

# Corporations

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# CORPORATIONS

*Lewis Collens\**

*In this review of the developments in Illinois Corporation Law that have occurred since his article of a year ago, Professor Collens analyzes judicial interpretations in four major areas of corporate activity. His examination focuses on the liability of officers and directors, with a special caveat to members of the legal profession serving in such capacity; the dependent dividend rights of a parent corporation and its wholly-owned subsidiary; the attendant problems in the purchase and sale of close corporation stock and the related issues arising from the determination that corporate conduct constitutes oppression of minority shareholders.*

## LIABILITY OF OFFICERS & DIRECTORS

**A**TTORNEYS often serve as directors and officers of closely held corporations that they represent. However, as indicated in *Sears v. Weissman*,<sup>1</sup> this situation "may turn out to be fraught with danger for the honest and well intentioned but unwary lawyer."<sup>2</sup> In *Sears*, the trial court held an attorney acting as director and secretary liable to an unpaid creditor of a dissolved corporation. While the appellate court reversed the lower court, thereby relieving the attorney of liability, it specifically reminded the members of the bar that there is no statutory reason to serve as members of corporate boards.<sup>3</sup> This statement is a clear warning to the profession to be wary of accepting directorships.

Before considering the merits of *Sears* and the reasons for the court's warnings to the bar, I think it is useful to consider why attorneys serve as members of corporate boards. The *Sears* court suggests two reasons: glamour and the hope of financial return. While a certain amount of glamour may attach to those who are directors of public corporations, it is hard to believe that attorneys consider it glamorous to hold directorships in close corporations. More likely, attorneys seek directorships in the belief that the board seat

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1. 6 Ill. App. 3d 827, 286 N.E.2d 777 (1972).

2. 6 Ill. App. 3d at 835, 286 N.E.2d at 784.

3. *Id.*

will insure their receiving the corporation's legal business.<sup>4</sup> I doubt, however, that it is possible to establish empirically a causal connection between board membership and placement of legal business. It is undoubtedly true that most attorneys who sit on close corporation boards are attorneys for those corporations. However, they sit on the board because they are the corporate attorney; they are not the corporate attorney because they sit on the board.

If it is not clear what attorneys have to gain from membership on corporate boards, it is *clear* that they have much to lose. No member of the legal profession should need to be reminded that today corporate directors are targets of substantial numbers of not only shareholder derivative suits and direct shareholder suits but also consumer and governmental actions. Furthermore, with the escalating demands for corporate responsibility, it is safe to predict that corporate directors will be involved in an ever-increasing amount of litigation.

To the extent that it is believed either by client or counsel that the attorney's presence at board meetings is necessary, there is no reason why he cannot attend without being a member of the board. If the attorney feels uncomfortable attending a meeting without a formal role, he can be appointed secretary of the meeting (not corporate secretary) and be responsible for preparing minutes of the meeting.

A review of the merits of *Sears* invites consideration of one frequent criticism of directors—that they fail to take an active interest in the corporation, *i.e.*, that they fail to direct.<sup>5</sup> *Sears* illustrates one dimension of this problem. In relieving the attorney from liability, the appellate court indicated that one of the "potent factors" operating in his favor was that he had "no knowledge whatsoever regarding any financial affairs"<sup>6</sup> of the company. This remarkable

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4. This may be based on the assumption either that the attorney's presence will enable him to use his charismatic charm or that he will make valuable contributions to deliberations on substantive business decisions.

5. Implicit in the complaints about inactive directors is the assumption that active participation on their parts would result in different corporate actions. There is no empirical support for this proposition. See J. Galbraith, *ECONOMICS AND THE PUBLIC PURPOSE* 218 (1973), where the author suggests that no change in corporate boards can make corporations more socially responsible in terms of his criticisms of the modern corporation.

