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THE LAW OF CLOSELY HELD CORPORATIONS

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2011 SUPPLEMENT

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The Law of Closely Held Corporations

by Douglas K. Moll and Robert A. Ragazzo

While a study of corporate law necessarily includes a study of closely held corporations, the closely held corporation is sufficiently distinct from its publicly held counterpart to warrant a stand-alone treatment. A closely held corporation can be generally defined as a corporation whose stock is not publicly traded on an established market. Unlike publicly traded corporations whose stock can be bought and sold on an exchange simply by contacting a broker, a closely held corporation lacks an established market of buyers and sellers for its shares. Similarly, while a public corporation's stock is widely owned by a large number of passive investors, a closely held corporation usually has a much smaller number of owners who tend to take a more active role in the management and operation of the business.

Indeed, despite the fact that the general law of corporations applies to closely held corporations, there are additional legal doctrines in every jurisdiction that apply only to the closely held venture. An attorney handling a closely held corporation matter, therefore, needs to understand not only corporate law generally, but also closely held corporation law specifically. This treatise is designed to provide both that general and specific knowledge.

The 2011 supplement contains the following highlights:

- Important updates on the law of contracting in closely held corporations (See Chapter 3)
- Recent developments with respect to buying and selling shares in closely held corporations (See Chapter 3)

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- Significant new cases on piercing the corporate veil (See Chapter 5)
- The latest material on piercing the corporate veil (See Chapter 5)
- New cases added to existing 50-state charts on:
  - — shareholder oppression (See Figure 7.1),
  - — minority discounts (See Figure 8.1), and
  - — marketability discounts (See Figure 8.3)
- significant recent state and federal cases on the shareholder oppression doctrine (See Chapter 7).
- Updated Tables of Cases and Statutes and an updated Index are included.

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To Stefanie, Asher, Samara, and Zelda,
who make it all fun.

Douglas K. Moll

To Richard,
whose birth renews the promise of the future,
and Maria and Daniel,
whose companionship enriches the present.

Robert A. Ragazzo

ABOUT THE AUTHORS

Professors Douglas K. Moll and Robert A. Ragazzo are both nationally recognized experts in the field of corporate law. Their research focuses on the law of closely held corporations.

Professor Moll graduated *magna cum laude* from Harvard Law School in 1994, where he was an editor of the Harvard Law Review. After a clerkship on the United States Court of Appeals for the Fifth Circuit with the Honorable Carolyn D. King, Professor Moll joined the law firm of Fulbright & Jaworski L.L.P. in Houston, Texas. His practice focused on commercial litigation and general business disputes. In 1997, Professor Moll joined the faculty of the University of Houston Law Center. He is presently the Beirne, Maynard & Parsons, L.L.P. Professor of Law, and he has taught Business Organizations and other business law courses for the past 12 years. Professor Moll's articles and other scholarship can be accessed at http://ssrn.com/author=190549.

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PREFACE

This treatise is a comprehensive study of the law of closely held corporations. While a study of corporate law necessarily includes a study of closely held corporations, the closely held corporation is sufficiently distinct from its publicly held counterpart to warrant a stand-alone treatment. Indeed, despite the fact that the general law of corporations applies to closely held corporations, there are additional legal doctrines in every jurisdiction that apply only to the closely held venture. An attorney handling a closely held corporation matter, therefore, needs to understand not only corporate law generally, but also closely held corporation law specifically. This treatise is designed to provide both that general and specific knowledge. We hope that it will be useful to practitioners, academics, and anyone else seeking analysis and citations on the subject.

We welcome any comments or suggestions that you may have on these materials. Please feel free to contact us by email at dmoll@central.uh.edu or at rragazzo@central.uh.edu.

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CHAPTER 1

INTRODUCTION

A closely held corporation can be generally defined as a corporation whose stock is not publicly traded on an established market. Unlike publicly traded General Electric, for example, whose stock can be bought and sold on the New York Stock Exchange simply by contacting a broker, a closely held corporation lacks an established market of buyers and sellers for its shares. Similarly, while General Electric's stock is widely owned by a large number of passive investors, a closely held corporation usually has a much smaller number of owners who tend to take a more active role in the management and operation of the business.[1]

What makes closely held corporations worthy of separate study? First, the number of closely held corporations in this country vastly exceeds the number of publicly held companies.[2] While publicly held corporations often dominate the headlines, the reality is that closely held firms are far more numerous, and most lawyers will have significantly more interaction with closely held corporations than their publicly traded counterparts.

Second, shareholders in closely held corporations often expect to run their businesses in ways that differ dramatically from traditional corporation norms—norms that are generally designed to serve the needs of publicly held corporations. These differing expectations often make the task of organizing a corporation more challenging in the closely held setting. For example, shareholders in closely held corporations usually want an active role in the management of the venture. That desire,

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[1] *See, e.g.*, Donahue v. Rodd Electrotype Co., 328 N.E.2d 505, 511 (Mass. 1975) ("We deem a close corporation to the typified by: (1) a small number of stockholders; (2) no ready market for the corporate stock; and (3) substantial majority stockholder participation in the management, direction and operations of the corporation.").

