equal ownership" if the application of those rules will "serve to defeat such equality of ownership, impede justice and perpetrate fraud," and that it will not permit mere "irregularities" in the transactions of a family corporation to affect the validity of those transactions.

   O'NEAL at § 1.15.

solete statutory requirements. At the same time, these participants are dedicated to the goal of informal operation. Careful consideration of the formal prerequisites and the degree of shareholder latitude allowed under state statutory schemes may reveal that "corporateness" does not offer the advantages contemplated by the family farm operator.

This Comment will address the uniqueness of close-corporate government and the means by which shareholders attempt to effect control under traditional statutory schemes and analyze the difficulties which confront close corporate shareholders under Nebraska's statutory scheme.

II. MINI-CORPORATENESS; MAXI-FORMALITY

Incorporating a business which has traditionally been commanded by a single individual or a select group of individuals involves a nearly total change in business philosophy. Where the business was operated on an informal and pragmatic basis, it is now subject to the complexities of corporate government. This metamorphosis in philosophy is manifested by increased complexity in management and general policy-making demanded by traditional corporate government.

In purely legal contemplation, all corporations share common legal attributes, e.g., a registered trade name under which the corporation operates, the capacity to sue and be sued in that name, continuity of life or perpetual existence, centralized management, limited liability and interests which may be freely alienated.[8] Collectively these attributes comprise the corporateness of the enterprise—the existence of the corporation as an entity distinct from its owners. Theoretically, corporateness is a privilege granted pursuant to strict compliance with statutory norms. The corporate privilege is conferred by statute and failure to comply with statutory formalities, either in the incorporation process or post-incorporation activity, typically exposes the corporation to revocation of the corporate charter or loss of the corporate shield for purposes of limited liability.[9] These statutory norms rarely distinguish be-

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8. *Id.* at 17-21.
9. Generally the risk that corporate status will be disregarded is encountered in two situations: defective incorporation and continuing use of the corporation as a proprietorship. Unless proponents of the corporation are able to use the doctrine of de facto corporation, the entity will be subject to attack through a quo warranto proceeding for maladies in the incorporation process. W. CARY, CASES AND MATERIALS ON CORPORATIONS 92 (4th ed. unabridged 1969) [hereinafter cited as CARY]. Non-compliance with statutory norms by an ongoing enterprise exposes the individual shareholders to arguments by creditors who at-

tween close and public issue corporations. The most common examples of such uniform treatment require that, (1) the management of the corporation be vested in a board of directors,[10] each of whom must exercise their director functions collectively and with independent discretion;[11] (2) decisions regarding policy and management are to be made according to set voting procedures designed according to the principle of majority rule;[12] and (3) under several state constitutions, the charter voting procedures must provide for minority representation.[13] These are general principles applicable to all corporations, regardless of size, type or the fact that they are closely held. Nevertheless, unique attributes which distinguish the close corporation from publicly traded corporations justify their independent recognition and separate treatment. Unlike shareholders in a public issue corporation, close corporation participants will seek to perform active roles in management and will be chiefly concerned with control of the enterprise, job security and the exclusion of outsiders;[14] in short, ownership and control will

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tempt to "pierce the corporate veil." *Id.* at 122-23. Close corporations are especially vulnerable to attack because of the informal management usually adopted by the shareholders. *See* O'NEAL §§ 3.62, 8.04; *cf.* CARY 123-24.

10. "The business and affairs of a corporation shall be managed by a board of directors." NEB. REV. STAT. § 21-2035 (Reissue 1974).
11. E.K. Buck Retail Stores v. Harkert, 157 Neb. 867, 62 N.W.2d 288 (1954); Long Park, Inc. v. Trenton-New Brunswick Theatres Co., 297 N.Y. 174, 77 N.E.2d 633 (1948).
12. *See* CARY at 362.
13. Typically, protection of minority interests is effected through constitutional or statutory provisions for cumulative voting which allows the shareholder to multiply his voting power by the number of directors to be elected. Not only does Nebraska have cumulative voting, NEB. REV. STAT. § 21-2033 (Reissue 1974), but the statute seems to prohibit non-voting common stock—a provision unique to Nebraska. *See* Mills, *The Mathematics of Cumulative Voting*, 1968 DUKE L.J. 28.
14. One recognized goal of the participants is to achieve partnership advantages within the close corporate form of organization. Hetherington, *supra* note 3.

> For instance, shareholders in a close corporation commonly are greatly concerned about the identity of their associates and have a strong desire to gain and hold the power to choose future shareholders or at least to veto prospective purchasers of shares whom they consider undesirable. They are reluctant to run the risk of having the harmony and balance of their business organization disturbed or the mutual respect and confidence of the shareholder-managers shattered by the unwelcome intrusion of strangers. As a matter of fact, businessmen forming a close corporation not uncommonly consider themselves partners as to each other. They adopt the corporate form of business to obtain . . . some . . . real or fancied advantage . . . but among themselves they are still "partners."

O'NEAL at § 1.07.

coalesce. Individual shareholder investments will be more crucial since equity ownership is not freely marketable, either because of a lack of a ready market,[15] restrictions on the transfer of stock,[16] or both. Shareholders will seek to protect their interests by retaining management control, placing strict requirements on the transfer of stock in order to limit new participants and modifying the traditional majority rule through high percentage quorum and voting procedures in the articles of incorporation, by-laws and private shareholder agreements[17] in order to augment their individual control of the corporation.

Traditional statutory schemes tend to ignore the uniqueness of close corporations and their prescriptions of formal corporate government are often burdensome to shareholders who would, more often than not, prefer to operate the business and provide for major business decisions through private and informal agreements. This informal corporate government offends traditional notions of the corporate structure. On the other hand, proponents of separate close corporate treatment see strict adherence to corporate norms as inconsistent with the fact that those who own the enterprise completely should be able to arrange management of it as they wish, so long as corporate creditors are protected.[18] Philosophically, these two views—the concession theory and the contract theory—mark the parameters of corporate juridical treatment.[19]

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15. As usually defined, the close corporation is one which has no publicly traded shares (in addition to other attributes). *See, e.g.*, the close corporation statutes of Delaware and Pennsylvania which prohibit close corporations from making a public distribution of stock. DEL. CODE ANN. tit. 8, § 342(a)(1)-(3) (1975); PA. STAT. ANN. tit. 15, § 1372 (1974). A ready market would be precluded in any case because the commonly present buy-sell arrangements or transfer restrictions imposed by the shareholders or the corporation's charter. *See* note 17, *infra*.
16. For a well-written summary of arrangements concerning the transfer of close corporate stock, see Bradley, *Stock Transfer Restrictions and Buy-Sell Agreements*, 1969 U. ILL. L.F. 139.
17. Professor O'Neal discussed inumerable provisions which can be used to tailor the corporate charter and by-laws to accommodate the incorporators' individual needs in his two volume treatise on close corporations, O'NEAL, *supra* note 5. *See generally*, O'NEAL §§ 3.01-3.80.
18. *See, e.g.*, Galler v. Galler, 32 Ill. 2d 16, 203 N.E.2d 577 (1964). In *Galler*, the court specifically enforced a shareholder's voting agreement which otherwise impinged upon the statutory requirement of majority rule and ran the risk of impairing director discretion. The court, however, recognized the distinction between close and public issue corporations and the propriety of allowing close corporate shareholders freedom to contract within the corporate form so long as it did not detrimentally affect creditors.
19. *Compare* Galler v. Galler, 32 Ill. 2d 16, 203 N.E.2d 577 (1964) *with* McQuade v. Storeham & McGraw, 263 N.Y. 323, 189 N.E. 234 (1934). The

Prospective incorporators should assess the statutory scheme and interpretations of the common law in their state to determine whether they as shareholders will be afforded the wide degree of latitude contemplated by their "chartered partnership."

Although several states[20] have promulgated laws specifically designed to recognize the uniqueness of close corporations and tend to permit direct control by the participants, this type of legislation is relatively new. Moreover, there are relatively few decisions which tighten shareholder control of close corporations.[21] It must be assumed that the traditional common law approach to corporate government will continue to be an influential factor in arranging control of the close corporation.

