



**Digital Commons@**

Loyola Marymount University  
LMU Loyola Law School

Loyola of Los Angeles Law Review

---

Volume 9  
Number 4 *California's New General Corporation  
Law: A Symposium*

Article 5

---

9-1-1976

## A Comparative Assessment of the California Close Corporation Provisions and a Proposal for Protecting Individual Participants

Edwin J. Bradley

Follow this and additional works at: <https://digitalcommons.lmu.edu/llr>



Part of the [Law Commons](#)

---

### Recommended Citation

Edwin J. Bradley, *A Comparative Assessment of the California Close Corporation Provisions and a Proposal for Protecting Individual Participants*, 9 Loy. L.A. L. Rev. 865 (1976).

Available at: <https://digitalcommons.lmu.edu/llr/vol9/iss4/5>

This Symposium is brought to you for free and open access by the Law Reviews at Digital Commons @ Loyola Marymount University and Loyola Law School. It has been accepted for inclusion in Loyola of Los Angeles Law Review by an authorized administrator of Digital Commons@Loyola Marymount University and Loyola Law School. For more information, please contact [digitalcommons@lmu.edu](mailto:digitalcommons@lmu.edu).

# A COMPARATIVE ASSESSMENT OF THE CALIFORNIA CLOSE CORPORATION PROVISIONS AND A PROPOSAL FOR PROTECTING INDIVIDUAL PARTICIPANTS

by Edwin J. Bradley\*

## I. INTRODUCTION

This article analyzes the recently enacted California corporation code<sup>1</sup> as it pertains to the close corporation. The objectives and principles which should animate legislation governing the close corporation are proffered as the basis of this analysis. In general, the article submits that close corporation legislation should do two things: (a) liberate close corporation planning, and (b) minimize unfair treatment of minority shareholders. The conclusions arrived at are, first, that the California statute accomplishes much but not all of the hoped-for contractual liberation of close corporation planning and that in some respects the provisions are not consistent with the fundamental policy considerations which should guide close corporation legislation. Further, the article contends that a major area of unfinished business remains with respect to the second objective, that of minimizing unfair treatment of minority shareholders in the close corporation. The article concludes with a proposal that a statute should define the close corporation on a mandatory basis and supplement that mandatory definition with provisions conferring upon each participant in the close corporation certain presumptive minimum rights.

## II. POLICIES AND OBJECTIVES OF CLOSE CORPORATION STATUTORY PROVISIONS

### A. *Planning Liberation—The Contractual Principle*

The preeminent purpose of close corporation legislation is to free planning from senseless legal obstacles. The strong legislative trend<sup>2</sup>

\* B.A., 1950 (Mt. St. Mary's College); LL.B., 1955 (Georgetown University); Professor, Georgetown University Law Center.

1. Law of Sept. 12, 1975, ch. 682, § 7, [1975] Cal. Stat. — [hereinafter cited as GCL or General Corporation Law].

The GCL will take effect on January 1, 1977. Amendments were adopted by enactment of the technical amendments bill, August 27, 1976, ch. 641, [1976] Cal. Stat. —. These amendments are reflected in the article where relevant.

2. See for examples of comprehensive close corporation statutes DEL. CODE ANN. tit.

is opposed to hobbling the close corporation by a set of rigidified prescriptions pertaining to how a corporation ought to be set up and operated. The foremost expectation from a particular close corporation legislative reform is the declaration of a pervasive principle of freedom of contractual planning so that the participants may adopt whatever arrangements they decide are useful and conducive to the success of their venture. That principle should apply to every facet of the close corporation's affairs. The point should be made with the utmost clarity that the price for limited liability and the corporate entity privilege is not a planning straightjacket.

The California close corporation provisions require examination on the basis of this first objective of close corporation legislation to determine whether they include a generous and comprehensive legitimization of arrangements pertaining to every important category of close corporation planning. Those categories include shareholder voting; guarantees of directorships; the functioning of the board of directors; guarantees of employment and compensation; the mechanism and manner of formulating business policy; business administration and supervisory responsibilities and autonomy; financial policy and distribution of profits; fundamental changes with respect to the capital structure or otherwise; settling disagreements, resolving deadlock and dissolution; and stock transfer restrictions.

### *B. Protection of Individual Participants— The Fiduciary Principle*

Close corporation legislation may also be expected to confront the need to minimize unfairness and oppression of minority shareholders. This is a problem which has been dealt with to some extent but inadequately by the courts.<sup>3</sup> To date, close corporation legislation has missed the boat on this point.

---

8, §§ 341-356 (1974); KAN. STAT. ANN. §§ 17-7201 - 17-7216 (1974); MD. ANN. CODE tit 4, §§ 4-101 - 4-603 (1975); PA. STAT. ANN. tit. 15, §§ 1371-1386 (1974); TEX. CIV. STAT. art. 2.30-1 - 2.30-5 (Supp. 1975).

As representative of treatment given by noncomprehensive statutory schemes see shareholder provisions, GA. CODE ANN. § 22-611 (1970); MICH. COMP. LAWS ANN. § 450.1463 (Supp. 1975); N.J. STAT. ANN. § 14A:5-21 (Supp. 1974); N.Y. BUS. CORP. LAW § 620 (McKinney 1974); N.C. GEN. STAT. § 55-73 (1975); S.C. CODE ANN. § 12-16.22 (Supp. 1975); TENN. CODE ANN. § 48-714 (Supp. 1975).

3. In *Jones v. H.F. Ahmanson*, 1 Cal. 3d 93, 460 P.2d 464, 81 Cal. Rptr. 592 (1969), Justice Traynor noted:

The increasingly complex transactions of the business and financial communities demonstrate the inadequacy of the traditional theories of fiduciary obligation as

By de facto definition, the close corporation involves few participants who are engaged in a business together on a fairly intimate personal basis and in a relatively closely-knit relationship. That reality justifies a natural presumption that each participant is meant to have certain minimum rights. Moreover it justifies the presumption that each of the participants understands and is sympathetic to the expectations which each of the other participants has from the business relationship and that each is willing to work for their mutual realization. It should not be assumed that the associates in a close corporation have the right to be primarily self-serving. The highly personal and closely-knit relationship makes a stringent fiduciary principle more appropriate as a basis for defining the legal concepts to control that relationship.

In addressing the problem of unfairness and oppression in the close corporation, legislation will have to first define the close corporation in a manner which does not make that status merely optional. In addition, care must be taken to make sure that the substantive provisions do not affirmatively assist the majority in effecting an unfair situation for minority shareholders. Finally, the statute should formulate a set of minimum rights which each participant is entitled to, however, only presumptively and subject to the agreement of the parties. An equal voice in management and an equal share of profits would deserve the highest priority for inclusion in a catalogue of minimum rights, as would the right to information about the business. Other rights may be similarly deduced from the innate features of the close corporation relationship. The objective is to protect individual participants against exclusion from management, employment, salaries, dividends or other forms of corporate freeze-out, unless it is clear that what is happening is according to a compact unanimously arrived at. Legislation should nourish the principle that the close corporation is a cooperative undertaking for the mutual benefit of all of the parties involved.

### III. RESUMÉ OF THE CALIFORNIA PROVISIONS OF SPECIAL REFERENCE TO THE CLOSE CORPORATION

The California legislative technique of regulating close corporations is to intersperse special close corporation provisions among the general provisions. No separate chapter segregates the special provisions. A

---

tests of majority shareholder responsibility to the minority. These theories have failed to afford adequate protection to minority shareholders and particularly to those in closely held corporations . . . .  
*Id.* at 111, 460 P.2d at 473, 81 Cal. Rptr. at 601.

"close corporation" is defined<sup>4</sup> and certain substantive provisions are made applicable to those corporations.<sup>5</sup> Other provisions relating to its formation and termination are set forth. The general statutory provisions apply to the close corporation unless the context requires otherwise.<sup>6</sup> They often affect vital planning areas and provide useful planning devices. The innovative special close corporation provisions naturally command greater interest and have a more far-reaching effect. Section 158(g) lists all sections making specific reference to the close corporation.<sup>7</sup> A full assessment of the statute must take into account the general provisions as well.

### A. *The Definition*

The definition of a close corporation found in section 158(a) of the new California statute is simply a corporation whose articles say "this corporation is a close corporation"<sup>8</sup> and limit the number of shareholders of record to a specific number which cannot exceed ten.<sup>9</sup> These are the only definitional elements.<sup>10</sup>

---

4. GCL, *supra* note 1, § 158(a).

5. *Id.* §§ 186, 202(a), 204, 300, 418, 421, 706, 1111, 1201, 1800, 1904.

6. *Id.* § 101.

7. *Id.* §§ 186, 202(a), 204, 300, 418, 421, 706, 1111, 1201, 1800, 1904.

8. The close corporation is formed by means of the same mechanics used to form any corporation. For example, sections 202 and 204 govern the mandatory and optional provisions of the articles except that section 158 requires the additional close corporation recitals. Section 202(a) requires that the name of a close corporation contain the word "corporation," "incorporated" or "limited" or an abbreviation thereof. GCL, *supra* note 1, §§ 202, 204, 158, 202(a).

9. Section 158(d) of the GCL permits counting husband and wife as one shareholder, as well as a corporation, partnership or trust, unless formed deliberately for the purpose of evading the number limit. For Subchapter S purposes, section 1371(a)(2) of the INTERNAL REVENUE CODE of 1954 allows only an individual, other than an estate, to be a shareholder but section 1371(c) does permit counting husband and wife as one shareholder. However, Treas. Reg. § 1.1371-1(d) (1968) treats each joint, common or entirety tenant, other than a husband and wife, as a separate shareholder and further states in (e) that a corporation in which any shareholder is a corporation, trust or partnership does not qualify. Voting trusts are not trusts for Subchapter S purposes. *A. & N. Furniture and Appliance Co. v. United States*, 271 F. Supp. 40 (S.D. Ohio 1967).

