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Guidelines for Advising a Small Close Corporation in North Dakota

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GUIDELINES FOR ADVISING A SMALL CLOSE CORPORATION IN NORTH DAKOTA

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The small close corporation can become involved in nearly every field of the law, and the common problems which arise range from bankruptcy to labor relations. It is the purpose of this article to discuss a few of the most common problems which small close corporations face under the North Dakota Business Corporations Act[1] and to point out several other areas the attorney should be watchful of. It has been assumed for the purposes of this article that the decision to incorporate, rather than to operate in some other form, has been correctly made. The advantages and disadvantages of the corporate form will therefore not be discussed.

In order to properly consider the problems facing the attorney who advises a small close corporation, a definition of a "close corporation" is needed which will point out the particular type of business organization being discussed, and will enable the reader to visualize the problems involved.

One court held that a corporation whose shares were owned by fifty-six people, many of them descendants of the founders of the company, and which were neither listed on a stock exchange nor traded over the counter, was, in the semantics of the market place, a close corporation.[2] Another example of what a court defined as a close corporation was a business which incorporated and the three former partners owned all the stock in the same proportions that they had owned the partnership.[3] A New York[4] case referred

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1. N.D. CENT. CODE chs. 10-19 to -23 (1960).
2. Phelps v. Watson-Stillman Co., 293 S.W.2d 429, 431 (Mo. 1956).
3. Industrial Equipment Co. v. Montague, 224 S.C. 510, 80 S.E.2d 114, 115 (1954).

to a close corporation as "one that has been organized by an individual or a group of individuals seeking the recognized advantages of corporations . . . but regarding themselves basically as partners.' The Supreme Court in 1934 described a corporation, four-fifths of its shares being owned by one man, as a close corporation.[5] For estate tax purposes, a corporation whose policies and activities were dominated and controlled by majority stock ownership in two families was held to be a close corporation.[6]

Although a "close corporation" has been variously defined by judges and legal writers, there does not appear to be a recognized definition of a "close corporation," nor are judges in agreement as to what factors are needed to qualify a corporation as "closed." The definition that best fits the purpose and scope of this article, however, is given by a writer who used an economic approach.

[A] "close corporation" is an enterprise in corporate form in which management and ownership are substantially indentical. As a result of that identity the participants consider themselves as "partners" and seek to conduct the corporate affairs to a greater or lesser extent in the manner of a partnership.[7]

STOCK AND SHARE ARRANGEMENTS

At the time of the incorporation of a small close corporation, several potential areas of disagreement can be resolved by using special provisions in the articles of incorporation or the corporate charter. One such area regards the equitable distribution of profits to the various shareholders of the corporation. Since profits are often retained in the corporation to provide funds for future expansion, it is unwise to assume that the parties will be able to share equitably in the profits through salaries and other direct benefits such as expense accounts, insurance and pension plans. In cases where one person may contribute money or property to the corporation and another contribute his special talent or services, it is important to remember that stock may be issued for services as well as for property,[8] in order to obtain the desired ratio of stock ownership, although future services cannot be considered payment for shares of a corporation.[9] The goodwill of an existing business is also an asset in exchange for which stock may be issued,[10] often a very important asset for a partnership which is incorporating and taking in people as shareholders who were not previously mem-

4. Application of Pivot Punch & Die Corp. 15 Misc. 2d 713, 182 N.Y.S.2d 459, 462 (Sup. Ct.), *modified,* 9 App. Div. 2d 861, 193 N.Y.S.2d 34 (1959).
5. Detroit Trust Co. v. The Barlum, 293 U.S. 21, 30 (1934).
6. Brooks v. Willcutts, 9 F. Supp. 19, 21 (D. Minn. 1934).
7. Israels, *The Close Corporation and the Law,* 33 Cornell L. Q. 488, (1948).
8. N.D. CENT. CODE § 10-19-16 (1960).
9. *Ibid.; see* B. & C. Elec. Const. Co. v. Owen, 163 N.Y. Supp. 31 (App. Div. 1917).
10. Bryan v. Northwest Beverages, Inc., 69 N.D. 274, 285 N.W. 689, 694 (1939). Although this case was decided under the COMP. LAWS 1913 § 4528, the language of the present statute is not substantially different, see N.D. CENT. CODE § 10-19-16 (1960).

bers of the partnership. The judgment of the board of directors or shareholders as to the valuation of property received for shares is conclusive in the absence of fraud,[11] although there may be constructive fraud where there was no actual intent to defraud.[12] The problems of adequacy of consideration for shares may be greatly lessened by the use of no par value shares or shares of nominal par value, since no-par shares do not require a specific amount of money consideration for each share, as do par value shares.[13] In addition to assuring the desired ratio of stock ownership by issuing stock for services, another method of assuring the desired division of profits is by the use of cumulative preferred shares, especially to assure an inactive man a share of the profits which might otherwise be distributed through salaries to the active members of the firm.[14] Cumulative preferred shares usually require that a certain per cent dividend must be paid upon them before dividends may be paid on common stock, and that the preferred shares will be given voting rights in the event that dividends are not paid for a certain number of years.