Nebraska's situation is somewhat complex since judicial authority appears to favor traditional norms of corporate government[22] while recent legislation under the Nebraska Business Corporation Act is decidedly more liberal. Further, the Act does not foster certainty in planning close corporate control since, despite its liberal nature, it still contains provisions which unquestionably

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concession or fiat theory of corporateness can be traced through a line of decisions beginning with Jackson v. Hooper, 76 N.J. Eq. 592, 75 A. 568 (Ct. Err. & App. 1910), a decision which espoused the view that a corporation is a corporation is a corporation.

> The law never contemplated that persons engaged in business as partners may incorporate, with intent to obtain advantages and immunities of corporate form, and then, Proteus-like, become at will a copartnership or a corporation, as the exigencies or purposes of their joint enterprise may from time to time require. They cannot be partners *inter sese* and a corporation as to the rest of the world.

Id. at 599, 75 A. at 571. Two decisions following the view of strict statutory adherence are Benintendi v. Kenton Hotel, Inc., 294 N.Y. 112, 60 N.E.2d 829 (1945) and Long Park, Inc. v. Trenton-New Brunswick Theaters, 297 N.Y. 174, 77 N.E.2d 633 (1948). *Benintendi* struck down, *inter alia,* a by-law provision requiring unanimous shareholder votes to elect directors and *Long Park* invalidated the transfer of control to an outside corporation (used as an attempt to "sterilize" the board of directors). Viewed as the bulwarks of the concession theory, these decisions may be fairly stated to stand for the proposition that those who seek the benefits of a statute must rigidly comply with its provisions. As the court in *Benintendi* noted:

> The State, granting to individuals the privilege of limiting their individual liabilities for business debts by forming themselves into an entity separate and distinct from the persons who own it, demands in turn that the entity take a prescribed form and conduct itself, procedurally, according to fixed rules.

294 N.Y. at 118, 60 N.E.2d at 831.

20. *See* note 35 *infra.*
21. Galler v. Galler, 32 Ill. 2d 16, 203 N.E.2d 577 (1964).
22. *See* note 25 and accompanying text *infra.*

demand adherence to traditional statutory norms.[23] Attention is directed to *E.K. Buck Retail Stores v. Harkert*.[24] Although *Buck* held a shareholder's agreement valid and, therefore, arguably supports the contract theory of close corporate management, the court in dicta relied heavily upon traditional principles of corporate government which severely undermine the shareholder latitude sought in a chartered partnership.[25]

On the other hand Nebraska practice is afforded some liberal statutory dispensations. Formal shareholder meetings need not be held for the purposes of taking shareholder action if written consent to the action to be taken is obtained from all of the shareholders entitled to vote.[26] Of course annual meetings are still required, but traditional notice of the meetings is not required if the time and place are designated in the charter.[27] Similarly, director action may be taken without a meeting if unanimous written consent is obtained from board members.[28]

Nebraska's statutory scheme does not formally recognize the close corporation management heirarchy, since it is still contemplated that management shall be vested in a board of directors[29] and formal minutes and records of shareholder and director proceedings must be maintained.[30] These provisions would indicate that close corporation participants are afforded some flexibility in managing the corporation and are able to carry out daily operations on an informal basis. Yet it is also reasonably certain, that these provisions envision the operation of a corporate government, informal though it may be, and do not officially sanction the concept of a chartered partnership.

III. IMPEDIMENTS TO CLOSE CORPORATION CONTROL

Among the several corporate attributes that work a hardship

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23. *See, e.g.*, NEB. REV. STAT. § 21-2027 (notice of shareholders' meeting); § 21-2042 (board of directors' meetings); §§ 21-2052 to 2057 (adoption and amendment of articles of incorporation) (Reissue 1974).
24. 157 Neb. 867, 62 N.W.2d 288 (1954). *Buck* upheld an agreement which bound the parties to a predetermined ballot of directors and insured representation on the board by the parties or their heirs. *Buck* is discussed in more detail at notes 62-73 and accompanying text, *infra*. While *Buck* is a pre-business corporation act case, its clear articulation of legal principles may be useful in interpreting those sections of the act which still require adherence to corporate norms.
25. *Id.* at 891, 62 N.W.2d at 303.
26. NEB. REV. STAT. § 21-2028 (Reissue 1974).
27. *Id.* § 21-2027 (Reissue 1974).
28. *Id.* § 21-2042 (Reissue 1974).
29. *Id.* § 21-2035 (Reissue 1974).
30. *Id.* § 21-2050 (Reissue 1974).

on shareholders in a close corporation[31] is the concept of centralized management. Why should participants whose cooperative efforts provide the basis for operating the close corporation be forced to abide by management decisions made by a board of directors with independent authority and discretion? At best the board requirement is a formality, yet it is a formality that may create severe consequences if it is not adhered to. Those who wish to provide partnership-like control and informality will require a specially tailored charter[32] or shareholders' contract[33] which vests manage-

31. The traditional attribute of continuity of life, common to all corporations, can also work a hardship on these shareholders. Unlike other forms of business, most particularly the general partnership, a corporation has perpetual existence and, as a separate entity, is not affected by life span, capacity, bankruptcy or withdrawal of the individual participants, unless a defined percentage of the stockholders vote to dissolve the corporation. This perpetual life has the advantage of ensuring the continued existence of the enterprise despite the fact that a dissenting shareholder would prefer to dissolve the corporation and recoup his investment. This often oppresses a minority shareholder who has become locked into his investment. *See* Hetherington, *supra* note 3.

    In the corporate farm, perpetual life may be advantageous where the principal owner desires to have the farming operation continue after his death. For example, where father and son have worked together as a team, the father's death will not likely halt the operation even though other heirs are reluctant to maintain the corporation. On the other hand, death or withdrawal of a shareholder may create financial problems for the corporation which is obligated to purchase a decedent's stock through some type of buy-sell arrangement, or management problems where the shareholder was a key employee or a swaying influence who had previously avoided problems of deadlock. Attempting to circumvent the problems propagated by continuity of life principles may, in turn, create further problems for the close corporation. Illustrative of this self-perpetuating problem is the device used for purchase of stock by the corporation; namely, insurance. Some buy-sell arrangements are funded by insurance purchased by the corporation on the life of the shareholder. This may create estate tax problems on the death of the shareholder, *see, e.g.*, C. LOWNDES, R. KRAMER & J. MCCORD, FEDERAL ESTATE AND GIFT TAXES, ch. 13 (3d ed. 1974), and statutory problems in terms of adherence to statutory norms since the purchase of life insurance for an individual (if that type of funding arrangement is used) is arguably a loan, and loans of corporate funds to directors are specifically prohibited by NEB. REV. STAT. § 21-2045 (Reissue 1974).

32. For an excellent summary of charter tailoring techniques, see O'NEAL §§ 3.11-3.39. Contrary to the traditional corporate model, close corporation participants will seek to modify the charter to provide them with real and effective control over management. Assuming this goal initially requires a voice in board make-up, ideally the charter could provide that each shareholder could appoint a specified number of directors. The immediate issue presented by such a clause is whether the statutory prescription of cumulative voting would be violated. *See*

ment in the shareholders as a practical matter, yet pays tribute to the concept of director management. In the absence of legislation, charters and agreements are often limited in the latitude of control which they afford shareholders.

Assuming that the participants are faced with the formal requirement of a board of directors, their primary interest will be focused upon attaining representation on the board and manipulating that representation to reflect their personal wishes. These desires are, of course, qualified by the maxim that a board of directors must be free to exercise discretion in managing the affairs of a corporation, unhampered by shareholder influence.[34]

A. The Board Requirement

In light of the fact that close corporation participants generally desire a voice in the affairs of the enterprise, the principle which dictates that directors must independently manage the ordinary affairs of the corporation is rarely suitable. Management and ownership coalesce where the shareholders retain control.

In jurisdictions like Nebraska where many traditional corporate norms prevail, the issue necessarily becomes one of the legality of such unified management. Prospective Nebraska incorporators are faced with three principal inquiries. First, is a board of directors in fact required? Second, if the foregoing question is answered in the affirmative, how may participants best assure themselves a voice on the board? Finally, may the board be constructively dispensed with and actual management decisions be made by the participants?

NEB. REV. STAT. § 21-2033 (Reissue 1974) and note 47, *infra*. Arguably, § 21-2033 is not violated where each shareholder may appoint a director, so long as cumulative voting would not allow him to elect a number in excess of the allowance granted by a charter provision. *See* note 37 and accompanying text *infra*.