For purposes of meeting the California securities exemption requirement of ten or less beneficial owners, CAL. CORP. CODE ANN. § 25102(h) (West Supp. 1976) allows husband and wife to be counted as one. Commissioner's Rule 102.5 states that securities held by a partnership or joint venture are deemed to be beneficially owned by each partner or venturer and securities held by a trust are deemed owned by each of the beneficiaries. 10 CAL. ADM. CODE § 260.102.5.

10. Although DEL. CODE ANN. tit. 8, § 342(a)(1) (1974) is the source of the definition, see CALIFORNIA LEGISLATIVE ASSEMBLY COMMITTEE ON CORPORATIONS, EXPOSURE DRAFT NO. 2: GENERAL CORPORATION LAW 6 (Oct. 4, 1974) [hereinafter

*B. The Key Substantive Provisions: Sections 300(b) and 706(a)*

Sections 300(b) and 706(a) comprise the substantive heart of the special provisions validating close corporation planning arrangements. The former section is the most revolutionary in effect among the new provisions. This provision relates to "shareholders' agreements,"<sup>11</sup> which effect any phase of the affairs of the close corporation, including but not limited to, the management of the business, the division of its profits and the distribution of its assets upon liquidation. Such shareholders' agreements are defined in a way which require the assent of all the shareholders. Section 706(a) validates close corporation shareholder voting agreements, among two or more shareholders.

IV. THE MAJOR SUBSTANTIVE PROVISIONS—  
WHAT DO THEY ACCOMPLISH?

Assume a new venture is in formation. The parties, each with their respective and relative bargaining power, are all deeply involved in the planning and bargaining process. A deal is struck involving novel and drastic departures from the usual ways of corporate life. What degree of legal certainty attaches to the arrangements agreed upon? To what extent can the special close corporation provisions be counted on to sustain their validity?

*A. Section 300(b): Shareholder Agreements*

1. Agreements Adopting Partnership Practices

Both counsel and the business associates seek the utmost in legal certainty for planning arrangements intended to protect themselves and assure realization of management and profit sharing expectations. For that reason, the statute should be free as possible from ambiguity and should not invite unintended narrowing constructions or interpretations.

The claim may be made with great force that the intent of the draftsmen of the new California general corporation law must have been to legitimize, on a sweeping basis, close corporation planning agreements. However, section 300(b) is not as specific and comprehensive

---

cited as EXPOSURE DRAFT No. 2], the California draftsmen wisely jettisoned the definitional prohibition found in the Delaware section against a public offering under the Securities Act of 1933, 15 U.S.C. § 77(a) *et seq.* (1970). Few concepts suffer from more uncertainty. The Delaware shareholder ceiling of 30, DEL. CODE ANN. tit. 8, § 342(a)(1) (1974), was also departed from.

11. GCL, *supra* note 1, § 186.

as it could be and its negative and eccentric form detracts from its clarity and force.

Section 300(b) provides in pertinent part:

[N]o shareholders' agreement, which relates to any phase of the affairs of a close corporation, including but not limited to management of its business, division of its profits or distribution of its assets on liquidation, shall be invalid as between the parties thereto on the ground . . . that it is an attempt to treat the corporation as if it were a partnership or to arrange their relationships in a manner that would be appropriate only between partners.<sup>12</sup>

"Shareholders' agreement" is defined as a written agreement among all of the shareholders of a close corporation.<sup>13</sup>

The drafting model followed in section 300(b) traces back to the pioneer effort in close corporation legislation, *i.e.*, the North Carolina statute.<sup>14</sup> Two things stand out about the drafting technique employed: the negative thrust, that no agreement shall be invalid, and the reference to two specific rationales for possible invalidation. The tentativeness and indirect approach may have been understandable in the hostile legal environment facing the North Carolina draftsmen. Today, a straightforward affirmation of the validity of close corporation shareholders' agreements would be more fitting.

---

12. *Id.* § 300(b).

13. *Id.* § 186.

Transferees of shares are covered by the obligations of a section 300(b) shareholders' agreement if that agreement is (a) filed for inspection with the secretary of the corporation and (b) the purchaser has actual knowledge thereof or notice by a notation provided for in section 418(c). The transferee ceases to be a party unless he was a party to the contract in a capacity other than as a shareholder. The transferee must then consent to any change in the contract unless a change upon consent of less than all the shareholders is provided for in the contract. Transferees of shares are also bound by shareholder voting agreements entered into under section 706(a) and irrevocable proxies under section 705(e), if the transferee has actual notice or if a statement of the fact of such arrangements appears on the stock certificate as provided in section 418(c). GCL, *supra* note 1, §§ 300(b), 418(c), 706(a), 705(e).

14. N.C. GEN. STAT. § 55-73(b) and (c) (1975). See Latty, *The Close Corporation and the New North Carolina Business Corporation Act*, 34 N. CAR. L. REV. 432 (1956) [hereinafter cited as Latty].

DEL. CODE ANN. tit. 8, §§ 350, 354 (1974) seem to have the same ancestry as GCL, *supra* note 1, § 300(b). California consolidates the "partnership" and "director-discretion" rationales into a single section and cleans up the confusion and contradictions of the North Carolina and Delaware sections. This was something of a near miss since the EXPOSURE DRAFT NO. 2, *supra* note 10, was hopelessly muddled providing for partnership-type arrangements on the vote of all the shareholders and validated "director-discretion" contracts if entered into by "all or less than all" of the shareholders. *Id.* at 24.

The chief draftsman of the North Carolina close corporation provisions has described the "incorporated partnership" language as serving merely to set a friendly tone which might prove useful in unanticipated cases not specifically covered, but the function was chiefly envisioned as a basic philosophy provision.<sup>15</sup> That function would be fine if the statute were to proceed to affirmatively validate agreements involving a comprehensive and specific catalogue of close corporation planning matters.<sup>16</sup>

Courts might pronounce a contract bad for reasons other than those specified, although the reason should have to be a very good one if all of the shareholders have consented. However, instead of having to depend on that hope, planners would be better off with the protection of statutory language which directly and flatly validates the agreements and does not invite the invention of other nullifying rationales.<sup>17</sup> The earnest hope is that the California courts will resist the temptation to invent other reasons to strike down shareholders' agreements. The purpose and spirit of the California legislation was clearly to liberate close corporation planning from legal doubt to a pervasive extent.<sup>18</sup> The legislature should be understood as acknowledging the vital need for creative close corporation shareholders' agreements and their great

15. Latty, *supra* note 14, at 438.

16. Maryland exemplifies a straightforward drafting technique. Section 4-401 of the Maryland Code 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;
- (2) Restrictions on the transfer of stock;
- (3) The right of one or more stockholders to dissolve the corporation at will or on the occurrence of a specified event or contingency;
- (4) The exercise or division of voting power;
- (5) The terms and conditions of employment of an officer or employee of the corporation, without regard to the period of his employment;
- (6) The individuals who are to be directors and officers of the corporation; and
- (7) The payment of dividends or the division of profits.

(b) *Amending unanimous stockholders' agreement*—A unanimous stockholders' agreement may be amended, but only by the unanimous written consent of the stockholders then parties to the agreement.

MD. ANN. CODE tit. 4, § 4-401 (1975) (emphasis in original). See also TEX. REV. CIV. STAT. ANN. art. 2.30-2 (Cum. Supp. 1975).

17. California precedents conform to the customary theme at common law that management by the board may not be made the subject of contractual deviation. See, e.g., *Kennerson v. Burbank Amusement Co.*, 120 Cal. App. 2d 157, 260 P.2d 823 (1953); *Smith v. California Thorn Cordage, Inc.*, 129 Cal. App. 93, 18 P.2d 393 (1933). But see *Merlino v. West Coast Macaroni Mfg. Co.*, 90 Cal. App. 2d 106, 202 P.2d 748 (1949).

18. See generally 1 F. O'NEAL, CLOSE CORPORATIONS: LAW AND PRACTICE §§ 5.04-.06 (1971) [hereinafter cited as O'NEAL].



utility as investment incentives and bulwarks against unfairness or oppression.<sup>19</sup>

## 2. Agreements Interfering with Board Discretion

The California statute fails to expressly provide for the option of management of the close corporation directly and exclusively by the shareholders. Authorization for a governance system which abandons the traditional board of directors is found in several of the leading close corporation statutes.<sup>20</sup> The argument can be made that section 300(b), along with sections 204(d) and 212(b),<sup>21</sup> support a close corporation arrangement which abolishes the board. Section 300(b) provides in pertinent part:

[N]o shareholders' agreement which relates to any phase of the affairs of a close corporation, including but not limited to management of its business, division of its profits or distribution of its assets on liquidation, shall be invalid as between the parties thereto on the ground that it so relates to the conduct as to interfere with the discretion of the board

. . .<sup>22</sup>

In combination, those sections may permit a complete "sterilization" of the board of directors as a partnership-type modification. However, the pointed omission from the statute of a shareholder-management provision similar to those of other statutes places that possible construction of the statute very much in doubt. That conclusion creates a disturbing thought about the scope of section 300(b). If that section cannot be construed as allowing the abolition of the board of directors, then what is the limit upon shareholders' agreements which restrict the discretion of the board of directors? If the discretion of the board may be inhibited only up to a point, a pall is cast over the prospects that

19. A shareholders' agreement under section 300(b) may not waive or alter certain statutory provisions which are set forth in section 300(c). Contractual tampering with the definition of a close corporation is forbidden. For example, the parties can't agree that instead of the statutory 10, the maximum number of shareholders is to be 20. Nor may an agreement excuse compliance with the regulations of dividends and share purchases, GCL, *supra* note 1, §§ 500, 501. And the proscription also applies to sections 1111 and 1201 (special voting on mergers and reorganizations which terminate close corporation status); Chapter 15 (corporate records and reports); Chapter 16 (inspection rights); Chapter 18 (involuntary dissolution); and Chapter 22 (crimes and penalties). GCL, *supra* note 1, §§ 300(b), 300(c), 1111, 1201.