6. 6 Ill. App. 3d at 834, 286 N.E.2d at 783.

proposition obviously did not trouble the court and probably will not trouble many readers of the opinion because the attorney was not in any way actively involved in what amounted to a scheme to defraud the plaintiff. Nonetheless, one would expect anyone who was truly functioning as a director of a company, particularly an attorney, to have some knowledge of the financial affairs of the company. To hold that this type of ignorance relieves a director from liability is simply to encourage directors to refrain from critical inquiry regarding the corporation's affairs.

In fairness to the *Sears* court, it is important to keep in mind the precise issue with which it was confronted: whether the attorney "assented to" an improper distribution of the corporation's assets.<sup>7</sup> The plaintiff's money had been deposited in the corporation's bank account and then paid out to the two shareholders of the company who comprised the majority of the corporation's three-man board. The holding that the attorney had not "assented to" the distribution was consistent with prior Illinois case law.<sup>8</sup> The court in effect affirmed the proposition that the active members of the board are not considered agents of the inactive ones—even where the inactive ones have clearly decided to "entrust" management to the active members.<sup>9</sup>

While most readers of *Sears* are apt to believe that the court reached a just result, the court must have been troubled by the implication that ignorance of corporate affairs is a good defense for director defendants. Hence, the court warned the bar about accepting directorships—a warning which I believe is also an indication that in the future the court may be less willing to reach the same result.

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7. § 42.1 of the BUS. CORP. ACT, ILL. REV. STAT. ch. 32, § 157.42-1 (1971), imposes liability on directors who "vote for or assent to the . . . distribution of the assets . . . if, at the time of such . . . distribution, the corporation is insolvent. . . ."

8. *Lewis v. Montgomery*, 145 Ill. 30, 33 N.E. 880 (1893).

9. *Id.* But note that directors have been deemed to have assented to transactions that they did not specifically approve, *DeMet's, Inc. v. Insull*, 122 F.2d 755 (7th Cir. 1941) (where action was approved by an executive committee and liable directors had authorized creation of the executive committee); *Slater v. Taylor*, 241 Ill. 102, 89 N.E. 271 (1909) (where directors held personally liable for acts of agent hired by board even though specific acts giving rise to liability were not authorized by board).

## DIVIDEND RIGHTS

*Kern v. Chicago & E. Ill. R.R.*<sup>10</sup> (C&EI) sharply raises the question: how is it possible for directors to discharge fairly their fiduciary duty to all shareholders when there is more than one class of shareholders? In *Kern*, the railroad had preferred shareholders who were to receive cumulative annual dividends of two dollars per share so long as there were "net earnings available for dividends." The corporation did not declare dividends on the preferred stock in 1959 because the corporation claimed that earnings were approximately \$18,000 below the amount needed to declare dividends. However, the corporation had a wholly-owned subsidiary, Chicago Heights Terminal Transfer Railroad, (CHTT), that had 1959 earnings of \$392,000. The CHTT board had declared a dividend of \$300,000, which was reported as 1959 income by C&EI, but the remaining \$92,000 was not included in income. Had the \$92,000 been included in income the preferred stockholders would have been entitled to dividends.

What justification was there for the CHTT board, which obviously was completely under the control of C&EI, not declaring the additional dividends? Unfortunately, the court did not directly address this question. It held that the preferred shareholders were not entitled to dividends. It argued, first, that under accounting principles set by the Interstate Commerce Commission earnings of subsidiaries are not to be considered earnings of the parent until dividends are declared.<sup>11</sup> While this is true, it of course says nothing about whether dividends ought to have been declared. Secondly, the court argued that an ICC decision<sup>12</sup> refusing permission to C&EI to merge with CHTT meant that the corporate identity of CHTT was to be maintained and that any order compelling C&EI to include all CHTT earnings would amount to piercing the corporate veil. While this might technically be correct, it still begs the question. Why didn't C&EI have a duty to order its CHTT directors

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10. 6 Ill. App. 3d 247, 285 N.E.2d 501 (1972).

11. Under generally accepted accounting theory, however, it is considered appropriate to prepare consolidated statements for a parent and a wholly-owned subsidiary that are engaged in the same type of business. See R. WIXON & W. KELL, ACCOUNTANT'S HANDBOOK § 23, at 2-4 (5th ed. 1970).