Tailoring the charter will most often involve the use of provisions which specify unanimous shareholder approval of corporate acts and procedures for transfer of stock and dissolution of the enterprise, leaving board composition to be determined by voting agreements. O'NEAL § 3.14. Moreover, a charter provision limiting the number of shares one can hold is useful in preventing a corporate take-over. This could also be done indirectly by a provision prohibiting the issuance of additional stock and the use of a tightly drawn buy-sell agreement.

33. Shareholder agreements are useful since they provide flexibility and informality in contrast to formal charter provisions. Participants will likely view such agreements as the principal method of providing for a pre-determined board make-up, tenure of corporate employees and restrictions on the transfer of their holdings. *See* O'NEAL § 5.02.
34. *See* McQuade v. Stoneham, 263 N.Y. 323, 189 N.E. 234 (1934).

Modern close corporation statutes provide for formal eradication of the board,[35] recognizing the realities of a close corporation's structure. In Nebraska, however, management is vested in a board by statute[36] and shareholders who wish to retain practical control must consider this impediment. Facets of management which are normally left to the discretion of the board are purchase and sale of assets, appointment of officers together with respective employment compensation arrangements and policies regarding distribution of dividends and profits. Board action may, therefore, be crucial to shareholders who wish to manage the corporation as a partnership, and securing representation on the board will be a paramount goal.

It should be noted that choosing methods by which the board will be elected and controlled will depend upon the number of participants contemplated and the extent of equity contribution by each. The former sole proprietor may have an easier task if he intends to be the sole shareholder and, *a fortiori*, the sole director. Nebraska allows the one man corporation to be managed and operated by a sole director.[37] This is, of course, advantageous to the former sole proprietor who will not be anxious to leave management decisions to the unqualified discretion of a board of directors even where the board is composed of family members[38] since family ties often loosen in the face of financial self-interest.[39] The former sole proprietor also has a personal stake in the outcome of the busi-

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35. Under Maryland law, the board can be officially abandoned. MD. ANN. CODE § 4-401 (1975) further provides:

> (a) *Governing the corporation.*—Under a unanimous stockholders' agreement, the stockholders of a close corporation may regulate any aspect of the affairs of the corporation or the relations of the stockholders, including:
> (1) The management of the business and affairs of the corporation;

See also DEL. CODE ANN. tit. 8, § 351 (1975); FLA. STATS. ANN. § 608.72 (1974-75); N.J. REV. STATS. § 14A:5-21(2) (1969); PA. STATS. ANN. tit. 15, § 1382 (1974-75) MAINE BUS. CORP. ACT (1974); ME. REV. STATS. ANN. tit. 13-A, § 701(2) (1973); MICH. STATS. ANN. § 21.200(501) (1974); TEX. BUS. CORP. ACT art. 2.30-1(B) (1974-75 Supp.); O'NEAL § 3.60.

36. NEB. REV. STAT. § 21-2035 (Reissue 1974).
37. *Id.* § 21-2036 (Reissue 1974).
38. Prior to its revision, NEB. REV. STAT. § 21-2036 (Reissue 1974), required the traditional three director board.
39. Family ties can be made of paper when financial interests are at stake. Witness the case of Glazer v. Glazer, 374 F.2d 390 (5th Cir. 1967), *cert. denied*, 389 U.S. 831 (1967), where a sibling feud over a shareholders' agreement resulted in a conspiracy action prosecuted by a brother against two brothers who were privy to the agreement and which requested the award of treble damages.

ness which represents his livelihood as opposed to a part-time investment, and this personal stake is better protected where he represents the sole management influence in the enterprise.

Where possible, the one man board would be advantageous to a principal stockholder in close enterprises of few or several participants but it is arguable that a one man board is not permissible in Nebraska except in those situations where the sole director is the sole shareholder. In Nebraska, cumulative voting is required by constitutional mandate.[40] If multiple shareholders were permitted to use a one man board by agreement, cumulative voting would have no impact, and the minority interests would be denied a director. This analysis results from judicial interpretation to the effect that while shareholders may agree among themselves to waive cumulative voting guarantees, the corporate charter may not provide for such a waiver.[41] Because the number of directors are required to be set forth in the by-laws,[42] it is possible that a provision establishing a one man board would be viewed as a corporate act eliminating the right to minority representation.

As a practical matter, however, there is a further limitation on the use of a single director—the desire of minority shareholders to participate in business decisions. Even if it were possible to circumvent the constitutional guarantee of cumulative voting, it might be difficult to obtain the minority approval, to forego their opportunity to have a voice in fixing dividend policies and salaries since these items may constitute their sole source of income.[43]

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40. NEB. CONST. art. XII, § 1 (Cum. Supp. 1974). Cumulative voting allows a shareholder to concentrate his voting power by magnifying it and directing it to the representative of his choice. It is best explained through statutory language; Nebraska's implementing statute provides in part:

> In all elections for directors every stockholder entitled to vote at such elections shall have the right to vote in person or by proxy for the number of shares owned by him, for as many persons as there are directors *to be elected* or to cumulate said shares and give one candidate as many votes as the number of directors multiplied by the number his shares shall equal, or to distribute them upon the same principle among as many candidates as he shall think fit, *and such directors shall not be elected in any other manner.*

NEB. REV. STAT. § 21-2033 (Reissue 1974) (emphasis added).

41. E.K. Buck Retail Stores v. Harkert, 157 Neb. 867, 62 N.W.2d 288 (1954). The rationale is that the corporate charter must at least permit cumulative voting and if the shareholders privately agree to waive their right to it, that is a different matter. *See* Sensabaugh v. Polson Plywood Co., 135 Mont. 562, 342 P.2d 1064 (1959).
42. NEB. REV. STAT. § 21-2036 (Reissue 1974).
43. Unlike the public issue shareholder who can "buy short" and "sell long," "it is only in the close corporation that a participant or investor in a business venture can simultaneously be excluded from participa-

Where the former proprietor or former partners must rely upon outside capital or services, it is safe to assume that a board will be demanded which is large enough to ensure a modicum of representation. Thus the problem becomes one of board make-up—how may participants best assure themselves a voice on the board?

Perhaps the least troublesome method is through a private agreement. A shareholders' agreement which predetermines how a participant shall cast his vote is permissible in Nebraska[44] and may be preferable to the alternatives described below.

Another method of allocating control of voting power to elect the board is the use of more than one class of stock. Under this scheme, two or more classes of shares are issued to the shareholders with each class having the voting power to elect a specified number or percentage of directors. Control of the board is assured by holding the majority of each class even though equity interests in the enterprise are more evenly apportioned.[45] The obvious drawback to using more than one class of stock is the loss of ability to use the subchapter S election under the Internal Revenue Code and the consequential condemnation of the enterprise to double taxation.[46]

A third technique classifies the board itself.[47] This is really

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tion in earnings and prevented from withdrawing his investment and at least a portion of his share of accumulated profits from the business." Heatherington, *supra* note 4 at 21.

Such shareholder's plight is threefold. First, he is locked into his investment because of its highly personal nature. *See* Kramer & Zieger, *The Choice of Form for the Family Owned Business*, 16 HASTINGS L.J. 509 (1965). Second, there will nearly always be some provision for restriction on his transfer of stock. *See* Bradley, *Stock Transfer Restrictions and Buy-Sell Agreements*, 1969 U. ILL. L.F. 139. Third, there will be no ready market for the stock since the stock will not be registered on any public exchange. *Id.*

44. E.K. Buck Retail Stores v. Harkert, 157 Neb. 867, 62 N.W.2d 288 (1954). Although NEB. REV. STAT. § 21-2034 (Reissue 1974) provides that such an agreement is enforceable, it is uncertain if a Nebraska court would award specific performance for such an agreement if it were breached. *See* Ringling-Bros.-Barnum & Bailey Combined Shows, Inc. v. Ringling, 29 Del. Ch. 610, 53 A.2d 441 (1947); Abercrombie v. Davies, 36 Del. Ch. 371, 130 A.2d 338 (1957).

45. *See* O'Neal, *Close Corporation Control Devices*, 61 ILL. B.J. 118, 119 (1972).