20. *See, e.g.*, DEL. CODE ANN. tit. 8, § 351 (1974); MD. ANN. CODE tit. 4, § 4-303 (1975); TEX. REV. CIV. STAT. ANN. art. 2.30-1(G) (Cum. Supp. 1975).

21. *See* notes 40-42 *infra* and accompanying text for discussion of GCL, *supra* note 1, §§ 204(d) and 212(b).

22. GCL, *supra* note 1, § 300(b).

section 300(b) liberates close corporation planning from needless legal uncertainty. A way out for the courts, if they are sympathetic to the purpose of this legislation and want to see it accomplish a full measure of the intended reform, is to construe section 300(b), buttressed by sections 204(d) and 212(b), as permitting shareholder management. That is, after all, the logical outcome of the incorporated partnership concept. It is also consistent with the spirit and policy behind the close corporation portions of the statute. If management and ownership overlap, removing an unnecessary tier of bureaucracy makes sense, for in the close corporation centralized management is not a needed expedient.

A construction of section 300(b) as allowing the total abolition of the board of directors would clear the air but it is not particularly necessary in terms of solving a practical need in close corporation planning. Shareholder management is not a planning alternative that is vitally needed in order to solve planning problems which cannot be solved in any other way. If the substantive provisions respecting shareholders' agreements restricting director discretion and shareholder voting agreements are generously construed so as to uphold all manner of arrangements not shown to be positively harmful to creditor or other interests in a rational sense, shareholder management as such is not really needed to accomplish any planning goal not otherwise attainable. That is to say, once close corporation planning is relieved from serious legal doubt as to agreements which impinge upon the free exercise of discretion by the board of directors, the pressure is lifted to resort to shareholder management as an end run around the common law objections concerning limiting board discretion.

Whether director management or shareholder management is used, the fundamental planning questions are the same. Who is to make what decisions and by what vote? Management directly by the shareholders does not inherently solve any important planning problem except that it eliminates the need to guarantee particular shareholders a directorship. But that is a simple thing to do through cumulative voting, classes of stock or shareholders' voting agreements. The gain in avoiding director meeting formalities is slight in the close corporation. Also, there is a real human problem in trying to do business in the market place as a corporation with no board of directors. Such a creature is a strange animal indeed to, for example, the traditionalist bank loan officer for whom novelty is calamity.

The absence of the shareholder management option from the California statute may have stemmed from a nagging worry about veil

piercing induced by the use of innovative corporation arrangements. The statute does bespeak that concern even as to the seemingly less revolutionary section 300(b) permission to restrict the discretion of directors. The courts are exhorted to refrain from penetrating the corporation shield by section 300(e) which provides:

The failure of a close corporation to observe corporate formalities relating to meetings of directors or shareholders in connection with the management of its affairs, pursuant to an agreement authorized by subdivision (b), shall not be considered a factor tending to establish that the shareholders have personal liability for corporate obligations.<sup>23</sup>

The fervent hope is that section 300(e) will convince the courts to conclude that limited liability is compatible with a corporate governance structure that varies from the ancient rites of the corporation.

### B. Section 706(a): Shareholder Voting Agreements

#### 1. Validation of Agreements: Self-Execution Devices

Section 706(a) deals with a much less embattled common law sector, shareholder voting agreements. Its language would seem to confer a *carte blanche* upon the business associates and their counsel to map out whatever allocation or division of voting power and whatever manner of exercising the voting right they find suitable and serviceable, no matter how unorthodox or imaginative. Some of the general sections also support the highly flexible use of traditional methods of structuring decision-making in the corporation and will be described below.<sup>24</sup>

Section 706(a) imposes no time limitation on shareholder voting agreements.<sup>25</sup> The section contains a strong exhortation to the courts to specifically enforce voting agreements despite the absence of the traditional equity jurisdictional requirement, inadequacy of a remedy at law. But the planner will always seek self-executing mechanisms for shareholder voting agreements. Lawsuits are a wholly futile device

---

23. *Id.* § 300(e).

24. See text accompanying notes 25-27 *infra*.

25. A ten year limitation on shareholder agreements is imposed by DEL. CODE ANN. tit. 8, § 218(c) (1974). It was both a good and a bad idea not to copy that limitation. Since section 706(a) of the GCL applies strictly to a close corporation, unlike the Delaware provision, no justification for a time limit exists if all shareholders are required to be parties. If a time limit is thought to be useful in a given case, the parties may fix it for themselves. In this application, the limitation would be a bad idea. However, the section also applies to agreements between two or more shareholders. A ten-year limitation seems a good idea in a statute which does not require all shareholders to consent. The limitation would prevent perpetual control alliances among less than all of the shareholders.

for getting the shares voted in the way promised. Hence, irrevocable proxies and voting trusts were conceived. Section 706(a) appears to suggest a distinctive kind of special close corporation transfer of stock to third persons for voting purposes in conjunction with voting agreements. What that really means and does is not clear. The most obvious guess is that the provision is meant to deal with a situation where, for example, two shareholders agree to vote in unison and agree to arbitration by a third person if they cannot concur on the manner of voting.<sup>26</sup> But the problem with the statute is the same one which plagued efforts of this same kind at common law—is the transfer to the arbitrator, if that is what is envisioned by section 706(a), revocable or not? If a lawsuit is needed to vindicate the third person's right to retain and vote the stock, the method is unsatisfactory and inferior to either the proxy, if it can be made irrevocable, or the voting trust.

Section 706(b), a general provision, is a standard voting trust provision, though new in California in some respects. It stipulates compliance with the usual voting trust formalities and fixes a ten year time limitation. Section 706(c) makes clear that a voting agreement which is not in compliance with the formal voting trust statutory requirements is not to be nullified for that reason. Hence, it is possible to escape the rigid ten year limitation of the voting trust by use of the section 706(a) agreement. In most cases that will be desirable. But, the possible revocability of the section 706(a) transfer of the stock for voting purposes remains as a problem. Section 705(e) makes a proxy irrevocable if it is given to a person designated in a section 706(a) close corporation shareholders' voting agreement.<sup>27</sup> Since a section 706(a) agreement is not subject to any time limitation, and the proxy's life is coextensive, the use of the irrevocable proxy seems to be indicated as the most clearcut self-enforcement mechanism under this statute.<sup>28</sup> That may well be the outcome intended by the nebulous transfer referred to in section 706(a).

---

26. See *Ringling Bros. - Barnum & Bailey Combined Show, Inc. v. Ringling*, 53 A.2d 441 (Del. 1948).

27. A proxy is also rendered irrevocable if it is held by a pledgee, a purchaser or person who has agreed to purchase, or an optionee, a creditor if given to extend or continue credit, a person who has contracted to perform services as employer of the corporation if stated to be in consideration therefor. GCL, *supra* note 1, § 705(e).

28. Section 418(a)(3) requires a statement on the share certificate that the shares are subject to a voting agreement under section 706 or an irrevocable proxy under section 705(e). Otherwise section 418(b) makes those arrangements unenforceable against transferees of shares without actual knowledge. GCL, *supra* note 1, §§ 418(a)(3), 706, 705(e), 418(b).

Section 706(a) seems to validate voting arrangements on a broad front and then provide, in conjunction with section 705(e), for a legally certain self-execution device. Where all of the shareholders are participating in the bargaining and planning, that seems the only relevant question.

## 2. Policy Difficulties With Validation of Voting Agreements Among Less Than All of the Shareholders

Judicial thought in the twentieth century turned to the view that shareholder voting agreements were not legally suspect<sup>29</sup> as were contracts which compromised the independent judgment of the directors. A conceptual block involved in the general thinking about close corporations led to an insistence on assigning the few shareholders of the close corporation discrete roles as shareholders and as directors. That insistence traces to orthodox thinking about corporate governance which saddled the close corporation with stereotyped normative statutory provisions and judicial predilections about how a corporation should be run. For corporations of more widely held shares it made sense to assert that when shareholders act as shareholders they can be expected to seek their own selfish interests with vigor,<sup>30</sup> to fight for control and attempt formation of control alliances to gain control, while as directors they exercise power primarily for the benefit of all of the shareholders. In the latter capacity, they serve as fiduciary representative to the corporation and to the shareholders collectively. The unreality of the distinction is well understood today as it pertains to the close corporation.<sup>31</sup> For example, we have seen that under section 300(b) the hands of the directors may be tied by contract, but it must be done by means of a compact unanimously arrived at.<sup>32</sup>

The partnership theme embraced in section 300(b) should be followed in section 706(a). Partnership law has always recognized a demanding fiduciary duty among partners.<sup>33</sup> Close corporation legislation should disavow the idea that shareholders in a close corporation

---

29. See O'NEAL, *supra* note 18, § 5.04.

30. Of course, significant progress has been made in the courts in holding controlling shareholders to reasonably civilized standards of behavior. *Jones v. Ahmanson*, 1 Cal. 3d 93, 460 P.2d 464, 81 Cal. Rptr. 592 (1969), is outstanding in this respect and will continue to exert great influence. See, e.g., *Bourne v. Jutkowicz*, No. CA 000268 (L.A. Super. Ct. Calif., Nov. 19, 1975).