12. Chicago and E. Ill. R.R. Merger, 312 I.C.C. 564 (1961).

to vote for a larger dividend? C&EI did not argue that it was serving some interest of its common shareholders by not declaring dividends. Had it so argued, the court clearly would have been required to decide how a director should discharge his fiduciary duty when there is a conflict between two classes of shareholders.<sup>13</sup>

Implicit in the court's decision is a determination that the CHTT retention of \$92,000 was in the best interests of CHTT. This suggests two questions. First, when are the interests of the subsidiary to be considered apart from the interests of the consolidated corporation? In this instance concern for the subsidiary's interest seems appropriate because of the ICC determination that the public interest will best be served by maintenance of a separate identity of the subsidiary. Second, if the best interests of the subsidiary are to be considered, how do we determine whether CHTT needed to retain the \$92,000? The court does not tell us that \$50,000 was placed in the corporation's mandatory sinking fund and that the balance was kept in retained earnings. This information, however, is not adequate to determine whether retention of the full \$92,000 was justified.

If corporations involved in this case had not been publicly regulated, it would have been more difficult for the court to reach the same result because of the lack of any public interest argument for retaining the independent identity of the corporation.

*Kern* provides at least two practical guidelines for attorneys. First, fewer problems are likely to arise if the preferred stock is cumulative, rather than cumulative-if-earned.<sup>14</sup> Second, in the unlikely event

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13. *Cf. Honigman v. Green Giant Co.*, 309 F.2d 667 (8th Cir. 1962), *cert. denied*, 372 U.S. 941 (1963), where the court sustained a recapitalization that arguably discriminated against Class B shareholders in favor of Class A shareholders. Note, however, that 92% of the Class B shareholders had approved the plan. In *Kern* no such approval existed or could have been obtained.

14. Nevertheless, the cumulative-if-earned provision does prevent the kind of problem that arose in *Cent. Standard Life Ins. Co. v. Davis*, 10 Ill. 2d 566, 141 N.E.2d 45 (1957), where the amount of accrued preferred stock dividends arguably exceeded the value of the corporation. The use of non-cumulative preferred is rather rare and in any event can lead to problems as to whether in fact the stock is actually non-cumulative. *Guttman v. Ill. Cent. R.R.*, 189 F.2d 927 (2d Cir. 1951); *Sanders v. Cuba Ry.*, 21 N.J. 78, 120 A.2d 849 (1956); *Bassett v. United States Cast Iron Pipe and Foundry Co.*, 74 N.J. Eq. 668, 70 A. 929 (Ch. 1908), *aff'd* 75 N.J. Eq. 539, 73 A. 514 (Ct. Err. & App. 1909). For a general discussion of the use of various types of preferred stock see 1 A. Dewing, *THE FINANCIAL POLICY OF CORPORATIONS* 131-148 (5th ed. 1953).

that a *Kern* type problem arises, counsel for the corporation would be safer in advising the company to have all earnings of the subsidiary passed on to the parent as a dividend.<sup>15</sup>

#### PURCHASE AND SALE OF CLOSE CORPORATION STOCK

The problems lurking in the purchase and sale of significant blocks of stock in close corporations are numerous and offer a continuing challenge to the creative drafting skills of any attorney. Several cases decided during the past year illustrate such drafting problems.

In *Siemans v. Thompson*,<sup>16</sup> the plaintiff agreed to purchase 49 percent of the stock of Thompson Motor Sales, Inc. from Alan Thompson, the sole shareholder of the defendant corporation. The agreement provided for a \$6,000 down payment and additional payments of \$7,000 per year for seven years. Further, both Siemans and Thompson were to be employed by the corporation and receive salaries of \$1,000 per month plus bonuses. Everything went smoothly for about a year; then the corporation fell upon hard times. Thompson proposed that both he and Siemans refrain from drawing their salaries until the cash position of the company improved. Siemans refused and two months later notified the defendant that he was terminating the stock purchase agreement. He brought suit for rescission of the contract and recovery of the value of his services for the few months he had worked without pay.