[2] *See, e.g.*, Margaret M. Blair & Lynn A. Stout, *Trust, Trustworthiness, and the Behavioral Foundations of Corporate Law*, 149 U. PA. L. REV. 1735, 1801 (2001) ("Yet despite the high degree of mutual vulnerability their participants must endure, closely held corporations continue to exist and, indeed, to outnumber publicly held corporations vastly.").

however, conflicts with the traditional "centralized management" norm of the corporation. Under centralized management, shareholders vote for a board of directors but otherwise have little role in managing the corporation. It is the board that manages, or supervises the managing of, the corporation's affairs. The board also appoints the officers, who run the corporation's daily business. Thus, unless shareholders are also directors and officers, the traditional centralized management norm gives them little role in managing the corporation.[3]

This traditional governance model adequately serves the needs of publicly held corporations, as the sheer number of shareholders in such ventures makes direct shareholder-management impractical. As a result, the ordinary shareholder in a publicly held corporation expects to serve (and does serve) merely as a passive investor. In a closely held corporation, however, this traditional model poses difficulties for accomplishing the active management wishes of the typical shareholder. When organizing a closely held corporation, therefore, an attorney needs to understand the nuances of contractually altering the centralized management norm in a legally enforceable manner.[4]

As a further example, shareholders in closely held corporations are frequently connected by family or other personal ties, and there is often a desire to prevent outsiders from joining the organization. For this and other reasons, shareholders in closely held firms typically want restrictions on the transferability of their shares.[5] Under traditional corporation norms, however, free and unrestricted transferability of ownership interests is the standard. After all, in a publicly held corporation, the identity of the shareholders is largely irrelevant to the operation of the firm, as the shareholders have little role in managing the corporation. Thus, unlike the organization of a publicly held corporation, the organization of a closely held corporation requires an attorney with knowledge of permissible techniques for altering the traditional "free transferability" norm.[6]

Third, because closely held corporations lack a market for their shares, significant problems arise in the closely held context that are largely absent in the publicly held setting. For example, in most closely held corporations, the lack of a market effectively results in the lack of an exit for investors who disagree with the majority will and who would

[3] *See* Sections 2.01[A][2], 7.01[A].

[4] *See* Chapter 3.

[5] *See* Section 4.01.

[6] *See* Section 4.01.

prefer to liquidate, or "cash out," their investments. In addition, unlike a partnership, a minority owner has no easy means of dissolving the corporation to obtain a return of his invested capital. A minority shareholder's investment, in other words, can remain trapped within a closely held corporation—a situation that may call for judicial intervention on the grounds of "oppression" if egregious majority conduct is involved.[7] By contrast, this oppression issue is relatively non-existent in a publicly held corporation, as the presence of a market allows dissatisfied owners to liquidate whenever they wish. The owners simply sell into the market and recover the value of their investments. The lack of a market also increases the importance of other mechanisms for monitoring the managers of a corporation, as the disciplinary effect of a market—i.e., the possibility that large numbers of dissatisfied owners will sell, decrease the market price of the corporation's shares, and place the managers' positions in jeopardy—is, by definition, absent in a closely held corporation.[8]

In combination, the sheer number of closely held corporations, the differing expectations of closely held business owners, and the existence of oppression issues that uniquely affect closely held firms justify treating such corporations as a distinct topic of legal analysis. Keep in mind, however, that a closely held corporation is also a corporation. As a consequence, fiduciary duty and other traditional corporation doctrines

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[7] *See* Section 7.01.

[8] As commentators have observed:

> . . . Market restraints are most visible and workable in the case of publicly held corporations. If management is inefficient, indulges its own preferences, or otherwise acts contrary to shareholder interests, dissatisfied shareholders will sell their shares and move to more attractive investment opportunities. As more shareholders express their dissatisfaction by selling, the market price of the company's shares will decline to the point where existing management is exposed to the risk of being displaced through a corporate takeover . . . The mere threat of displacement, whether or not realized, is a powerful incentive for managers of publicly held corporations to promote their shareholders' interests so as to keep the price of the company's shares as high and their own positions as secure as possible.

J.A.C. Hetherington & Michael P. Dooley, *Illiquidity and Exploitation: A Proposed Statutory Solution to the Remaining Close Corporation Problem*, 63 VA. L. REV. 1, 39-40 (footnote omitted); *see also* Krishnan S. Chittur, *Resolving Close Corporation Conflicts: A Fresh Approach*, 10 HARV. J.L. & PUB. POL'Y 129, 158 (1987) ("The close corporation is not comparably reviewed or controlled by the market because it has no publicly traded stock. There is little possibility of a proxy fight or a takeover bid." (footnote omitted)).