31. See O'NEAL, *supra* note 18, § 1.07.

32. See text accompanying note 26 *supra*.

33. See, e.g., UNIFORM PARTNERSHIP ACT § 21.

can be expected as a primary matter to pursue their own individual selfish interest. Voting agreements should comport with the same contractual and fiduciary considerations which underlie the requirements for the executing of agreements affecting director action. The variance in treatment in the statute between "director discretion" agreements and "shareholder voting" agreements is a vestige of the discredited common law dichotomy.<sup>34</sup> The same mutual interdependence and need for the highest trust and confidence call for confining shareholder voting agreements to cases where all of the shareholders agree to them.<sup>35</sup>

The common law rule which tolerated agreements governing voting among any number of shareholders seems to have been accepted uncritically as an appropriate close corporation statutory provision.<sup>36</sup> But on analysis, that rule seems inappropriate. It should not be supposed that vital interests are not at stake. Shareholder voting agreements may erect voting patterns which effect a freeze-out against minority shareholders. As a result, the investment of those shareholders may be rendered unproductive and the business relationship entirely uncongenial for them.<sup>37</sup>

---

34. A recent case applying the "corporate business opportunity" aspect of the duty of loyalty manifests an awareness of the meaninglessness of any distinction between a person as a shareholder and as a director for purposes of that doctrine. The court held that competition with the corporation could not be justified unless status as a director, officer and shareholder was terminated. *Cain v. Cain*, 334 N.E.2d 650 (Mass. Ct. App. 1975).

35. The law cannot decree equality of bargaining power. The right to use most effectively whatever bargaining clout a person has, can and should be assured. However, once the majority makes a deal and the law provides enforcement, as section 706(a) of the GCL provides, the minority shareholder is helpless. The fact that the statute makes the agreement valid only as between the parties doesn't mean that the shareholder who is shut out may realistically expect to be able to gain protection from a declaration of invalidity. That seems to be the intended outcome of the statutory language. If the agreement is valid as between the parties and they are threatened by a damage action for non-performance, the coercion to conform to the contract seems to assure that conformity.

36. *See, e.g., GCL, supra note 1, § 706(a).*

37. *E.g., Ringling Bros. - Barnum & Bailey Combined Shows, Inc. v. Ringling*, 53 A.2d 441 (Del. 1948). The two Ringling sisters agreed to vote the stock they owned in unison. By doing so they would control the board of directors and hence the business policy of the corporation and they would make employment, dividend and other crucial decisions. If the third shareholder, eyes open, willingly assumed the status as minority shareholder understanding that a permanent coalition was in control and that through cumulative voting he was to have representation on the board but no guarantee beyond that, the arrangement may be proper. If the business deal is attractive and the minority shareholder is willing to run the risks, that is his choice to make. But if a corporation is routinely formed by three equal shareholders, an alliance created later by two of them is

The statute, as noted, may properly be looked to for the broadest feasible validation of shareholder agreements in the close corporation, whether relating to what "shareholders" do or what "directors" do. However, in both cases that should require the consent of all of the business associates. Agreements among less than all should be left to seek validation by courts only if those who claim validity are able to show that the agreement can pass a stiff test of nonprejudice to shareholders who are not parties.

*C. Effect of End of Close Corporation Status on  
Shareholders' Agreements*

A close corporation shareholders' agreement which involves partnership-like arrangements or invades the board's discretion is terminated by section 300(b) upon the termination of close corporation status. Section 706(a) causes a similar termination for voting agreements. The statute might better have provided that the agreements survive to the extent they are valid under the general statutory provisions or at common law, unless the agreement itself provides for termination or termination is agreed to by all of the shareholders at the time the close corporation status is divested.<sup>38</sup> This would best preserve the original intentions of the parties.

A question left unanswered by sections 300(b) and 706(a) is whether the shareholders of a close corporation may agree that the agreements are to continue in effect in the event of termination of close corporation status. If shareholders have a backstop shareholders' agreement to govern the relationship as a non-close corporation will it be enforceable? Another way of raising the same question is to ask whether shareholder agreements which impinge on board discretion or affect shareholder voting are valid under the general provisions as applicable to a non-close corporation or at common law in California.

The decrees of termination of the 'shareholders' agreements found in sections 300(b) and 706(a) do not necessarily have to be read as

---

essentially unfair to and is inconsistent with the reasonable and justifiable expectations of the third shareholder.

38. *See, e.g.*, TEX. REV. CIV. STAT. ANN. art. 2.30-2(D) (Cum. Supp. 1975) which provides that:

If an agreement authorized by this Article contains any provisions which would not be valid under other provisions of the Act, such provisions shall be valid only so long as the corporation maintains its status as a close corporation under this Act. No other provision of the agreement shall be affected unless the parties thereto otherwise provide.

*Id.*

meaning that agreements of the same general kind are not valid in a non-close corporation. They do imply that position because they pointedly apply to only the close corporation. But section 706(c) provides that the section does not invalidate any voting or other agreement among shareholders not otherwise illegal. While the statute does not elsewhere contain a provision applicable to all corporations validating shareholder voting agreements, at common law shareholder agreements were usually sustained.<sup>39</sup> If the close corporation shareholders plainly agree that upon termination of close corporation status a backstop shareholder voting agreement is to become operative, the chances are good that it will be a valid agreement.

Absent close corporation status, the validity of a shareholders' agreement which impinges on board discretion is a much more troublesome point. Nothing in the statute even hints at validity and the common law picture is cloudy. If all of the shareholders are parties to the agreement, it may be valid if it doesn't go too far in compromising the board's classic prerogative to manage the business with an exercise of independent discretion.

## V. GENERAL STATUTORY PROVISIONS AFFECTING CORPORATION PLANNING FREEDOM

### A. *Governance In General*

Section 300(a) is the typical provision stating that the board shall manage. But that "norm" is made subject to a broad proviso: "[s]ubject to . . . limitations in the articles relating to action required to be approved by the shareholders. . . ."<sup>40</sup> Section 204(d) permits the articles to contain "[a]ny other provision, not in conflict with the law, for the management of the business and for the conduct of the affairs of the corporation. . . ."<sup>41</sup> Section 212(b) permits the bylaws to contain any provision, not in conflict with law or articles, for the management of the business and for the conduct of the affairs of the corporation, including the qualifications, duties and compensation of directors; appointment and authority of committees of the board; and the appointment, duties, compensation and tenure of officers. Section 312(b) provides that officers shall be chosen by the board and serve at the pleasure of the board except as otherwise provided in the articles, bylaws or board resolution.

---

39. See O'NEAL, *supra* note 18, § 5.04.

40. GCL, *supra* note 1, § 300(a).

41. *Id.* § 204(d).



These are traditional provisions and their approximate counterparts are present in many corporation statutes. Courts have not been inclined toward viewing them as legislative sanction for adventuresome contractual variations from the stereotyped, normative statutory corporate model. However, the effect of the enactment of a new California statute including close corporation provisions evidencing a public policy favoring flexibility of planning may be to give these provisions a new and real significance for corporation planning flexibility, at least in the close corporation.<sup>42</sup> If a corporation does not elect the special close corporation status, these sections, if construed generously as the literal language invites, along with the other general provisions described hereafter, seem to provide a legislative basis for flexible planning almost as broad as the special close corporation provisions. But that may be a highly disputed matter in terms of legislative intent. It may be argued that a corporation must clearly identify itself as a legislative close corporation in order to make special planning arrangements legally acceptable.

### B. *Voting of Shares; Classes of Stock*

Great planning latitude emerges from the collection of provisions in the area of voting of shares and stock classification. Shareholder voting is subject to a rule of one share, one vote<sup>43</sup> but variations are possible; more or less than one vote per share may be conferred,<sup>44</sup> classes of stock with different voting features may be created,<sup>45</sup> debt securities may be given a voting right<sup>46</sup> and the planner may employ shareholder voting agreements,<sup>47</sup> voting trusts,<sup>48</sup> and irrevocable proxies.<sup>49</sup> Section

---

42. DEL. CODE ANN. tit. 8, § 102(b)(1) (1974) similarly provides for provisions regarding corporate management to be contained in the certificate of incorporation. The chairman of the drafting committee has commented by saying that section 102(b)(1) of the Delaware Code confers power to include any provision deemed appropriate for the conduct of corporate affairs. This includes stockholder power to embody in the charter a provision departing from the common law rules, provided that it does not transgress a statutory enactment or a public policy settled by the common law or implicit in the General Corporation Law itself. E. FOLK, *THE DELAWARE GENERAL CORPORATION LAW: A COMMENTARY AND ANALYSIS* 10 (1972).

43. GCL, *supra* note 1, § 700(a).

44. *Id.* § 112. This section is not explicit authority for allowing more or less than one vote per share. Rather, it makes specific reference to such a possibility in determining what a majority of shares means. Implicitly, therefore, disproportionate voting is valid.

45. *Id.* § 400(a).

46. *Id.* § 204(a)(7).

47. *Id.* § 706(d).

48. *Id.* § 706(b).

49. *Id.* § 705(e)(5).

418 requires a statement to be placed upon the share certificate of whatever voting restrictions are imposed upon the stock of a close corporation in order to make the restriction effective against a transferee of shares without actual notice.

If classes of stock are used, a careful and detailed delineation of the special rights, preferences, privileges and restrictions must be undertaken in the articles or "shareholders' agreement."<sup>50</sup> Section 301(a) specifically allows the use of a class of stock to elect a certain number of directors, a very prevalent use of classes of stock. The use of classes of stock has other planning applications and is a highly effective planning device.<sup>51</sup>

### C. Cumulative Voting

Section 708 perpetuates a California corporation statutory trademark—compulsory availability of cumulative voting. Cumulative voting

---

50. *Id.* § 203.