46. If the corporation has more than one class of stock, it is not a "small business corporation" under section 1371, and, therefore, may not make an election under section 1372.

47. Classified boards are one method by which the effect of minority representation can be diluted. For example, if a nine director board were split into three classes, each of which was to be elected at alternate yearly intervals, minority shareholders would not be able to procure

an exception to the normal requirement that the whole board be elected annually. By dividing the board into two or three classes and electing only one class annually, a majority shareholder may magnify his control through the election of a majority of each class. While classified boards are permitted in Nebraska,[48] it remains to be seen whether that provision is constitutional in light of the cumulative voting requirement.[49] Classified boards were found unacceptable in *Wolfson v. Avery*,[50] where the Illinois Supreme Court held that cumulative voting requires all of the directors to be elected annually. This decision raises serious doubts about the validity of Nebraska's statute allowing classified boards.[51]

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representation. *See* Wolfson v. Avery, 6 Ill. 2d 78, 126 N.E.2d 701 (1955) which held that a statute permitting such classification was unconstitutional in view of that portion of the Illinois Constitution mandating cumulative voting. *But see* Janney v. Philadelphia Transp. Co., 387 Pa. 282, 128 A.2d 76 (1956). But classified boards are not merely useful as a means of maintaining majority control since they also provide management continuity and stability.

48. NEB. REV. STAT. § 21-2037 (Reissue 1974).

> In lieu of electing the whole number of directors annually, the articles of incorporation may provide that the directors be divided into either two or three classes, each class to consist of not less than three directors . . . .

49. *See* note 40, *supra*.
50. 6 Ill. 2d 78, 126 N.E.2d 701 (1955).
51. The defendants in *Wolfson* claimed that the constitutional provision for cumulative voting was not violated by a classified board since the phrase, "to be elected" (*compare* note 36, *supra*), contemplated proper elections where less than all of the board was to be elected. Therefore, argued the defendants, so long as a shareholder was allowed to cumulate his votes at an election, irrespective of the fact that it was an election of one class only, the constitutional guarantee was provided for. *Wolfson* held, in effect, that cumulative voting requires all directors to be elected annually.

> A careful examination of the entire section fails to disclose any indication that the words "to be elected", appearing in the first clause, were intended to imply that less than the entire board could be elected at one time. On the contrary, the second clause of the section, which deals expressly with cumulative voting, indicates rather that all directors must be elected at each regular election.
>
> . . . .
>
> Section 35 of the Business Corporation Act, in authorizing the classification of directors is inconsistent with the constitutional right of a stockholder to cumulate his shares through multiplying them by the "number of directors," . . . .

Id. at 85-86, 95, 126 N.E.2d at 706, 711. Nebraska's statute allowing classification of the board is nearly identical with the provision struck down in *Wolfson*. *See* NEB. REV. STAT. §§ 21-2033 and 21-2037 (Reissue 1974). Reliance upon these sections is questionable.

In addition to classification of stock and directors, it must be remembered that power to remove a recalcitrant director is also important to the close corporation shareholder. Under the common law, Another means by which participants may predetermine who shall serve as directors is the voting trust, also permissible in Nebraska.[52] The voting trust allows shareholders to do indirectly what a voting agreement accomplishes directly, *i.e.*, set forth nominees for director slots who shall receive predetermined votes. Shareholders enter into a trust agreement whereby they transfer title to their shares to a voting trustee in exchange for ownership certificates. The trustee, of course, will vote in accordance with the trust agreement.[53]

B. Controlling the Board

To be distinguished from the problem of predetermining board composition is the question of whether director decisions may be controlled. Control over who shall comprise the board is clearly not the same as control over the board's judgment. It is reasonably certain that close corporation participants will seek to control the every day operation of the business either as directors themselves or through effective control over the directors. Within acceptable statutory parameters, they will attempt to fix by charter provision or shareholder agreement policies regarding their powers to remove

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a director could be removed only for cause. Auer v. Dressel, 306 N.Y. 427, 118 N.E.2d 590 (1954). While modern statutory schemes allow director removal with or without cause, *see, e.g.*, ABA-ALI MODEL BUS. CORP. ACT § 39 (1971) (allowing removal with or without cause by a majority of the shareholders), this power is substantially diluted in the usual instance by added provisions which protect the cumulative voting right. Nebraska's statute offers a good example:

> Any director . . . may be removed, with or without cause, by a vote of the holders of a majority of the shares then entitled to vote at an election of directors. If less than the entire board is to be removed, no one of the directors may be removed if the votes cast against his removal would be sufficient to elect him if then cumulatively voted at an election of the entire board of directors.

NEB. REV. STAT. § 21-2039 (Reissue 1974). This power is also limited where shareholders make use of classified boards or separate classes of stock since shareholders of one class of stock only possess power to remove directors elected in that class. O'NEAL § 3.59.

52. NEB. REV. STAT. § 21-2034 (Reissue 1974).

53. Holding companies may also be formed for the purposes of arranging defined voting procedure. In Baum v. Baum Holding Co., 158 Neb. 197, 62 N.W.2d 864 (1954), the court sustained the validity of an arrangement whereby four corporate shareholders established a separate corporation to hold their stock. Thus a majority shareholder in the holding company exercised effective control over the whole transferor corporation even though he had not been a majority shareholder of the transferor. While holding companies are obviously permitted in Nebraska, they are simply another step in the already too complex scheme of controlling the close corporation and do not appear to be worth the time or expense.

directors, inspect books and records, exercise pre-emptive rights, resolve disputes and deadlocks, compensate directors and officers, declare dividends and distribute profits.[54]

The extent to which participants may practically vest management in themselves, despite the existence of a board, is not clear in Nebraska. Although statutory provisions authorize the appointment of an executive committee to manage the corporation, such a committee is still subject to director supervision.[55] A strict cur-

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54. Leaving such powers to the board of directors would remove corporate control from the hands of the principal shareholder and, more importantly, would subject minority shareholders to the dictates of the majority. More importantly, participation in the close corporation is very likely the only income available to the shareholder, thus, he will prefer to bargain for such items as compensation and distribution of profits rather than leaving such matters to a majority vote or, in the alternative, demand that more than a majority vote is required to change policies that are set forth in the original charter. *See*, Hetherington, *supra* note 3; O'NEAL § 4.13.

55. NEB. REV. STAT. § 21-2041 (Reissue 1974) permits the creation of an executive committee composed of directors who may exercise the authority of the directors in some circumstances. Most notably, such an executive committee *may not* exercise director function with respect to sale, leases, exchanges, mortgages or pledges of all or substantially all of the corporate property and may not take action regarding amendments to the charter or dissolution.

    On the surface, § 20-2041 would seem to allow some latitude for focusing powers of management, otherwise vested in the board, upon specific named shareholders—a palatable prospect for the former farm operator since the section requires only that a majority of the board elect such a "management committee." It would therefore be possible totally to control corporate management by virtue of a simple majority of the voting power of the corporation. Such a broad interpretation of the provision may be unwarranted, however.

    Courts have traditionally allowed such "management arrangements" if such an executive committee is under the supervision of the board, *see, e.g.*, Marvin v. Solventol Chem. Prods., Inc. 298 Mich. 296, 298 N.W. 782 (1941), realizing that true management power still remains with the board. Section 21-2041 seems to fit this mold since it provides: "The designation of any such committee and the delegation thereto of authority shall not operate to relieve the board of directors, or any member thereof, of any responsibility imposed by law." Arguably, this provision is intended to retain power in the board notwithstanding the creation of an "executive committee." Directors would still be under a fiduciary duty to protect the best interests of the corporation and would not be permitted to use such a device to their own or a selected shareholder's benefit.

    Nor would the use of the section to create a *de facto* abolition of the board appear proper not merely because of the express proviso in the statute but also because such use would be vulnerable to attack on several grounds. Such abolition would surely violate the statutory requirement of § 21-2035 that management be vested in a board of directors. It is also arguable that creation of such a committee would tailment of directors' functions would be questionable in light of the Nebraska Supreme Court's dictum recognizing the common law prohibition against creation of a dummy or sterilized board.[56] The independent discretion of the board may not be impinged.

