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1-1-1972

Review of Close Corporations by F. Hodge O'Neal

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Recommended Citation

John A. Humbach, Review of Close Corporations by F. Hodge O'Neal, 39 Brook. L. Rev. 507 (1972) (book review), <http://digitalcommons.pace.edu/lawfaculty/105/>.

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monograph—lurk the seeds of inevitable repetition of some of our worst mistakes, but on a far grander scale.

*George Ginsburgs**

Close Corporations. F. Hodge O'Neal. Mundelin, Illinois: Callaghan & Company. 1971. Two vols. (looseleaf).

Courts, lawyers and legislators in this country have finally begun to appreciate what their counterparts in Europe have known all along: there is a place for a type of business organization which has some characteristics of partnerships and some characteristics of chartered public corporations but which, in the final analysis, is a species unto itself. American law has made some place for the close corporation but in a rather grudging, piecemeal fashion. Consequently, the "law of close corporations" is not a coherent body of law. Rather, it is a plethora of exceptions and adaptations appended to the general corporation law in order to accommodate the distinctive needs of non-publicly held, chartered business organizations. *Close Corporations* is a two-volume treatise, in loose-leaf form, which concentrates on these exceptions and adaptations.

This work is probably too intense and specialized for the average law student's interest, though students will profit by reading it. It should prove nearly indispensable to the law scholar or the comparatively rare practitioner who, by interest or practice, is primarily concerned with the theory and practicalities of creating specially tailored organizational frameworks for multi-investor business enterprises. The real test of a work such as this, however, is its utility to the lawyer who is not a corporate specialist, but whose clientele includes a number of local (usually "small") businessmen who may find their businesses advantaged by use of the corporate form.

General corporate law largely retains its orientation towards wide but passive investor participation. It is thus, in many respects, irrelevant to the organizational needs of small businessmen clients (except insofar as its pitfalls must be avoided). Masses of irrelevancies and large enterprise orientation hinder and confuse efforts to resolve these clients' needs by resort to research in general corporation law sources. Professor O'Neal has pulled together the principles and considerations which are applicable to close corporation needs, and has thereby produced a very convenient reference and practice tool.

The first edition of *Close Corporations* appeared in 1958. It has had progeny.¹ Since 1958, the legislatures of several states, notably New York

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¹ Concentrating on the particular laws of the states of New Jersey and New York are R. KESSLER, *NEW YORK CLOSE CORPORATIONS* (1968) and R. KESSLER, *NEW JERSEY CLOSE CORPORATIONS* (1970).

and Delaware, have acted to give statutory warrant for close corporation governance more or less along the lines of general partnership management.² Developments have, in fact, reached the point where a skilled draftsman can provide the client with virtually all of the advantages of the partnership form, at least as concerns control relationships, and with limited liability besides.

But two gloomy holdovers from an earlier time mar the present picture. First, incorporation means rigidities in tax and financial matters. The flexible allocability of items of income, deduction, tax credit and the like, which makes the partnership vehicle so attractive to many types of ventures (risky ones in particular) is absent when the corporate form is selected. Second, the law conferring special treatment on close corporations remains somewhat more esoteric than seems necessary for the protection of any valid public interests. A draftsman, if he does not know what he is about, can easily fail in his purpose.³ And failure to sail through the technical requirements and procedural requisites imposed by law can leave the clients, who were clear in their understandings, living under quite a different arrangement from the one they agreed to.

The first holdover, rigidities in tax and financial matters, is deeply affected by questions of tax policy (as opposed to strictly business organization policy), but nonetheless the effects of taxation on non-revenue related affairs should be an integral consideration in tax policy. A major broadening of the availability and effect of a Subchapter S⁴ type of election, in order to allow any closely-held corporation to elect to be treated truly "as a partnership" for tax purposes, could minimize the inconsistencies in present tax policies in this area without seriously impairing revenue objectives.⁵

The second holdover, unnecessary formal requisites and traps for the unwary, exists strictly as a matter of state policy concerning the permissible types and characteristics of business organizations. Following the pattern of partnership law, a discrete, unified law of close corporations could be established to provide an equitable set of ground rules which would be subject to

² Provisions in the New York law having special interest for the draftsman of documentation for close corporations would include New York Business Corporation Law section 609(f) (irrevocable proxies), sections 616 and 709 (supermajority quorum and voting), section 620 (voting agreements and sterilization of board of directors), and section 1104 (dissolution in case of deadlock). In the minus column, one must place New York Business Corporation Law section 628 (liability of shareholders for wages, etc.). In Delaware, Subchapter XIV of the General Corporation Law provides a unified approach.