The proper planning of the financial affairs of the new corporation is vital, and the attorney, the incorporators, and their accountant should fully consider all aspects before issuing any shares.

The shares of stock issued also determine who controls the management of the corporation, as well as the profit division. It is very important, therefore, to assure each party his voice in the management. Non-voting stock is very convenient for this purpose. The proper ratios of both control and profits can usually be worked out by issuing various amounts of voting and non-voting shares, since it may happen that the parties do not wish to have control and profits divided in the same ratio.

Many small close corporations tend to regard themselves as partnerships, and therefore the incorporators may want provisions which will give any one of the shareholders power to veto corporate action. This type of control may be achieved in several ways, such as voting trusts,[15] voting agreements,[16] and irrevocable proxies.[17] Another method, probably more adaptable for use by small close corporations, involves a high or unanimous voting requirement for shareholder action or for director action where all the shareholders are also directors. The use of unanimous or very high voting requirements is authorized by statute,[18] and can be easily tailored

11. N.D. CENT. CODE § 10-19-16 (1960).
12. N.D. CENT. CODE § 9-03-09 (1960).
13. See N.D. CENT. CODE § 10-19-15 (1960).
14. Kessler, *A Close Corporation Checklist for Drafting the Certificate of Incorporation Under the New York Business Corporation Law*, 31 Fordham L. Rev 323, 333 (1962).
15. N.D. CENT. CODE § 10-19-35 (1960).
16. Ringling v. Ringling Bros.-B. & B. Combined Shows, 49 A.2d 603 (Del. Ch. 1946); *modified* 53 A.2d 441 (Del. 1947).
17. N.D. CENT. CODE § 10-19-33; State v. Pacific Waxed Paper Co., 22 Wash. 2d 844, 157 P.2d 707 (1945).
18. N.D. CENT. CODE §§ 10-19-34, 10-19-41 (1960).

to the requirements of the individual business as to what types of decisions shall require unanimous approval. Any such voting requirements should be stated in the articles of incorporation,[19] the by-laws,[20] and also be printed on the stock certificates to avoid any purchaser claiming lack of notice to defeat the voting scheme.

Provisions should be made to resolve deadlocks between the shareholders. The draftsman should provide conditions of dissolution so far as possible,[21] but care must be taken not to overlook the statutory provisions regarding dissolution.[22] A provision whereby a dissenting stockholder could be bought out by the corporation is feasible, but a method of funding such a provision would be necessary. In North Dakota, such dissenting shareholder has a right to have his shares purchased by the corporation in the event of a merger or consolidation,[23] or upon the sale or exchange of the corporate assets.[24] The use of arbitration provisions to resolve deadlocks should also be considered,[25] but in North Dakota an agreement to submit a controversy to arbitration may not be specifically enforced.[26]

CORPORATE FORMALITIES

One common area of problems for small close corporations is that they fail to observe the formalities required by law such as the keeping of minutes,[27] notice of shareholders' meetings,[28] and even the holding of actual shareholders' meetings.[29] In view of the fact that the directors of many small close corporations are also the sole shareholders of the corporation, some courts have been willing to waive the rigid requirements for directors' and shareholders' actions.[30] One court said that "where a corporation consists of a small number of persons, like a partnership, they may transact all their business by conversation, without formal votes, and it will be a violation of the plainest principles of justice to hold those who deal with them to prove all their acts by regular votes."[31]

The safest practice is to follow the statutory requirements religiously, and to operate the corporation as a business entity completely separate from the shareholders' individual business dealings. The corporation must be given its own books, records and bank accounts; it must have sufficient assets to carry on the purpose

19. N.D. CENT. CODE § 10-19-34 (1960).
20. N.D. CENT. CODE § 10-19-41 (1960).
21. See, *e.g.*, 2 O'NEAL, CLOSE CORPORATIONS § 10.28 (1958).
22. N.D. CENT. CODE §§ 10-21-02, -03 (1960).
23. N.D. CENT. CODE § 10-20-08 (1960).
24. N.D. CENT. CODE § 10-20-11 (1960).
25. N.D. CENT. CODE ch. 32-29 (1960).
26. N.D. CENT. CODE § 32-04-12 (1960).
27. N.D. CENT. CODE § 10-19-51 (1960).
28. N.D. CENT. CODE § 10-19-28 (1960).
29. N.D. CENT. CODE § 10-19-26 (1960); but see N.D. CENT. CODE § 10-19-27 (1960).
30. *E.g.*, Merchants' & Farmers' Bank v. Harris Lumber Co., 103 Ark. 283, 146 S.W. 508 (1912); see generally, Annot. 64 A.L.R. 712 (1929).
31. O.G. Orr & Co. v. Fireman's Fund Ins. Co., 235 App. Div. 1, 256 N.Y.S. 79, 81 (1932).