Avoiding a course of action which binds the directors to predetermined conduct is of paramount importance, but additional considerations respecting control weigh heavily against the choice of the corporate form. Few close corporation shareholders are enamored with the thought of complex business procedures. But effective control of the close corporation in a state which has traditional statutes requires sophisticated charter drafting[57] and attention to business detail in the actual operation of the business.[58] Although Nebraska's statutory scheme is fairly liberal, the fact remains that a corporation should not be allowed to operate as a partnership.

Of course, shareholders would prefer to control the business without the use of charter and by-law provisions. Shareholders'

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create a sterilized board of directors or impinge upon the individual shareholder's right to cumulatively cast their votes.

Finally, as a practical matter, total control could not be achieved in this type of arrangement in any case since directors hold office for limited terms. Since the committee is chosen by the board, it would also be subject to yearly fluctuations. O'Neal, *Buy-Sell and Dispute Arrangements*, 61 ILL. B.J. 186 (1972).

The shareholder/directors must tread carefully in allocating control among themselves so as not to violate the maxim that a "sterilized board of directors cannot be created." O'NEAL § 3.60; McQuade v. Stoneham, 263 N.Y. 323, 189 N.E. 234 (1934).

56. In holding a shareholders agreement valid because, *inter alia*, it did not infringe upon board discretion, the court in E. K. Buck Retail Stores v. Harkert, 157 Neb. 867, 62 N.W.2d 288 (1954), implied that the provision vesting management in a board of directors is a statutory command that cannot be circumvented:

> There are certain fundamentals pertaining to corporate control . . . upon which there can be little or no dispute. . . . An agreement purporting to control the actions of directors after they are elected, in handling the ordinary business of the corporation, is ordinarily void. . . . The law imposes the business management of the corporation on its directors, who represent all of the stockholders and creditors, and they cannot enter into agreements among themselves or with stockholders by which they purport to abdicate their independent judgment.

Id. at 882-83, 62 N.W.2d at 299. Even the statutory provision for appointment of an executive committee would not seem to impair this principle. *See* note 55, *supra*.

57. For a summary of some of the more sophisticated means of controlling the close corporation, see O'Neal, *supra* note 45.

58. Even the practicing bar would concede that close corporations are not in the habit of following technicalities such as formal notice being sent to the board prior to the time of a meeting. *Nebraska State Bar Proceedings*, 43 NEB. L. REV. 177, 310 (1963).

agreements provide the traditional method for achieving this informality. It is regrettable that without special close corporation legislation, shareholders can never be quite sure to what extent they may control the enterprise through private agreement.[59] To the extent they are possible, shareholder agreements are desirable because they provide flexibility and informality. Yet the necessity of adhering to statutory formality often precludes the use of such devices. As a general rule, such agreements are inconsistent with traditional statutory norms if they operate to invade the province of the directors. Courts have also rejected shareholder agreements where they adversely affect shareholders who are not privy to the contract.[60]

The modern judicial trend, on the other hand, is to uphold shareholder agreements if they are designed to effectuate a particular corporate policy or assure adherence to a particular course of business.[61] Nevertheless, it would seem imprudent to assume that shareholders need only resort to private contracts to effect control of the board since the parties may not know whether the agreement is valid or enforceable until it is tested by litigation, and would prefer some certainty at the planning stages of the enterprise.

59. Close corporation statutes often delineate all of the acceptable facets of control which may be handled by shareholder agreement. For example, under Maryland law, agreements may deal specifically with management of business affairs, restriction on the transfer of stock, rights of the shareholders regarding dissolution of the corporation, voting power, employment contracts, dividends and distribution of profits and the make-up of the board of directors. MD. ANN. CODE art. 23, § 105(a)(1) (Repl. vol. 1973). Shareholders' agreements are obviously permissible in Nebraska under the common law by virtue of E. K. Buck Retail Stores v. Harkert, 157 Neb. 867, 62 N.W.2d 288 (1954), but there is also little doubt that the discretion of the board of directors cannot be impinged. *Id.* As a result, the prospective incorporator is unsure whether an agreement regarding the distribution of profits or some other aspect of management normally left to the discretion of the board of directors' will be acceptable.

60. Note that even in states which have promulgated close corporation statutes specifically allowing shareholders' agreements, there is a requirement that all shareholders be signatories to such agreements.

    * * *

    Such stockholders' agreement shall be embodied in the charter, the by-laws or a written instrument signed by all of the stockholders of the corporation.

    MD. ANN. CODE art. 23, § 105(a) (Repl. vol. 1973). Query whether a shareholders' agreement would pass muster in Nebraska without the assent of all stockholders. Since there is no statutory provision, one is forced to guess in light of the available decisions. Arguably, it is possible in view of *Buck*, which upheld a shareholders' agreement signed by only two of several stockholders.

61. O'Neal, *supra* note 45 at 122.

Close corporation participants will, therefore seek some certainty in determining how far they may go in constructively dispensing with a board through shareholder agreements. At least two decisions partially answer this question. *Buck Retail Stores v. Harkert*,[62] involved a shareholders' agreement which predetermined the appointment of directors.[63] Although the case is somewhat dated and has surely been qualified by the Nebraska Business Corporation Act, it provides a perspective on how the court views the function of a board.

Buck and Harkert agreed that each would have the power to designate two of the corporation's four directors. The agreement compelled the parties to vote at each annual election in accordance with this agreement. Additionally, it provided for a long term executive appointment of Harkert, an appointment normally left to the discretion of the board. Harkert claimed that the agreement was invalid since it impinged upon director discretion and violated the constitutional guarantee of cumulative voting.[64] The court up-

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62. 157 Neb. 867, 62 N.W.2d 288 (1954).

63. The contract actually provided:

> That the number of the members of the Board of Directors of Harkert Houses be reduced from five, as it now is, to the number of four, and that said four members of the new Board shall consist of said Walter E. Harkert, Mercedes C. Harkert, his wife, Earl K. Buck and Rodney B. Devor, and that the number of members of said Board of Directors shall be maintained at four in number, of which at all times two thereof shall be such persons as shall be nominated or designated by the said Walter E. Harkert or his heirs, representatives or legatees, and the other two thereof shall be persons as shall be nominated or designated by the said party of the second part. And it is further mutually agreed between the parties that at all stockholders' meetings of the said Harkert Houses held for the purpose of election of directors or director (in case of vacancy on the Board of Directors), that all of the said shares of stock of parties of the first part and also of party of the second part and also any additional shares of stock of the Harkert Houses which may be subsequently acquired by the said parties or either of them shall be voted in such manner and for such person or persons as will keep and maintain the Board of Directors four in number, of which two thereof shall be such persons as shall be nominated or designated by the said party of the second part.

Id. at 870, 62 N.W.2d at 293.

64. The argument claiming constitutional infringement centered on language providing that directors shall not be elected in any other manner. NEB. REV. STAT. § 21-2033 (Reissue 1974). According to the argument, this language logically prohibits the election of directors by prearranged agreement. The court disagreed, finding that the language only operates to

> prevent a corporation by its articles of incorporation, by-laws, or any act of its directors or stockholders from depriving a

held the validity of the arrangement, reasoning that such control agreements are not ipso facto void and are enforceable where the shareholder contracts with respect to his own stock voting rights and does not injure the corporation or work a fraud upon creditors.[65]

The more recent Illinois decision in *Galler v. Galler*[66] also involved the question of the permissible scope of a shareholders agreement. Two brothers owned nearly all of the shares of a wholesale drug company. The brothers agreed to amend the bylaws of the enterprise to provide for four directors and that as shareholders they were bound to cast their votes for themselves and their wives. The agreement further provided that in the event of either brother's death, his wife would have the right to nominate a replacement who had the right to receive shareholder votes under the agreement just as the predecessor had. Unlike the *Buck* contract, however, the contract also contained provisions for the declaration of a minimum dividend and a salary continuation stipulation which served as a "widow's pension." The court upheld the validity of the contract recognizing that a close corporation was to be distinguished from its public issue counterpart and that agreements entered into by participants in a close corporation were not invalid even where they controlled the power and discretion of the board provided that the creditors of the enterprise were not adversely affected.[67]

Although *Buck* is often cited for the proposition that shareholder agreements are valid under the modern trend of judicial authority,[68] the case may not stand for so broad a proposition. *Buck* recognizes that shareholder agreements are neither ipso facto void nor valid. The decision may be said to stand for two general propositions. First, a court is likely to uphold shareholder agreements where no single shareholder is placed in absolute control or uniquely benefited.[69] Second, shareholder agreements are acceptable, assuming the first criterion has been met, only so long as they

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stockholder of the right to vote his stock in the manner specified in the Constitution and statute.