³ Even an expert in the field can run into trouble in attempting to reduce some of the esoterica to practice, as evidenced by the experience reported by O'Neal concerning one of his colleagues, at 3.05 n.6.

⁴ INT. REV. CODE of 1954 §§ 1371-79.

⁵ Lest this statement go entirely unsupported, the following is offered: Principals in closely-held ventures, if they have the benefit of informed counsel, seem to find a way to avoid outright double taxation. The intricacies of the tax laws provide ample outlet for the genius of the tax planning expert. Simplifying the taxation of closely-held business ventures (whether corporate or non-corporate) may cause the loss of excess tax revenue now collected from uninformed taxpayers. However, the fool in his folly is hardly a just base for taxation.

contrary agreement of the parties. Such separate unified close corporation statutes have not found favor in the United States,⁶ and the result has been unfortunate: failure of the principals to agree on a particular ground rule or to comply with prescribed formal requisites in making their agreement means that the public corporation rule will apply. That rule will often be wholly alien to the principals' needs or desires. A set of "fall-back" rules appropriate to close corporations would be definitely preferable.

Professor O'Neal has made few assumptions concerning the prior knowledge of the reader. The treatment of each topic begins with basic, sometimes almost simplistic, background information which is developed methodically through detailed observations, recommendations and, where appropriate, analysis of judicial decisions. True to the author's intention to provide a practical work, the emphasis is mainly on the "how-to" aspect of the problem, usually not dwelling on doctrinal discussions any more than necessary to allow the practitioner an intelligent appraisal of the suggestions or alternatives. At the same time, in the opening chapter and scattered elsewhere in the book, the reader will find considerable background information and theoretical insights which can be of help to those whose interest goes beyond immediate practice needs. Ample footnotes and citations make the treatise an excellent research jumping-off point.

Getting into this treatise should pose no problem for anyone who is at least minimally acquainted with corporate law and close corporation problem areas. The work is logically organized and the table of contents is sufficiently detailed to provide a useful tool for structuring one's own thinking as well as for locating the discussions of specific pertinent topics. The 105-page index, the cross-references, and the tables of statutes (the latter including extensive citations to the corporation laws of Delaware, New York and other important states of incorporation) make this a thoroughly accessible treatise.

The discussion of registration under the state and federal securities laws, though an amplification of that in the 1958 edition, may still be criticized by some as inadequate. It is the author's evident belief that this is not the place for a detailed discussion of the registration of securities, and perhaps this belief is sound. Nonetheless, the assumption that an exemption from state or federal registration applies when it does not is undoubtedly one of the most common errors made by non-securities lawyers whose clients offer securities to more than a bare handful of close business associates. In any event, the limited discussion of the problems involved in the securities area is the only serious deficiency in the completeness of this work and seems deserving of remedy on that ground alone. The extent of the discussion of Rule 10b-5⁷ could also be broadened, especially in light of cases such as

⁶ Professor O'Neal cites some of the reasons at § 1.13 a.

⁷ 17 C.F.R. § 240.10b-5 (1972). In broadest generalization, Rule 10b-5 forbids fraud, misrepresentation, misleading, deceit or manipulation in connection with transactions in securities. For a thorough recent treatment of the considerable judicial activity on this subject, see Note, *Developments in the Scope of Rule 10b-5*, 38 BROOKLYN L. REV. 1178 (1972).

Movielab, Inc. v. Berkey Photo, Inc.,⁸ which make this Rule directly applicable in even highly "private" transactions, such as the purchase of commodities where a promissory note is involved.

The 1958 edition of the treatise was supplemented by pocket parts through 1970, and the new edition, though embellished in text and citation at many points, is more of a change in form than in overall substance. Nevertheless, the change is welcome. An orderly presentation without necessity for constant reference to a pocket part is a great aid to the reader, and the looseleaf format of the present edition raises the hope that substitute pages will be issued to continue this convenience into the future. There are significant substantive additions as well. In particular, the added attention to the matter of federal income taxation gives deserved recognition to this important factor in business organization decision making and increases the utility of the work.

Finally, the value of this treatise to the practitioner whose clientele consists mainly of large corporations should not be overlooked. Subsidiary corporations, particularly those with some outside shareholders, are very much within the treatise's purview, and much of the discussion, especially in such areas as by-law drafting, classes of shares, high vote requirements⁹ and employment contracts, illuminates the law applicable to publicly and closely held corporations alike.

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⁸ 452 F.2d 662 (2d Cir. 1971).

⁹ High vote requirements as a defense to takeover attempts aimed at publicly-held corporations have had a recent surge of popularity.

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