In deciding the case, the court had to consider two different models of the Siemans-Thompson relationship, each of which would produce a different result. The court could have viewed Siemans and Thompson as major shareholder-partners who were to share the entrepreneurial risk. This view would have resulted in Siemans being held liable for the unpaid amount due on the stock purchase agreement. Alternatively, the court could have viewed Siemans as just another hired hand of the corporation (controlled by Thompson) who had been given additional compensation in the form of the right to purchase stock in the company. Under this view, Siemans would

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15. Dividends received by a parent corporation from a wholly-owned subsidiary are completely excluded from income for tax purposes so long as the appropriate affiliated group election has been made. INT. REV. CODE OF 1954, § 243.

16. 11 Ill. App. 3d 856, 297 N.E.2d 241 (1973).

have recovered for unpaid salary. (The implications of this view on the stock purchase agreement will be reviewed later). Based on the above recitation of facts, I think that most corporate attorneys would conclude that the shareholder/partner model was more appropriate; the court thought otherwise. It viewed the key issue as whether the employment agreement and the stock purchase agreement were divisible. Concluding that they were not, the court said:

[O]ne intending to purchase a share of a business and to help manage, operate and obtain his livelihood from that business would hardly have an interest in the purchase provision if he was deprived of his status of employee-manager.<sup>17</sup>

This conclusion is unsatisfactory. It is true that one would not want to purchase stock if he were depending on the corporation for his livelihood *and* he knew that the corporation would soon be unable to pay him. But here the agreement between the parties reflects no consideration of the possibility of the economic decline of the business. The court concludes that the entire downside risk is to be borne by Thompson for a period of at least seven years.<sup>18</sup> While it is possible that the parties so intended, there is not one shred of evidence cited by the court to support this view.

This case underlines the importance of considering the result desired should the business fail to prosper. Surely this consideration would not surprise most attorneys, yet it was apparently overlooked by counsel in this case.<sup>19</sup>

Two recent cases involved alleged misrepresentations of corporate financial condition in conjunction with the sale of a corporation. In *Sher v. Robin*<sup>20</sup> the plaintiff sought rescission of his contract to purchase all the capital stock of North Shore Speed and Auto, Inc. Plaintiff alleged that during the course of negotiations he was shown an unaudited income statement which understated the cost of goods sold by \$24,000 and therefore overstated the gross profit margin

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17. 11 Ill. App. 3d at 858, 297 N.E.2d at 243.

18. Taken to its logical extreme, the court's position would require rescission of the stock purchase agreement any time Siemans was dismissed from employment, without cause, even if twenty years had passed.

19. It is, of course, possible that counsel was not involved in drafting the agreement, although my hunch is otherwise.

20. 53 Ill. 2d 301, 291 N.E.2d 801 (1973).



by over 10 percent. However, the income statement was not part of the contract and there were no warranties regarding income or gross profit margins. From the standpoint of the buyer such an omission is obviously inexcusable. If the buyer was relying on the business's past earnings record as a basis for determining the amount he was willing to pay for the business, then past income was clearly material and it should have been referred to in the contract. On the other hand, if the buyer was mainly buying assets, then he would have expected, at a minimum, that a representation of the assets of the company would appear in the contract.

Such a representation was contained in the agreement in dispute in *Medigroup, Inc. v. Schildknecht*.<sup>21</sup> The agreement there warranted that the balance sheets were "accurate and that there would be no changes before the closing except in the ordinary course of business."<sup>22</sup> This type of warranty, along with a warranty regarding past income, would have protected the buyer in *Sher*. Unfortunately, it did not provide complete protection for the buyer in *Medigroup* because a dispute arose over whether certain debts that were not stated in the financial statements relied on were pre-existing or subsequently incurred in the ordinary course of business.

The problem faced by the court when no warranties appear in the contract is whether to imply warranties. While implied warranties are certainly no strangers to the law, it is still necessary to have some factual and/or policy reasons for implying warranties. The court seems to be taking the position that whenever a seller shows unaudited financial statements to a buyer, he thereby warrants the accuracy of the statements. This position can lead to unjust results. Where the buyer has been given an opportunity to inspect all financial records and has relied on his inspection rather than representations, there does not appear to be any reason why the seller should be saddled with implied warranties.