157 Neb. at 873, 62 N.W.2d at 294.

65. *Id.* at 889, 62 N.W.2d at 302.
66. 32 Ill. 2d 16, 203 N.E.2d 577 (1964).
67. *Id.* at 27-30, 203 N.E.2d at 583-85.
68. *See, e.g.*, O'NEAL § 5.08.
69. It is possible to argue that a shareholders' agreement should accrue to the benefit of the corporation as a whole. The court in *Buck* seemed to favor the view that shareholder agreements bargain away certain voting powers in exchange for fresh capital (from the party seeking to obtain the agreement) which accrues to the benefit of all shareholders. *Id.* at 890-91, 62 N.W.2d at 302-03.

do not remove significant powers from the board of directors.[70] The agreement in *Buck* satisfied these requirements since no shareholder retained control of the board and the directors exercised full discretion after their initial appointment.[71]

Despite the importance of *Buck* as a decision recognizing the validity of shareholder agreements generally, it is perhaps an over statement to say that *Buck* recognizes the validity of discretion-limiting agreements. On the other hand, *Galler* seems to indicate that limiting board discretion is a permissible objective—at least where all of the participants are parties to the agreement and the agreement enforces a "permissible" corporate objective.[72] The importance of *Galler* cannot be over emphasized since it upheld the validity of the agreement in light of a business corporation act which is substantially similar to Nebraska's.[73]

In light of *Buck* and *Galler* it is arguable that shareholders' agreements are indeed valid in Nebraska—even to the extent of nominally limiting director discretion if those agreements accomplish a valid corporate purpose and do not adversely affect minority interests.

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70. There is no clear answer as to what constitutes a "sterilization of the board." It is clear that some director discretion can be taken away by shareholder agreement. *Buck* cites with approval the decision of Clark v. Dodge, 269 N.Y. 410, 199 N.E. 641 (1936) which arguably recognizes that some restrictions can be made on directorial functions so long as they are "negligible."
71. The decision must be placed in perspective as it relates to shareholders' agreements generally. It is possible to read the decision as relating only to shareholder agreements which are the functional equivalents of "vote pooling arrangements" or voting trusts. These types of agreements have traditionally been valid in Nebraska. The foregoing proposition is better seen in light of the court's reluctance to pass upon the validity of that portion of the Buck/Harkert agreement which provided for indefinite employment of Harkert as an officer at a fixed salary. The court declined to answer that issue and did not need to since it found that Harkert was estopped from contesting the validity of a provision he had reaped the benefits from for so long. 157 Neb. at 892, 62 N.E.2d at 303-04.
72. The court noted:

    > Obviously, there is no evil inherent in a contract entered into for the reason that the persons originating the terms desired to so arrange their property as to provide post-death support for those dependent upon them. Nor does the fact that the subject property is corporate stock alter the situation so long as there exists no detriment to minority stock interests, creditors or other public injury.

    32 Ill. 2d at 33, 203 N.E.2d at 586.
73. Galler v. Galler, 32 Ill. 2d 16, 203 N.E.2d 577 (1964). Illinois and Nebraska have both adopted the Model Business Corporation Act. *Compare* ILL. REV. STAT. *with* NEB. REV. STAT. §§ 21-2001 *et seq.* (Reissue 1974).

What in fact constitutes a "permissible objective" is not clear. Arguably the use of a shareholders' agreement to vest management discretion in a limited number of individuals would not be a permissible objective—at least without the consent of minority interests. The concept of legitimate shareholder agreements is probably best seen through use of the following situations.

1. *Contracting With Respect to Voting Rights*

In light of the constitutional guarantee of cumulative voting, it would appear that not all arrangements whereby shareholders agree to a pre-determined board composition would be invalid. *Buck* has determined, however, that the cumulative voting guarantee merely mandates that the corporation *permit* cumulative voting and a private contract among shareholders may waive that right.[74] In short, beneficial ownership can be separated from voting power. The constitution merely protects against the *involuntary* loss of the right to cumulate votes for the shareholder's choice of directors. It does not limit the right to contract with respect to one's own stock. It may therefore be fairly stated that in Nebraska, shareholder restrictions regarding voting rights may be freely bargained for, but the articles and by-laws may not infringe upon these rights.

It is doubtful, however, whether such a license really aids the former sole proprietor who is anxious to carry on his business as before, but now in a corporate form. The latitude granted shareholders in tailoring their votes for board composition or shareholder action is tempered by the apparent limitation that such an arrangement cannot uniquely benefit any one shareholder.[75] Since *Buck*

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74. *See* notes 64 & 65 *supra*.

75. Professor O'Neal suggests that the draftsman state purposes which benefit the corporation as a whole in the preamble to the agreement. O'NEAL § 5.08.

Perhaps the most comprehensive checklist available regarding factors which affect the validity of voting shareholders agreements is also articulated by Professor O'Neal:

(1) the purpose or object of the agreement,
(2) the statutes in force in the particular jurisdiction in which the agreement is made,
(3) The conceptions of public policy prevailing in the courts of the jurisdiction regarding the separation of voting power from the beneficial ownership of shares,
(4) the situation of the corporation and the shareholders at the time the agreement was made,
(5) whether or not all of the shareholders in the corporation are parties to the agreement,
(6) whether the contracting shareholders are also directors or expect to be at the time of the performance of the contract,

places heavy emphasis on the fact that no single shareholder has control of the board[76] it is reasonably clear that voting arrangements allowing one shareholder to determine unilaterally board composition would be carefully scrutinized.[77]

2. Contracting With Respect to Management

Clearly, director discretion cannot be uniformly abdicated by a shareholders' agreement. There must be a legitimate purpose for limiting discretion and careful attention must be paid to minority interests.

> [W]e think the correct rule is that stockholders' control agreements are valid where it is for the benefit of the corporation, where it works no fraud upon creditors or other stockholders and where it violates no statute or recognized public policy.[78]

Arguably, control agreements which uniformly restrict or control director function violate both the laws and policy of Nebraska.

> The creation of a dummy board of directors, or, in the language of some of the cases, a sterilized board of directors, by a stockholder agreement, is usually held to be void. But the mere fact that a board of directors of four members is created with the understanding that each shall nominate two, is not of itself unlawful. The *validity* of such a contract is determined by the nature of the re-

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(7) the length of time during which the agreement will control the shareholders' right to vote their shares,
(8) whether the person challenging the validity of the agreement is a party to it or is a creditor or shareholder not party to the agreement,
(9) whether the person challenging the agreement is simply trying to 'welch' on his undertaking,
(10) whether or not there is consideration, other than the mutual promises of the parties to support the undertakings, to vote in accordance with the terms of the agreement,
(11) how long the contract has been in operation and the extent to which action has been taken or positions have been changed in reliance on it, and
(12) perhaps the kind of corporation whose stock is subject to the voting arrangement.

O'NEAL § 5.07 (footnotes omitted).

76. The court noted:

> We point out once more that the agreement does not place Buck, the owner of 40 percent of the stock, in control of the corporation. It does give him a veto power over questions of corporate policy. It is plain that Buck would not have . . . [injected new capital] . . . without the stock control agreebeing made. It must be assumed that the purpose of the agreement was to prevent the corporation from getting into financial distress . . . .

157 Neb. at 890, 62 N.W.2d at 302-03.

77. *See* Kessler, *The Shareholder-Managed Close Corporation Under the New York Business Corporation Law*, 43 FORDHAM L. REV. 197 (1974).

78. 157 Neb. at 883, 62 N.W.2d at 299.