51. As admirable a device as stock classification may be for general corporate planning purposes, Subchapter S of the Internal Revenue Code and the requirements of the California Securities Law exemptions furnish disincentives to its use. The planner must do some adroit juggling. For Subchapter S purposes, classes of stock are not permitted. INT. REV. CODE of 1954 § 1371(a). An exception is where the qualities or characteristics of the stock of all classes are identical and the voting power is proportionate to the number of shares owned. Treas. Reg. 1.371-1(g) (1968). Thus, if there are three classes of common stock each consisting of 100 shares and each with the right to elect one director to a three person board of directors, and in all other respects the shares are identical as to their rights the stock will be deemed to be a single class. *Id.* Clearly, voting and non-voting classes of shares may not be used nor may shares with disproportionate voting power. It has been held that if voting and dividend differences between classes are compelled by the Corporation Commissioner, Subchapter S status is lost. *Paige v. United States*, 36 Am. Fed. Tax R.2d 75-5408 (C.D. Cal. 1975). Debt securities may constitute a second class of stock, and provisions in the articles which confer voting power disproportionate to the percentage of stock ownership are in grievous danger of having the effect of creating more than one class of stock for Subchapter S purposes. It seems now to be established at least that voting trusts, irrevocable proxies and shareholder voting agreements are safe and will not be given that effect if they are not formally created by the articles, whatever sense there may be in that distinction. *Parker Oil Co.*, 58 T.C. 985 (1972); Rev. Rul. 73-611, 1973-2 CUM. BULL. 312. See generally 7 CCH STANDARD FED. TAX REP. 4846C.20-47 (1976); 4 P-H 1976 FED. TAXES ¶ 33,367. Section 203 of the GCL, which allows various arrangements affecting voting of shares to be contained in a shareholders' agreement, would seem to have some potential importance in this regard.

The California Securities Law grants an exemption for a close corporation which is defined by resort to certain criteria, one of which is that the corporation have a single class of voting common stock. CAL. CORP. CODE ANN. § 25102(h) (West Supp. 1976). Debt securities evidently are not subject to the charge that they constitute a second class of stock 10 CAL. ADM. CODE § 260.102.4. No reason exists to think that shareholder agreements, proxies, voting trusts or anything of the sort will jeopardize the exemption.

may serve well as a planning measure in a particular situation, but the planner must protect its efficacy by supplemental provisions controlling the number of directors<sup>52</sup> to be elected and the number of shares outstanding. Presumably, since the statute does not indicate otherwise, the cumulative voting provision does not ban the use of non-voting stock, or classes of stock with special director-voting rights. Nor are shareholder voting agreements inconsistent with a cumulative voting system.

#### D. High Vote and Quorum Requirements

High vote and quorum requirements are useful in providing shareholders with vetoes against action detrimental to their interests which cannot be stopped under conventional voting patterns. The familiar shareholder quorum (majority of shares entitled to vote) and voting (majority of those present) rules are statutory rules of thumb made subject, however, to provisions otherwise in the articles.<sup>53</sup> Section 204(a)(5) authorizes a provision in the articles requiring a higher vote than specified in the statute, with some exceptions.<sup>54</sup> High shareholder quorum and voting requirements are thus at the almost full disposal of the planner where their use is deemed expedient.<sup>55</sup>

#### E. Directors

Section 301 requires the annual election of directors. The election is conducted by a plurality vote procedure<sup>56</sup> which is not subject to a high-vote requirement.<sup>57</sup> But denial of the chance to require unanimous election of directors is not a planning calamity. Other ways to guarantee directorships abound.<sup>58</sup> Directors serve the term for which

---

52. Section 212(a) of the GCL provides guidelines for the maximum and minimum number of directors.

53. GCL, *supra* note 1, § 602(a).

54. Section 204(a)(5) of the GCL, through its express exclusion of section 303 from its terms, precludes an increase in the statutory number of votes which, if cast against a director's removal without cause, will block that action. Cumulative voting and class voting are thereby protected. Plurality election of directors commanded by section 708 may not be altered, nor may the section 1900 provision commanding a fifty percent shareholder vote for voluntary dissolution.

55. To insure maximum safety, a careful planner will expressly provide that any high shareholder quorum or voting requirement is also applicable to shareholder action by consent in writing, taken pursuant to section 603(a) of the GCL.

56. GCL, *supra* note 1, § 708(c).

57. *Id.* § 204(a)(5).

58. For example, classes of stock, *id.* § 400, shareholder agreements, *id.* § 706(d), voting trusts, *id.* § 706(b) and irrevocable proxies *id.* § 705(e)(5).

elected or until successors are elected but are subject to removal without cause by a vote of a majority of the outstanding shares,<sup>59</sup> with a limitation designed to protect the cumulative voting right. Obviously, careful planning will protect against removal in any case unless there is excellent reason to allow it.

A mild inflexibility limits the use of the one or two-person board of directors to the one or two-shareholder corporation, respectively, otherwise the board must consist of three directors.<sup>60</sup> Where there are more than two shareholders, some other method of lodging control of the business in the hands of one or two must be found. Classes of stock, if not ruled out for other reasons, would be a workable method. Section 300(b) is clearly intended to be used for such arrangement in the statutory close corporation.

Director action may be made subject to a high-vote requirement.<sup>61</sup> Section 300(b) limits agreements interfering with board discretion to close corporations and requires the approval of all shareholders. The agreement terminates with close corporation status. In non-close corporations, such agreements are of doubtful validity. Nothing in the statute speaks to that point.

#### F. Amendments of the Articles

A standard amendment provision prescribes approval by the board of an amendment resolution and approval by the outstanding shares;<sup>62</sup> that is, approval by a majority of the outstanding shares entitled to vote,<sup>63</sup> subject to statutory<sup>64</sup> or agreed-upon class voting requirements. A higher vote may be required under section 204(a)(5). Ordinarily, high vote requirements would be indicated as a protective measure for minority participants, but that is a matter of sound planning and bargaining in a particular case.

#### G. Bylaws

The bylaws may be adopted, amended or repealed by the board *or*

---

59. *Id.* § 303(a).

60. *Id.* § 212(a).

61. *Id.* § 204(a)(5).

Proper planning dictates that any high-vote requirement be expressly applicable to director action taken by written consent, pursuant to section 307(f) of the GCL.

62. GCL, *supra* note 1, § 902(a).

63. *Id.* § 152.

64. *Id.* § 903(a).

by approval of the outstanding shares entitled to vote,<sup>65</sup> subject as well to high-vote requirements under section 204(a)(5).

#### *H. Officers, Agents, Employees*

Section 312(a) requires the corporation to have a chairman of the board or a president or both, a secretary and a chief financial officer and such others with such duties as shall be determined by the board or stated in the bylaws. Section 312(b) permits the officers to be chosen as provided for in the bylaws and their tenure may be governed by the bylaws. Hence, this matter is not one of director monopoly and is not, therefore, invariably within the common law no man's land of action involving board discretion. The critical planning questions of who is to be an employee, at what salary and for what tenure, may be answered through the use of bylaw provisions within shareholder voting prerogatives and supplemented by shareholder vetoes and other devices relating to shareholder action.

#### *I. Purpose Clause*

Section 202(b) permits the use in the articles of what is called an "all-purpose" clause. Limitations may, however, be imposed on the authorized scope of the business. Since stockholders often want protection against expansion or diversification, careful planning requires close attention to this matter. The automatic use of the "all-purpose" clause may be contrary to diligent counselling.

#### *J. Capital Structure and Financial Provisions*

Section 202 is a typical provision requiring a charter provision authorizing the corporation to issue a specified number of shares. Sections 400, 202(e) and 301(a) are also not exceptional provisions but they are of enormous utility to the close corporation planner. Those sections combine to allow the use of classes of stock with different dividend, liquidation and other rights, preferences or characteristics. Since the statute allows voting rights to be conferred on debt securities, any review of the use of debt or equity securities may now include the use of voting debt, which may seem strange to many lawyers but can be an excellent answer to a particular planning need.

Section 204(a)(2) allows the articles to provide for preemptive rights, which may be valuable in particular situations but which are no

---

65. *Id.* § 211.

panacea for the problems which beset the planning of the authorized stock level, the procedures for its increase, the issuance of stock and its price. Perhaps no planning area is as bedeviled. A dilemma confronts the planner at the incorporation stage. On the one hand, there is the desirability of providing each participant with a guarantee against future stock issuance which distorts the voting and property proportions carefully worked out in the planning stage. Future issuances may also unfairly dilute existing interests. Pricing close corporation stock is a difficult and uncertain art. They may induce unwanted associates and have the effect of transforming the enterprise into a much larger and different business than the one bargained for by a shareholder. On the other hand, financial needs may someday compel resort to the issuance of additional stock. Some of the participants may someday believe excellent business opportunities exist which may be exploited best by issuing more stock. At some future time, a public offering of stock may be greatly desired by some shareholders as the best way to realize their paper profits by giving them the benefit of a public market. Prospective employees or other persons who have special things to offer the company may be available only if they are allowed to become stockholders.

The statute cannot solve the problem in a given case of how to plan for the present and future capacity of the corporation to issue stock and what procedures must be followed in so doing. The statute provides the needed planning flexibility by allowing high-vote requirements for charter amendments<sup>66</sup> and by allowing shareholder voting agreements,<sup>67</sup> irrevocable proxies,<sup>68</sup> and close corporation shareholders' agreements which infringe upon board discretion.<sup>69</sup> Planning solutions providing for absolute vetoes against, or high shareholder or director votes to bring about, any change in the authorized or issued stock are clearly lawful; or the matter can be left to ordinary voting majorities. Moreover, any imaginative solution for this planning problem, involving perhaps the use of special classes of stock or which relates new stock issuances to demonstrable financial need or which might provide methods designed to protect against issuances at unfair prices or which provides for mandatory or optional buy-outs of stockholders, may lawfully be resorted to.

---

66. *Id.* § 204(a)(5).

67. *Id.* § 706(a).

68. *Id.* § 705(e)(5).

69. *Id.* § 300(b).

### K. *Consideration for Stock*

The statute validates preincorporation services as eligible consideration for stock,<sup>70</sup> thereby removing the legal cloud from a prevalently used but controversial form of payment for stock. Future services are still precluded as a valid form of consideration for stock. Presumably the rationale is creditor protection, which is an arguable point. The result is to deprive the close corporation of a useful arrangement where a stockholder has nothing else to offer except the promise of future services which are regarded as highly desirable. The statute allows a promissory note to serve as eligible consideration only if "adequately secured," which seems of small utility to the close corporation.<sup>71</sup> Partially paid shares may be issued (presumably that means with full voting power and equity buildup) although the dividend must be proportional.<sup>72</sup>

Happily, the statute inters par value and no par value and all of the foolishness connected with those terms. Section 409(a)(1) simply provides for the issuance of stock of whatever amount and kind (with certain disqualifications) of consideration, as determined from time to time, by either the directors or the shareholders if the articles so provide.