In *Sher* the buyer *did* inspect the financial records and, therefore, it would seem that the only question was whether he justifiably relied on the unaudited statements. Justice Goldenhersh, in his dissenting opinion, clearly thought that he did not, pointing in particular to

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21. 463 F.2d 525 (7th Cir. 1972).

22. *Id.* at 528.

the absence of warranties regarding past income and the inclusion of warranties regarding certain specific financial items (none of which were breached).

*Sher* and *Medigroup* read together illustrate the importance of precisely spelling out the financial data upon which the parties are and *are not* relying. Counsel for a seller in a situation such as *Sher* should include in the agreement a specific disclaimer of warranties and an affirmative statement regarding the inspection opportunities that have been provided to the buyer. *Medigroup* illustrates the potential danger to both parties of relying on the very commonly used clause stating that no transactions other than in the ordinary course of business will transpire between the signing of the contract and the closing. To the extent possible, counsel must probe to determine what types of borderline transactions have a reasonable chance of occurring during the pre-closing period.

#### OPPRESSION OF MINORITY SHAREHOLDERS

Litigation involving close corporation shareholders who formerly were congenial business associates is a recurring courtroom phenomenon. Conflicts of this type can often be avoided through proper counseling and shareholder agreement at the time the business venture is begun. However, even a comprehensive shareholder agreement does not guarantee that litigation will not arise.

In *Gray v. Hall*<sup>23</sup> agreement between the shareholders did not prevent litigation. Three shareholders formed a company to manufacture refrigeration valves. Townsend was the designer, Hall the supervisor of manufacturing and Gray the director of sales. Once the business was under way both Townsend and Hall devoted full time to the company's affairs, even though they concurrently were operating an engineering project partnership which provided the corporation with most of its business.<sup>24</sup> The corporate stock was divided equally among the three shareholders.

They had an agreement that provided for a first right of refusal in the event that any one of the shareholders wanted to sell his stock.

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23. 10 Ill. App. 3d 1030, 295 N.E.2d 506 (1973).

24. It is unclear how Hall and Townsend could have been considered full time employees of the corporation at the same time that they had what was apparently a flourishing partnership business. This discrepancy, however, had no apparent significance to the court.

Nonetheless, after about two years of operation, Hall obtained Townsend's stock in exchange for Hall's interest in the partnership. Although he apparently knew about the transaction, until the time of litigation Gray did not attempt to enforce his right to purchase his pro rata share of Townsend's stock. Therefore, the court held that he had waived his contractual right by waiting more than eight years to bring suit.

During the eight year period Hall, as the owner of two-thirds of the stock unilaterally made all corporate decisions, including raising his salary and authorizing the move of the corporate business from Illinois to North Carolina. These latter two acts were the main grievances which Gray sought to have redressed. Since the shareholder agreement apparently said nothing about salary or place of business, Gray had to find some other theory on which to base his action. His strategic position was weak because of the court's determination that Hall was the rightful owner of two-thirds of the stock, thereby giving Hall control of the board of directors,<sup>25</sup> the right to manage the affairs of the corporation and to establish all directors' compensation.<sup>26</sup>

Gray was forced to argue that Hall's conduct was "oppressive" within the meaning of section 86 of the Illinois Business Corporation Act.<sup>27</sup> A finding of oppression allows the court to dissolve the corporation and distribute its assets to the shareholders. However, since the statute does not define "oppressive," the court had to find guidance from a prior statement by the Illinois Supreme Court:

The word "oppressive" does not carry an essential inference of imminent disaster. . . . [It is not] substantially synonymous with "illegal" and "fraudulent."<sup>28</sup>

This definition, however, simply emphasizes that oppression is something to be determined by the court in the exercise of its general equitable powers. The *Gray* court does indicate that one method for determining whether oppression exists is to apply a comparability

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25. There apparently was no regularly functioning board. One meeting was held in 1968. 10 Ill. App. 3d at 1033, 295 N.E.2d at 508.