for which it was organized;[32] and a complete distinction must always be drawn between acts done on behalf of the corporation and acts of the individual shareholders done on their own behalf. Failure to observe these practices may result in imposing personal liability on the shareholders for a corporate action.[33] The use of a separate bank account for corporate funds is an absolute necessity, but many small close corporations even fail to do this.[34] The point at which the courts will "pierce the corporate veil" and thereby set aside the separate entity of a corporation is well illustrated by two fairly recent North Dakota cases. In *Mahanna v. Westland Oil Company*,[35] the court held that the separate corporate entities should be disregarded where "the affairs, assets, and equipment of the two corporations were so intermingled and confused, that insofar as the public was concerned the two corporations conducted a single business . . . ."[36]

In *Fire Ass'n. of Philadelphia v. Vantine Paint & Glass Co.*[37] the court refused to disregard the corporate entities where there was "not the slightest intimation that there was anything unfair or fraudulent in the conduct of the defendant corporations . . . or that one of the corporations was used as a cover for the others for any ulterior purpose."[38]

ANNUAL REVIEW

An excellent time for the attorney to review the practices of his client corporation is at the time of filing the annual report as required by North Dakota law.[39] Failure or refusal to file this report may result in a penalty of ten per cent of the original incorporation fee.[40] The attorney at this time should completely review the operations of the preceding year, examine the minute books and stock records and review the financial statements. It is essential that the corporation have a good accounting system and good bookkeeping. If they do not have a certified public accountant, the attorney should suggest that they retain one to establish an appropriate accounting system for their business and check over their records. An annual audit is essential to any well managed business, as it determines accurately the costs, income, profits or losses and the working capital situation.

At the time of this annual review of the operations of the corporation, it is important to emphasize certain problems which frequently cause trouble for small close corporations.

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32. See, Carlesimo v. Schwebel, 87 Cal. App. 2d 534, 197 P.2d 167 (1948).
33. Dixie Coal Mining & Mfg. Co. v. Williams, 221 Ala. 331, 128 So. 799 (1930).
34. For one instance see, Gordon v. Baton Rouge Stores Co., 168 La. 248, 121 So. 759 (1929).
35. 107 N.W.2d 353 (N.D. 1960).
36. *Id.* at 361.
37. 133 N.W.2d 426 (N.D. 1965).
38. *Id.* at 432.
39. N.D. CENT. CODE §§ 10-23-01, -02 (1960).
40. N.D. CENT. CODE § 10-23-03 (1960).

First, loans to and from shareholders, directors and officers are dangerous both from legal and tax standpoints. Under the North Dakota statute, "No loans shall be made by a corporation to its officers or directors, and no loans shall be made by a corporation secured by its shares."[41] Some loans by corporations to shareholders have been treated by the Treasury Department as dividend payments, and taxed as such.[42]

Another point to stress is that both by statute[43] and by the North Dakota Constitution,[44] par value stock may not be issued for consideration less than the dollar amount of the stock, and therefore par value stock may not be issued at a discount. This provision may easily be overlooked when a partnership is incorporated, and an arbitrary amount of stock is issued bearing no relation to the value of the partnership. Failure to observe this requirement could result in the shareholders being held personally liable for the difference between the actual value given for the stock and the par value stated thereon.

An important tax decision also faces most small close corporations. A domestic corporation having ten or less shareholders, none of which is a trust, a partnership, a corporation, or a nonresident alien individual, may qualify to elect to be taxed as a "small business corporation" under Subchapter S of the Internal Revenue Code.[45] Generally, the election under Subchapter S provides that the corporation is not taxed at all on its income, but each of the shareholders is taxed on his share of the corporation's net income, whether distributed to him or not. Careful study of the applicability and desirability of such an election should be made, for there are many technical points involved which can result in unfortunate consequences if they are not considered.[46]

CONCLUSION

Advising the small close corporation presents an interesting challenge to the attorney, as it involves a wide range of legal topics and the attorney's advice plays a key role in determining the success or failure of the business. Many small close corporations are badly in need of more legal advice, and in some cases better advice. This is an area which has not received the proper attention from the general practitioner, and many attorneys are failing to provide the quantity and quality of legal advice which such organizations need. The annual review of the operations which I have suggested should be the minimum amount of service given to the client corporation.

41. N.D. CENT. CODE § 10-19-46 (1960) .
42. General Aggregates Corp. v. Commissioner, 313 F.2d 25 (1st Cir. 1963), *cert. denied*, 375 U.S. 815 (1963).
43. N.D. CENT. CODE § 10-19-15 (1960).
44. N.D. CONST. § 138.
45. INT. REV. CODE OF 1954, §§ 1371-77.
46. See generally, Note, *Subchapter S Corporations*, 39 N.D. L. Rev. 341 (1963).