## VI. CLOSE CORPORATION STATUS

### A. *Formation*

At its inception, a corporation may adopt close corporation status by including the statutorily prescribed provisions<sup>73</sup> in the articles. The question of consent by all of the potential shareholders at the natal stage is not covered by the statute. A provision to that effect would have been desirable. Presumably the courts will enforce a rule requiring the consent of all of those who are contemplated to be shareholders of a corporation to be formed as a close corporation.<sup>74</sup>

---

70. *Id.* § 409(a)(1).

71. *Id.*

72. *Id.* § 409(d).

73. *Id.* § 158(a).

74. *See, e.g.,* TEX. REV. CIV. STAT. ANN. art. 2.30-1(D) (Cum. Supp. 1975) (requiring all initial subscribers to be incorporators) and *id.* art. 2.30-1(F) (requiring the affirmative vote of all outstanding shares of each class in order to elect to change to close corporation status).

*B. Election by Existing Corporation and  
Termination by Amendment*

An existing non-close corporation may take on close corporation status by an amendment of its articles adding the critical provisions. Section 158(b) requires the approval of that amendment by the affirmative vote of all of the shares of all classes, even those restricted or limited as to voting. This prevents a shareholder from being thrust into a close corporation unwillingly. The unanimity principle should be consistently followed since the relationship involved is predominantly close-knit and contractual. The statute, however, permits termination of close corporation status by an amendment deleting the crucial definitional provisions by the vote of only two-thirds of each class.<sup>75</sup> The statute expressly allows an agreement for a lesser vote<sup>76</sup> and expressly permits agreements to vote for a deletion amendment.<sup>77</sup> On the other hand, nothing is said in section 158 in validation of a requirement of a higher vote for such an amendment or an agreement not to vote for that step. The former seems clearly permissible under section 204(a)(5) and the latter under section 706. Nevertheless, the almost militant insistence in section 158 on the deletion power and the efforts to facilitate that step seem to suggest that the close corporation status is somehow confining and should be easily terminated. Far greater mischief can come from allowing termination of close corporation status without the consent of all shareholders, unless done in accordance with a shareholders' agreement, than from the possibility that persons might find themselves trapped in that status. The statute places the planning onus in the wrong place—on the minority shareholder to bargain in advance for a veto against termination of close corporation status. The statute should impose a requirement of unanimity before close corporation status can be divested unless the parties have otherwise agreed.<sup>78</sup>

*C. Termination Through Stock Transfers*

The statute does effectively provide for the protection of close corporation status against termination by inter vivos transfers of stock de-

---

75. GCL, *supra* note 1, § 158(c).

76. *Id.*

77. *Id.* § 158(f).

78. See, e.g., MD. ANN. CODE tit. 4, § 100(b) (1975). But see DEL. CODE ANN. tit. 8, § 346(b) (1974) (allowing any vote greater than two-thirds) and TEX. REV. CIV. STAT. ANN. art. 2.30-1(F) (Cum. Supp. 1975) (same).



signed to or having the effect of putting the corporation in violation of its shareholder number maximum as imposed by the articles. Section 158(e) provides for termination if shares are transferred or transmitted, or a trust, corporation or partnership is dissolved, and the effect is to distribute shares to a number of persons in excess of the maximum. But, section 158(e) limits that termination effect to a transfer which is not void under section 418. Section 418(c) requires a conspicuous legend on the certificate which states the maximum number of shareholders. The legend must also state that "any attempted voluntary *inter vivos* transfer which would violate this requirement is void." The "requirement" referred to is the required maximum which must be fixed by the articles on the number of shareholders of a close corporation. The articles must state that maximum, which cannot exceed ten, and the share certificate must contain a statement that the holders of record cannot exceed that maximum.

The upshot of this is that the shareholders of a close corporation may fix any limit on their number, up to ten. Compliance with section 418(c) with respect to the share certificate legend triggers section 418(d) which provides that any attempted *inter vivos* transfer which would result in violation of that ceiling is void. Section 421 provides that the holder of shares of a close corporation agrees to the restriction imposed on transfer for that purpose and waives any right to demand registration under the Securities Act of 1933.<sup>79</sup>

There is no reason to believe that agreements for the purchase of stock upon death of a stockholder would not be enforced. An agreement of that kind may solve the problem of preventing transfers on death which would defeat the status of the corporation as a close corporation.<sup>80</sup>

---

79. Where a transfer of shares is involved in a merger or reorganization which would effect a termination of close corporation status, sections 1111 and 1201(e) require the affirmative vote of two-thirds of each class of shares unless a smaller vote is agreed upon. Section 204(a)(5) permits a higher vote requirement. Section 300(c) prohibits a contractual waiver or alteration of the rights conferred by sections 1111 and 1201(e). GCL, *supra* note 1, §§ 1111, 1201(e), 204(a)(5), 300(c).

80. An option residing in the corporation or other shareholders to purchase stock on the happening of an event is valid and enforceable. *See Yeng Sue Chow v. Levi Strauss & Co.*, 49 Cal. App. 3d 315, 122 Cal. Rptr. 816 (1975). The option must be carefully and explicitly drafted so that the intention is unmistakable as to its application to the transfer at death. *See Riggs v. Midwest Iron & Steel Works*, 540 P.2d 361 (Colo. 1975); Bradley, *Stock Transfer Restrictions and Buy-Sell Agreements*, 1969 U. ILL. L.F. 139; 2 O'NEAL, *supra* note 18, §§ 7.01-29.

## VII. AREAS OF INCOMPLETE ATTENTION TO CLOSE CORPORATION PROBLEMS

### A. *Stock Transfer Restrictions*

A major gap in the California close corporation statutory reform is the failure to speak to the problem of the legality of stock transfer restrictions. The only substantive mention of this area is in section 204(b) which permits the articles to contain provisions placing "reasonable restrictions" upon the transfer of shares of their hypothecation.<sup>81</sup> Hence, the matter is left to the common law.<sup>82</sup> This means that a restriction which is more stringent than a first option restraint will continue to be of doubtful reliability as a planning device. The California cases have upheld the widely used first option but have never passed upon more stringent restrictions. Outside of California, the validity of a consent-type restraint is a matter of controversy and uncertainty.<sup>83</sup>

A consent restraint can be a highly desirable planning arrangement. The first option is often unsatisfactory because neither the corporation

---

81. Sections 418(a)(1) and 418(b) of the GCL require a conspicuous legend on the share certificate of the existence of a stock transfer restriction to make it enforceable against a transferee without actual notice. For the meaning of conspicuous legend, see *Leng & Co. v. Trinity Sav. & Loan Ass'n*, 482 S.W.2d 841 (Tex. 1972), *rev'g* 470 S.W.2d 441 (Tex. Civ. App. 1971) *discussed in* case note, 50 TEXAS L. REV. 528 (1972). See also *Lebowitz, Corporations: Annual Survey of Texas Law*, 27 Sw. L.J. 85 (1973).

Other corporation statutes which address the close corporation affairs go quite far in sustaining restraints on transfer. Delaware validates consent and other restraints, including one designed to preserve the Subchapter S status. DEL. CODE ANN. tit. 8, § 202 (1974).

Maryland upsets the entire analytical appellation by revolutionary provisions inspired by the partnership doctrine of *delectus personae*. This doctrine is codified in UNIFORM PARTNERSHIP ACT § 18(g): "No person can become a member of a partnership without the consent of all the partners." *Id.* The Maryland provisions prohibit any transfer of stock without the recent written consent of all other holders of stock. MD. ANN. CODE tit. 4, § 4-504(b)(1) (1975). The shareholder denied consent to transfer his stock is given a dissolution right, *id.* § 4-602(b)(1)(i); the other shareholders are given a corollary buyout right to stave off dissolution. *Id.* § 4-603(a). This is all made subject to a contrary unanimous stockholders' agreement, which may provide for merely a first-option arrangement or which may abrogate the dissolution right.

82. The right of first refusal or first option was upheld in *Groves v. Prickett*, 420 F.2d 1119 (9th Cir. 1970); *Tu-Vu Drive-In Corp. v. Ashkins*, 61 Cal. 2d 283, 391 P.2d 828, 38 Cal. Rptr. 348 (1964); *Vannucci v. Pedrini*, 217 Cal. 138, 17 P.2d 706 (1932).

83. An interesting compromise position on consent restraints is worked out by the court in *Fayard v. Fayard*, 293 So. 2d 421 (Miss. 1974). See also *Rafe v. Hindin*, 288 N.Y.S.2d 662, 29 App. Div. 2d 481 (Sup. Ct. 1968).

On consent restraints see generally 2 O'NEAL, *supra* note 18, § 7.08; Bradley, *Stock Transfer Restrictions and Buy-Sell Agreements*, 1969 U. ILL. L.F. 139, 141.

nor the other shareholders may be able to purchase. Planning, however, is not an exercise in legal pioneering. A first option had better be provided for in all cases as a backstop to another more stringent restriction.<sup>84</sup>

Section 204(b) makes the transfer restriction unenforceable against non-consenting outstanding shares when the restriction is introduced by an amendment to the articles.<sup>85</sup> This new portion is well advised and it heightens the importance of planning at the outset on this matter.

The adventuresome planner may be interested in experimenting with section 204(a)(3) which authorizes an optional provision in the articles establishing "special qualifications" for shareholders. That provision suggests some rather exotic and stringent limitations even to the point of actually naming specific people who alone are to be qualified as shareholders, subject to amendment only by unanimous consent.<sup>86</sup> If the "reasonable restriction" provision of section 204(b) takes precedence, any provision establishing qualifications for shareholders which is, as a practical matter, more restrictive than a first option would be subject to great legal doubt.