26. Ill. Rev. Stat. ch. 32, § 157.33 (1971).

27. Ill. Rev. Stat. ch. 32, § 157.86 (1971).

28. Cent. Standard Life Ins. Co. v. Davis, 10 Ill. 2d 566, 573-74, 141 N.E.2d 45, 50 (1956).

test, *i.e.*, to look at actions of similarly situated companies. The *Gray* court avoided the difficult task of applying this test by remanding the case for an accounting in order to determine all the facts.

Dissolution because of oppressive acts was granted in *Compton v. Paul K. Harding Realty Co.*<sup>29</sup> The case involved a dispute between two major shareholders<sup>30</sup> of a close corporation in a situation where there was a violation of a shareholders' agreement. The agreement specified that defendant Harding would be president of the corporation and draw a salary of \$175 per week while the plaintiff Compton would be executive vice president. In ordering the corporation dissolved the court found that Harding's conduct was oppressive because he had been "arbitrary, overbearing and heavy-handed"<sup>31</sup> in running the corporation. Specifically, he not only had increased his own salary above the amount specified in the shareholders' agreement but also had not consulted Compton with regard to management of the corporation—indeed no board meetings were ever held. Furthermore, he was dilatory in responding to Compton's requests for information.

In ordering repayment of Harding's excess salary and dissolution of the corporation, the court may very well have reached the fairest result possible. However, it is difficult to be sure on the basis of the facts stated in the opinion. Surely it is not an obvious proposition that dissolution is the appropriate remedy for excess salary payments. The court could have simply ordered Harding to repay the excess amount to the company and instructed him not to draw additional amounts without approval of Compton. Similarly, the court could have ordered the corporation to hold periodic board meetings. While Harding's "imperious attitude" toward Compton might have made working relations between them difficult, it is not clear that a personality clash is sufficient to justify dissolution.

In deciding whether to order dissolution for oppression a court not only should determine whether there have been oppressive acts but also must determine whether dissolution is the appropriate rem-

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29. 6 Ill. App. 3d 488, 285 N.E.2d 574 (1973).

30. There was a third shareholder, Compton's brother, who held an unspecified amount of stock.

31. 6 Ill. App. 3d at 499, 285 N.E.2d at 581.

edy.<sup>32</sup> Unfortunately, the *Compton* court did not analyze the probable alternative results of both dissolution and continuation of the business.

Both *Gray* and *Compton* illustrate that a shareholders' agreement often fails to anticipate the types of problems that may subsequently be confronted. The attorney who is asked to draft a shareholders' agreement cannot possibly foresee every contingency that might arise. Nevertheless, careful thought should be given to providing mechanisms for dispute settlement that will avoid or at least reduce the likelihood of litigation.<sup>33</sup> There are several possibilities, although none of them are free from difficulty. First, the agreement might provide for an automatic buyout right in the event either party petitions for dissolution. There is, of course, a danger here that a wealthy shareholder might use this as a means of forcing out an impecunious shareholder. Second, the agreement might provide for submission of the dispute to arbitration. The problem here, of course, is that generally it would seem unwise to have the company run by an arbitrator for an extended period of time. Third, the parties might agree to an automatic increase in the board of directors with the election of a previously determined provisional director. This, of course, has the same problem as arbitration with the additional difficulty of having to specify the arbitrator in advance. Finally, the parties might consider limiting the life of the corporation to a relatively short period, e.g., five to ten years, thereby forcing a periodic renegotiation in order to allow the business to continue. This can, of course, cause inequities that are impossible to forecast at the time the agreement is drawn.

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32. See generally Chayes, *Madame Wagner and the Close Corporation*, 73 HARV. L. REV. 1532 (1960).

33. See O'Connell, *Dissolution as a Remedy for Dissension and Deadlock in the New York Closely-Held Corporation*, 19 BUFF. L. REV. 585, 593-95 (1970).