> strictions placed upon the board in carrying out their duty to exercise their best judgment in managing the affairs of the corporation. Where the control agreement leaves the directors free to act after being selected, we fail to see where there is a violation of any law or established rule of public policy. The mere fact that a board is created which may split evenly on a matter of corporate policy is not a basis for voiding the contract. In the instant case the directors were free to manage the ordinary business affairs of the corporation without contractual restraint. It is not a dummy or sterilized board within the ordinary meaning of those terms.[79]

While the *Buck* decision clearly shows that shareholder agreements *inter sese* may validly affect voting rights, it is not clear whether such agreements may also predetermine such matters as employment and compensation arrangements or dividend policy. These subjects will be vitally important to the participants since salary and dividends are generally the sole means of recognizing a return on their investments. It is certainly arguable that the *Buck* and *Galler* decisions support the proposition that shareholders may properly contract with respect to these matters. *Galler* clearly indicates that dividend policy may be left to the discretion of the shareholders[80] and *Buck* seems to indicate that an agreement which crystalizes employment and compensation would pass muster.[81]

Nevertheless, it is far from certain whether agreements which deal with these matters are valid absent specific statutory authorization.[82] The rationale against validity is apparently based upon the prohibition against impinging upon board discretion, the prohibition against limiting the powers of future boards, the invalidity of agreements among directors themselves, and the practical impediment to the specific performance of employment contracts.[83]

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79. *Id.* at 891, 62 N.W.2d at 303.
80. *Galler* did note, however, that dividend policies must be designed to protect the corporation, *i.e.*, so long as a stated minimum surplus is retained, a mandatory dividend is a legitimate subject for shareholders agreements. 32 Ill. 2d at 34, 203 N.E.2d at 587.
81. 157 Neb. at 883, 62 N.W.2d at 299. Note, however, that *Galler* expressly held employment compensation to be a valid subject for such a contract. 32 Ill. 2d at 34, 203 N.E.2d at 587.
82. O'NEAL § 6.06.
83. *Id.* The policy is stated by Professor O'Neal as being twofold. First, corporate statutes give the board power to manage the affairs of the business, and it would be contrary to statutory norms to predetermine that management discretion in future boards. Second, the concept of annual elections of the board contemplates that shareholders will be given a chance to elect directors annually and through that board of directors, their choices for officers and other employees of the business.

    Note that since equitable remedies are generally unavailable to enforce employment contracts, a deprived party would be forced to rely upon damages at law, a situation which may not be palatable to a minority interest shareholder who is anxious to cement a long term

Close corporation participants are therefore left with the all-too-familiar balancing test: shareholders may contract with respect to certain management functions provided that the powers removed from the board of directors are not too extensive.

Another impediment to corporate control by the majority is the danger of overreaching minority interest participants. Although it would be difficult to label a shareholders' agreement *unconscionable* in the formal sense of the word,[84] the analysis followed in *Buck* indicates that the court will look closely at agreements that tend to work an unfair advantage on minority interests.[85] It is interesting to note that minority interests in the close corporate enterprise are traditionally oppressed. As one author has pointed out,[86] minority interests in the close corporation are forced to go along for the ride and follow the whims of the majority interests without the ability to liquidiate their interests—at least through their own volition. On the other hand, provisions for unanimity of decision set forth in the charter or outlined in shareholder agreements protect minority interests by conferring upon them veto powers but also subject the enterprise to the dangers of deadlock and stalemate.[87] It would appear that neither alternative would

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employment agreement. Perhaps a provision allowing liquidated damages should be demanded by minority shareholder-employees, a situation which would be equally unpalatable to majority shareholders.

84. Since the contracting parties are in a "take it or leave it" position, it would be difficult to find that a party is victimized by both procedural and substantive maladies in the contract forming process—traditional requirements for finding unconscionability. *See* J. WHITE & R. SUMMERS, UNIFORM COMMERCIAL CODE 118, 119 (1972).

85. Where control of the business is exploited to the prejudice of minority interests, it would appear that a Nebraska court would have little difficulty in striking down the agreement to control since no benefit accrues to the corporation as a whole.

86. Hetherington, *supra* note 3 at 20. Bradley, *A Comparative Evaluation of the Delaware and Maryland Close Corporation Statutes*, 1968 DUKE L.J. 525.

Professor Heatherington points out that minority shareholders rarely bargain for protection against future disagreements and retain little to protect themselves against majority discretion. Exploited minorities are the rule rather than the exception in the close corporate structure. Since the power to manage in the close corporation is tantamount to the power to allocate benefits arbitrarily among principal stockholders, he argues that, as an alternative, minority interests maintain the right to be bought out at pre-arranged figures.

87. A veto power in the hands of minority interests may mean a stultified board. The ability to render any policy decision nugatory will also invite extraordinary tactics on the part of minority stockholders. O'Neal, *supra* note 45. *See also* note 82 *supra*. The Maryland statute also provides that subsequent purchasers (as opposed to donees and

be acceptable to the former sole proprietor since in the latter instance he loses the flexibility of the "chartered partnership," and in the former instance he subjects himself to the danger of having agreements invalidated as "unfair." Of course, no shareholder is forced to enter the venture. This would auger against a contention that shareholder agreements are overreaching.

IV. ILLUSORY ADVANTAGES OF CLOSE INCORPORATION

The concept of limited liability is perhaps the most illusory advantage to incorporating the family farm. While the corporate form of business normally insulates the shareholders from personal liability, the unique qualities of the close corporation often create exceptions to this general rule. Proper planning and drafting will aid in avoiding these difficulties in many cases, thus those who wish to incorporate should become familiar with the numerous exceptions to limited liability in the close corporation. There are essentially three categories where the corporate shield inadequately protects the shareholders from personal liability. The first two relate to the creditors' ability to go behind the entity or "pierce the corporate veil." These two categories comprise situations where the participants fail to follow the statutory formalities of operating the business or inadequately capitalize the enterprise so that creditors are subjected to unwarranted risk of loss. The third category involves practical impediments to limited liability caused by operating the close corporation as a chartered partnership or de facto proprietorship.

A. Exposure to Liability Via Informality of Operation

Because the corporation is a creature of statute, the failure to follow statutory formalities will often result in the corporate form being disregarded and the recognition of individual shareholder liability. Perhaps the best example is a situation where the business has been improperly incorporated, *e.g.*, there may have been an improper filing or no filing at all. In such a case, the corporation is not a de jure entity and unless a particular jurisdiction accepts the doctrine of de facto incorporation, the individual shareholders will not be insulated.[88]

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legatees) of corporate stock will be deemed to assent to existing agreements only if they have actual knowledge of the agreement. This would effectively protect principal shareholders from the argument that they had "overreached" minority interests. Query whether, if in fact such agreements are valid in Nebraska, subsequent transferees or purchasers of stock must be placed on notice of agreements respecting that stock.

88. *See* O'NEAL § 1.09(a).

Close corporations are especially susceptible to defects in formality of operation rather than the formal prerequisites of incorporation.[89] Shareholders who know one another and are used to operating the business with day to day contact are reluctant to reduce all decisions to formal resolutions and votes. Under traditional statutory schemes the formalities of meetings and notice requirements are clearly spelled out. Nebraska grants numerous dispensations favorable to close corporations with respect to such formalities,[90] but the liability-conscious shareholder must be cognizant of the statutory requirements, no matter how liberal, and conduct the affairs of the corporation accordingly or else subject himself to personal liability.[91]

Informal operation is not only dangerous because of the formal statutory requirements, but also indicates how the individual participant or principal shareholder views the enterprise. It may be tacitly understood that the business is to continue under the direction of one or several participants, but their actions as shareholders must respect the entity as a separate enterprise. One argument often used to "pierce the corporate veil" is the assertion that the enterprise is merely a nominal entity or simulacrum—the "alter ego" of the operator or operators.[92] If the enterprise merely serves as a conduit for the participants' indivudual actions, a court would have little difficulty in finding that the shareholders have chosen to conduct their business without regard to the entity and cannot assert its independent status as a shield. The participants must respect the formalities of meetings, minute books and the

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89. *Id.*
90. NEB. REV. STAT. § 21-2028 (Reissue 1974).
91. To minimize the risk that courts will disregard a corporation's separate personality, the organizers and managers of the corporation should take the following precautions:
    (1) establish and maintain the company as a separate business and financial unit, keep separate records and accounts, and assiduously avoid intermingling its funds, property and transactions with those of its shareholders, directors or officers;
    (2) provide the corporation in the beginning with adequate capital to meet the reasonably expected obligations and contingencies of the enterprise;
    (3) observe carefully the formalities of corporate procedure, including the holding of shareholders' and directors' meetings; and
    (4) avoid representing in any way that the business is being conducted by the participants as individuals or as partners.