If the shareholders wish to allow the transfer of stock during lifetime or at death, or to allow the distribution of the trust, corporation or partnership stock, they may enlarge the shareholder maximum stated in the articles, but not beyond the statutory ceiling of ten. It is unclear whether the effect of section 158(b) is to require the consent of all shareholders to that amendment. That construction would best comport with the spirit of the close corporation provisions generally and that section in particular. In any case, a high-vote requirement to guard against the proliferation of shareholders through the increase in the shareholder maximum should be considered at the planning stage along with a specific provision allowing an amendment for that purpose by a lesser vote, down to a majority, if that is what the parties desire.

---

84. A very helpful provision, considering the uncertainty respecting the legality of restrictions, would have been one similar to a Delaware provision which confers upon the corporation an option to purchase the stock if a restriction is declared unenforceable. DEL. CODE ANN. tit. 8, § 349 (1974).

85. This provision overrules *Tu-Vu Drive-In v. Ashkins*, 61 Cal. 2d 283, 391 P.2d 828, 38 Cal. Rptr. 348 (1964).

86. The Delaware close corporation provisions also permit the certificate of incorporation to set forth the qualifications of stockholders. However, the following language restricts the potential broad use of such a qualification provision: qualifications may be set forth "either by specifying classes of persons who shall be entitled to be holders of record of stock of any class, or by specifying classes of persons who shall not be entitled to be holders of stock of any class or both." DEL. CODE ANN. tit. 8, § 342(b) (1974).

## B. Dissolution

### 1. Voluntary Dissolution Agreements or Vetoes

The California statute omits a provision commonly found in other state close corporation legislation<sup>87</sup> permitting shareholders to agree that any shareholder has the right to dissolution at will or upon the happening of a specified event or contingency.<sup>88</sup> The two major substantive provisions make no mention of dissolution, but arguably, section 300(b)<sup>89</sup> would validate such an agreement on the ground that it is merely an effort to introduce a right comparable to one which a partner may enjoy.<sup>90</sup> And section 706(a) makes mention of no specific application; rather it very broadly validates shareholder voting agreements. Even if section 300(b) does not support a dissolution agreement, a section 706(a) shareholder voting agreement seems to be all that is needed since director involvement is not required under California's unique voluntary dissolution provision.<sup>91</sup> An agreement among shareholders to vote for dissolution on demand of any one of them or on the occurrence of a specified event or the happening of a given contingency, reinforced in an irrevocable proxy for self-implementation, would seem to be valid at first blush. Nevertheless, that construction is to be gravely doubted no matter how devoutly one argues for it. The omission from the statute of a dissolution-on-demand provision is a compelling fact militating against that construction of section 300(b) or section 706(a). A most telling point is the unique character of the California voluntary dissolution provision which allows dissolution, without a director vote, on the vote of "shareholders holding shares representing fifty percent or more of the voting power."<sup>92</sup> That seems to suggest a sacrosanct voting provision. On one aspect of that question, the legislation is very emphatic. The authorization in section 204(a)(5) for provisions in the articles requiring high votes is made explicitly inappli-

---

87. See, e.g., DEL. CODE ANN. tit. 8, § 355(a) (1974); N.Y. BUS. CORP. LAW § 1002(a) (McKinney 1974); TEX. REV. CIV. STAT. ANN. art. 2.30-5(A) (Cum. Supp. 1975).

88. Section 204(a)(4) of the GCL allows articles to contain a provision which limits the duration of the corporation's existence. Conceivably, the articles could define the term of the corporation by reference to a contingency such as the failure of the business to show a certain profit level on the termination of employment of a named person. More fanciful is the possibility of stating that the corporate existence endures only so long as all shareholders consent.

89. See text accompanying notes 12, 22 *supra*.

90. See UNIFORM PARTNERSHIP ACT § 31(1)(b).

91. GCL, *supra* note 1, § 1900 *et seq.*

92. *Id.* § 1900(a).

cable to the section 1900 voting procedure. Therefore, it is very hard to attribute to the legislature an intention to allow section 706(a) to be used for a shareholder agreement to the effect that shareholders will vote against a voluntary dissolution resolution unless all shareholders agree on dissolution. While that may be plain enough in connection with an agreement giving a veto against dissolution, it is still possible to argue that an agreement on a lesser vote for dissolution is permitted by the statute. No good reason exists why that kind of an agreement should not be found to be valid. The policy supporting section 1900 is far from clear. In departing from the usual director resolution and two-thirds or majority shareholder vote procedure for the fifty percent shareholder vote provision, the legislature does not seem to be declaring a policy strongly opposed to agreements allowing dissolution on the wish of a lesser number than half of the shares entitled to elect directors. Nor does such an agreement seem offensive to the judicial gloss which has been placed upon the dissolution provision by the California courts. The California Supreme Court has held that dissolution may occur only if that move is "equitable"; that is, the parties seeking dissolution may not gain some unfair advantage as a result of the dissolution.<sup>93</sup> Although that limitation is an important equitable restraint on the exercise of power granted by the statute, it is similar to what other courts have done with respect to the more conventional dissolution provisions<sup>94</sup> and it does not amount to a judicial bias against agreements which confer, in effect, a dissolution-on-demand right.

Section 2000 allows the corporation or other shareholders to purchase the stock of a stockholder seeking dissolution. A fair price must be paid but a reduction is allowed for damages if the dissolution proceeding, according to the statute, is initiated in breach of an agreement. The agreement referred to would seem to have to be an agreement not to exercise the section 1900 voluntary dissolution power. If that is the most likely interpretation, then the implication is that an agreement of that kind is valid to the extent of serving as the basis of a reduction in the price to be paid in the exercise of the statutory buy-out right. But if that is correct, how can it be reconciled with the prohibition against using the section 204(a)(5) high-vote provision in the articles in connection with voluntary dissolution under section 1900? Perhaps the answer is that the owners of fifty percent are to be free to exercise

---

93. *See In re Security Fin. Co.*, 49 Cal. 2d 370, 317 P.2d 1 (1957).

94. *See, e.g., Lebold v. Inland Steel Co.*, 125 F.2d 369 (7th Cir. 1941), *cert. denied*, 316 U.S. 675 (1942).

a statutory *power* to seek dissolution but must face the price-diminution effect of an agreement not to do so. There is precedent for an approach of this kind since the Uniform Partnership Act provides for essentially that same power for each partner.<sup>95</sup>

If it is concluded that an agreement is valid under section 706(a) to vote for dissolution at the request of any shareholder on demand so as to satisfy the fifty percent requirement for dissolution under section 1900, will the courts respond by taking a strict view of when dissolution is "equitable" under the *Security Finance* test?<sup>96</sup> There is no way at this time to know the answer to that question.

The statute surely could have dealt with voluntary dissolution and the special problems of the close corporation with greater clarity and liberality. As the statute stands, it is in some respects unduly restrictive and in others it is ambivalent. Dissolution should not be an exception to the general principle of freedom of contract for close corporation planning. No basis exists for clinging in this one area to the statutory "norm" approach immune to change by a shareholders' agreement. It is possible to speculate that the present state of the statute is due to the belief that the parties may not know what is best for them and the court should always have the opportunity to pass on the "equity," that is, the wisdom of the dissolution. That brand of paternalism has haunted close corporation planning<sup>97</sup> and is completely out of step with section 300(b).

## 2. Involuntary Dissolution

The failure of the statute to come to grips with the problem of unfairness and oppression adequately, as discussed later in this article,<sup>98</sup> and the absence of a statutory license to enter into a free-wheeling dissolution agreement, may be offset to some extent by the intelligent use of the planning devices which are provided for. Cases of faulty or no planning are inevitable, however. The breadth and enlightenment of the California statutory provisions on involuntary dissolution compensate somewhat for those facts.

---

95. UNIFORM PARTNERSHIP ACT §§ 31(1)(b), 38(2)(a)(II).

96. See note 94 *supra* and accompanying text.

97. See, e.g., *Benintendi v. Kenton Hotel, Inc.*, 60 N.E.2d 829 (N.Y. Ct. App. 1945) where the court commented that, "Such a by-law (requiring unanimity for board action) . . . is, almost as a matter of law, unworkable and unenforceable for the reason (that) . . . 'in all acts done by a corporation, the major number must bind the lesser, or else differences could never be determined.'" *Id.* at 831.

98. See notes 115-36 *infra* and accompanying text.

Section 1800(a)(2) permits any shareholder of a close corporation to file a complaint for involuntary dissolution.<sup>99</sup> Subsection (b) of section 1800 enumerates the conditions that must be met and sets forth the criteria to be satisfied for a grant of dissolution or other appropriate relief.<sup>100</sup> Of particular interest are sections 1800(b)(4) and (5). The former section makes reference to "persistent unfairness" toward any shareholder by those in control as a basis upon which dissolution may be sought. An expansive reading of that section will contribute a great deal toward the protection of minority stockholders against the classic freeze-out. Of special consequence would be the recognition that the majority shareholders may be acting unfairly despite the fact that they are exercising literally lawful statutory majority voting prerogatives and seemingly legitimate business judgment privileges. Subsection (5) of section 1800(b) is potentially much more far-reaching in its effect and seems to be quite deliberately intended as a response to the need for protective devices for minority shareholders.<sup>101</sup> The subsection provides:

In the case of any corporation with 35 or fewer shareholders (determined as provided in Section 605), liquidation is reasonably necessary for the protection of the rights or interests of the complaining shareholder or shareholders.<sup>102</sup>

Neither of the above sections includes a deadlock or corporate paralysis requirement. Section 1800(b)(5) can be understood as having been quite deliberately not weighted in favor of a policy of prolonging the life of the corporation at the possible expense of minority shareholder interests. A court may use it to come to the rescue of a shareholder who is victimized by an exclusion from meaningful participation in the management or in the spoils of the business, whether salaries or dividends, although those in control are guilty of no fiduciary violation by traditional standards.