    O'NEAL § 1.10. It is submitted that following these types of formalities may be a bit more of a task than the farm operator had in mind when he decided to incorporate his business.
92. N. LATTIN, THE LAW OF CORPORATIONS 86, 87 (1971).

statutory scheme; the entity must be established and maintained as a separate financial unit.[93]

One aspect of the foregoing involves the situation where a principal shareholder fails to distinguish by accounts or otherwise between corporate and personal funds. This is a common situation in the close corporate farm where many of the participants' assets are tied up in corporate suspension.[94] Such treatment would undoubtedly expose the shareholders to arguments designed to pierce the corporate veil. Ironically, under Nebraska law, participants may not be able to avoid this difficulty by formally maintaining corporate books since the flow of corporate funds into the hands of the shareholders is severely limited. By statute, a corporation is prohibited from loaning funds to its directors.[95] Thus, the shareholder/director is prohibited by common law as well as statute from using funds for his own needs—a situation absent when he operated the business as a proprietorship.

As a practical matter, the prospective incorporator must balance two inconsistent standards. On one hand, he desires to use the corporate form to his advantage, specifically to escape personal liability, a desire which is unquestionably permitted. On the other hand, there is a strict prohibition against using control of a corporation to further his own rather than the corporation's business. If he violates the latter prohibition, he will be held liable for the corporation's acts under the doctrine of respondeat superior.[96] This kind of activity is clearly seen as a perversion of the privilege of incorporation.

B. Exposure to Liability due to Inadequate Capitalization

If the shareholders provide the enterprise with insufficient financial resources, the resulting undercapitalization exposes them to personal liability.[97] While undercapitalization alone may not

93. *See* note 91 *supra*.
94. *See* Harl, *Public Policy Aspects of Farm Incorporation*, 20 BUS. LAW. 933 (1965). The traditional concept involves several shareholders pitting their *producing* assets against the producing assets of others to achieve an equitable distribution of equity. This might involve the exchange of producing tools or producing services for the stock of the corporation. *See* D. HERWITZ, BUSINESS PLANNING 44-67 (1966).
95. NEB. REV. STAT. § 21-2045 (Reissue 1974).
96. Walkovsky v. Carlton, 18 N.Y.2d 214, 223 N.E.2d 6, 276 N.Y.S.2d 585 (1966).
97. There is some question whether undercapitalization, without more, is a sufficient ground for disregarding the corporate entity and holding the shareholders individually liable to claimants or creditors. Arguably, it is a sufficient basis if it can be shown that the capital is "il-

impose personal liability, it weighs heavily in determining the issue. Undercapitalization is a fraud on credtiors and an abuse of the separate entity. It will not exempt the shareholders from corporate debts. If capital is illusory or trifling compared with the business and the risks of loss, this is ground for denying the separate entity privilege.[98]

No particular debt-equity ratio is automatically acceptable for the purposes of determining whether a corporate entity is adequately financed,[99] it is reasonably clear that shareholders must have a realistic view of what their future obligations will be and capitalize the enterprise accordingly. The principle of undercapitalization does not place an undue burden in the close corporation but it does illustrate that the enterprise is more than a shell and the hoped for advantages which attend that enterprise are not without their costs.

C. Practical Liability

The close corporation may be a theoretical shield to individual shareholder liability, but practicalities of the small farm business are an impediment to this theoretical insulation. The former sole proprietor sees the business as highly personal and a far cry from the detached interests contemplated by shareholders of public issue corporations.[100] He may have such a personal interest in the business that he is less concerned with limited liability than with the successful operation of the business and may be willing to pledge his personal credit in periods of financial stress or use personal funds and assets to aid an ailing enterprise.

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lusory or trifling compared with the business to be done and the risk of loss . . . ." H. BALLANTINE, CORPORATIONS § 129 (rev. ed. 1946).

98. *Id.* The question becomes to what extent the capitalization of the enterprise can be said to be "trifling." Clearly a corporation need not infuse the treasury with funds required for any possible contingency. *See* Walkovsky v. Carlton, 18 N.Y.2d 214, 223 N.E.2d 6, 276 N.Y.S.2d 585 (1966); Note, *Should Shareholders be Personally Liable for the Torts of Their Corporations?*, 76 YALE L.J. 1190 (1967).

99. *Id.*

100.
> Another practical consideration that militates against the supposed advantage of sole corporate responsibility for debts is the personal and emotional response of a man . . . whose productive years have been identified with the birth and growth of . . . [his enterprise]. He is usually unable to view its financial difficulties objectively and will usually pledge his personal credit when the business is in difficulties.

Kramer & Ziegler, *supra* note 96 at 516. On the other hand, the public issue shareholder will have a ready market for the stock he holds in a truly separate and removed enterprise.

Financing institutions are often unwilling to loan funds to close corporations without the personal guarantee of its participants. The incorporated farm proves to be somewhat of an exception to this rule, at least where plots of land are corporate assets. Lenders would have little trouble loaning funds where substantial acreage is available as collateral.[101]

Additionally, there is the danger of personal liability resulting from malfeasance in carrying out the function of director or officer. The principle of limited liability does not protect shareholders fulfilling the function of management from liability for participating in torts, failing to carry out duties according to statute or abusing the office they hold.[102]

Thus, it can be seen that the concept of limited liability is truly "limited" in the close corporation. Legal and practical limitations are so numerous that blanket statements are not possible. One author has argued that the basic policies behind insulation of the shareholders no longer exist in the area of close corporations—at least with respect to tort liability—and perhaps the concept should not apply to the closely held enterprise.[103]

V. CONCLUSION

Although incorporation is often considered an advantage for the private entrepreneur or partnership, it is not without its attending complexities. For the farm operator, these complexities may be too burdensome to warrant changing to the corporate form.

The greatest difficulty confronting prospective incorporators is the problem of retaining control in themselves so that they can carry on the business in an informal manner yet comply with statutory norms which traditionally require that the management of a corporation be vested in a board of directors. Those states which have adopted close corporation legislation have dealt with this problem by allowing for the abolition of the board and formal management by the shareholders. Although Nebraska has relatively

101. The tax-minded incorporator, however, might prefer keeping land out of corporate suspension, opting for a rental arrangement under which he would receive a fixed income for the use of the property. *See* Eastwood, *The Farm Corporation From an Income Tax Viewpoint: Friend or Foe?*, 54 NEB. L. REV. 443 (1975).

102. O'NEAL § 1.10; Nichols v. Garrot, 139 Colo. 292, 338 P.2d 683 (1959). In *Nichols*, personal liability was imposed upon directors and officers for their failure to file required annual reports.

103. It is arguable that in the case of the close corporation, limited liability should not be afforded, since they rarely have sufficient assets with which to compensate tort victims.

liberal corporate legislation by virtue of its Business Corporation Act, it still demands that formal tribute be paid to the board of directors myth. This problem is compounded by the fact that the common law of Nebraska is more strict than its legislation. Without judicial interpretation of the Business Corporation Act, shareholders are afforded little certainty concerning how informally they may legally run their enterprise. Failure to follow the requisite formalities could result in an inability to control recalcitrant shareholders and the loss of the corporate shield for the purposes of limited liability.

Moreover the process of incorporation involves expense and complexity in terms of arranging the corporate charter and allocating the equity interests among all the shareholders. In short, the complexities and expense of incorporating the family farm may simply not be worth the effort.

The sole proprietor struggles to retain control of his newly formed corporation. He combats statutes which are tailored to the large public corporation with charter provisions, by-laws, voting trusts and shareholder agreements. One of his main goals, other than tax advantages,[106] is limited liability—the separation of his personal liability from that of his new legal entity. After successfully complying with the statutes and receiving the corporate charter the sole proprietor learns that limited liability is illusory with regard to his close corporation; the bank won't lend funds without his personal signature; personal liability for his tortious acts remains; and the "corporate veil" will be pierced if the business is undercapitalized or if he operates the corporation as his alter ego.

Farm lands and equipment must be appraised in order to calculate equity contributions. The charter, by-laws and shareholder agreements must be drafted; salaries of directors and officers must be paid. These procedures are expensive and time consuming. The sole proprietor must balance the advantages against the costs and disadvantages for his situation. Incorporating requires an analysis of the unique problems of the proprietor and his business. The practioner must realize that the best course of action may be not to incorporate.

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