The ground for dissolution appearing in section 1800(b)(5) also appears in the present version of the California Corporation Code,

---

99. Section 1800(e) allows a beneficial owner of shares who has entered into a shareholders' agreement to also file a dissolution petition. It should be kept in mind that section 300(c) outlaws any shareholder agreement altering or waiving any of the provisions of Chapter 18. GCL, *supra* note 1, §§ 1800(e), 300(c)

100. Section 1804 of the GCL empowers the court to "make such orders and decrees and issue such injunctions in the case as justice and equity require."

101. See F. O'NEAL, "SQUEEZE-OUTS" OF MINORITY SHAREHOLDERS: EXPULSION OR OPPRESSION OF BUSINESS ASSOCIATES §§ 9.09-.14 (1975) [hereinafter cited as O'NEAL OPPRESSION].

102. GCL, *supra* note 1, § 1800(b)(5).

though without the limitation to corporations of thirty-five or fewer shareholders.<sup>103</sup> That provision was construed in the case of *Stumpf v. Stumpf & Sons, Inc.*<sup>104</sup> as precluding a dissolution-on-demand approach. The California Court of Appeal held that the remedy of dissolution was not there for the asking on an automatic relief basis; rather, a showing of "fairness" must support that drastic measure.<sup>105</sup> But the dissolution provision was held to have an independent significance of its own and, on the facts, the court did grant the requested relief.<sup>106</sup> The thrust of the opinion is important to the instant discussion. The legislature was taken to have manifested an intention to empower the courts to assure fairness to minority shareholders.<sup>107</sup> The enactment of the subsection in the present statute, including a new departure for the close corporation and its distinct needs, should fortify the manifestation of that intention and give the subsection an even greater vigor and significance as a judicial tool for sheltering minority shareholders from unfairness and oppression. But a particular court's attitude is crucial. Feelings favorable to majority rights based on a mistaken view of their rightful place in a close corporation or a prejudice in favor of keeping a profitable business going despite an embittered relationship may cut against dissolution when it is the only sensible or fair thing for the minority. Judicial reactions to complaints for dissolution, it is to be hoped, will show a keen sensitivity to the minority shareholder who is suffering due to inadequate planning or the lack of fairness by the majority.

The broad planning avenues open to the parties under the new statute and whether they are comprehensively used in a given case will probably weigh heavily in a court's judgment when involuntary dissolution is sought. There is much to be said for the adage that one who has made his own bed should be made to lie in it. But it can be overdone. For example, mandatory buy-out agreements are available for use as alternatives to dissolution-at-will contracts. These agreements are not panaceas. They have their practical limitations. The absence of planning may be due to economic reasons or ignorance. A court may

---

103. CAL. CORP. CODE ANN. § 4651(f) (West 1955).

104. 47 Cal. App. 3d 230, 120 Cal. Rptr. 671 (1975).

105. *Id.* at 235, 120 Cal. Rptr. at 674.

106. For a discussion of the need for greater flexibility in meeting the dissolution problem of minority shareholders see Comment, *Dissolution Under the California Corporations Code: A Remedy for Minority Shareholders*, 22 U.C.L.A. L. REV. 595 (1975).

107. *Stumpf v. Stumpf & Sons, Inc.*, 47 Cal. App. 3d 230, 234, 120 Cal. Rptr. 671, 674 (1975).



determine that the parties in a given case faced the dissolution and corporate captivity issues and all of them may have freely chosen to adopt a plan which actively discouraged dissolution as a matter of the very clear and firm intention of the parties. Many business reasons suggest that approach in many cases. Hence, the parties may have consciously elected, after consultation with counsel, to forego an arrangement affording an easy exit from the close corporation. It is true that the statute expressly proscribes the use of a section 300(b) agreement to waive the right to seek dissolution under section 1800,<sup>108</sup> and that is as it should be as a matter of wise statutory policy. However, a court is entitled to exercise its discretion under subsections (4) and (5) of section 1800(b) and resolve doubts against dissolution on behalf of the complainant in the face of that expressed intention to promote the continued existence of the business and to live with a carefully worked-out governance and profit division plan.<sup>109</sup>

Section 1804 gives the court flexibility as to the form of relief to be granted in these involuntary dissolution cases.<sup>110</sup> Orders requiring dividend payments could be issued or perhaps a stockholder disenfranchised if the situation seemed to warrant that form of relief.<sup>111</sup> The reluctance of the court to become so deeply involved in the affairs of a close corporation would be understandable. Section 2000 provides for a buy-out by the corporation, or by the holders of fifty percent or more of the stock of the shareholder who seeks dissolution, except in the case of "persistent unfairness."<sup>112</sup>

### C. Definitional Problems

The definitional tack taken in the California statute is to make status as a close corporation ever optional. On the other hand, the definition

---

108. GCL, *supra* note 1, § 300(c).

109. The parties may, for example, have entered into arrangements for arbitration as a means of settling disagreement instead of resorting to efforts to secure dissolution. For a treatment of arbitration and its uses, *see* 2 O'NEAL, *supra* note 18, §§ 9.08-.25. In addition, section 308 of the GCL authorizes a petition for the appointment of a provisional director, under limited circumstances. For a discussion of that device, *see* 2 O'NEAL, *supra* note 18, § 9.30.

110. *See* note 101 *supra*.

111. For examples of innovative solutions, *see* O'NEAL - OPPRESSION, *supra* note 101, § 9.05.

112. A suit for liquidation by a minority shareholder under a similar statute, based upon allegations of oppression and waste of assets was not precluded by a bylaw conferring a buy-out-at-will right at par value. The stockholder was permitted to attempt to get a better deal in dissolution if the criteria were met. *Baylor v. Baylor Book Co.*, 216 S.E.2d 18 (Va. 1975).

operates to deny that status to non-complying corporations, so that if a corporation cannot show itself to be eligible under the definitional requirements of section 158, the shareholders cannot avail themselves of the special contractual privileges reserved for the close corporation.

Two aspects of that definitional approach deserve discussion. The matter of qualification by number of shareholders is the lesser problem. Whether this new status should have been required of all corporations which fit a statutory definition, that is, whether it should have been mandatory is a much more fundamental policy question.

### 1. The Number of Shareholders Limitation

The numerical limitation of ten, or any other number, is necessarily arbitrary.<sup>113</sup> It does not follow that this is a wrong approach. The issue does not seem to be an acute one, in any event. The accommodation of corporations with up to ten shareholders of record will provide for the overwhelming number of corporations which feel the need of special close corporation laws to a significant degree. Excluding from the statutory coverage corporations with a greater number of shareholders should not handicap planning in those corporations unduly since the general statutory provisions do not constitute a planning straightjacket by any means. Nor should the ceiling unduly hamper the raising of sufficient investment capital. Venture capital corporations are eligible close corporation shareholders and debt securities may be given voting rights. On the one hand, the position may be taken that where the number of shareholders is greater than ten, agreements affecting board discretion should be either outrightly invalid or at least that they become enough of a worry to require ad hoc judicial scrutiny for their validation. On the other hand is the contention that if all of the shareholders consent to the agreement, what is the objection to the use of special planning arrangements in corporations with a larger number of shareholders?<sup>114</sup>

---

113. Nevertheless, the statute is rigid on this requirement. Section 300(c) of the GCL prohibits the use of a section 300(b) shareholders' agreement to alter or waive the ten-shareholder requirement.

114. The proponents of the California legislation originally thought that thirty-five was an appropriate maximum. EXPOSURE DRAFT no. 2, *supra* note 10, at 6. Delaware fixes the number at 30, DEL. CODE ANN. tit. 8, § 342(a)(1) (1974), and Texas at 35 TEX. REV. CIV. STAT. ANN. art. 2.30-1(A)(4) (Cum. Supp. 1975).

Not every state with close corporation statutes has adopted a definition including a numerical limitation of shareholders. New York prescribes no number limitation but requires all shareholders to consent to agreements affecting board discretion. N.Y. BUS. CORP. LAW § 620(b)(1) (McKinney 1974). New York also makes the absence of

## 2. Mandatory Close Corporation Status—Herein of Minimum Rights for Close Corporation Shareholders

Unplanned or poorly planned close corporations will always be with us. The sad fact is that oppression and fraud and the corporate freeze-out<sup>115</sup> will not disappear under the new California General Corporation Law because the statute authorizes shareholders' agreements to deal with the problems of the close corporation over a broad front. Hence, the legislative treatment of the special problems of the close corporation is incomplete unless attention is given to the minimization of the possibilities of unfairness and oppression. The liberation of planning moves in the right direction by giving shareholders the opportunity to protect themselves by agreement. However the statute cannot assure the fullest or wisest use of its provisions in that regard. A further necessary step is to apply certain statutory provisions to all corporations fitting a statutory definition of the close corporation for the purpose of establishing a set of ground rules to govern the relationship of the parties in the absence of agreement, except in some cases. The ground rules could be similar to those promulgated by the Uniform Partnership Act which confers important basic rights on each partner. Those rights are regarded as inherently residing in someone involved in a partnership relationship and are therefore presumably intended by the parties absent a contrary agreement.

The ground rules which now apply to the corporation establish the rights of majorities to elect directors, amend the articles, and the like, and hence to govern the corporation, determine employment, salaries, dividends and other matters. The majority's actions are carried out under the protective umbrella of the business judgment rule and mis-

---

general trading in the share a pre-condition to agreements affecting board discretion. *Id.* § 620(c).

Another alternative to be found in other statutes is the Maryland approach. Maryland simply requires that the charter of a close corporation contain a statement that the corporation is a close corporation with no further requirement as to the number of shareholders or other definitional element. MD. ANN. CODE tit. 4, § 4-101(b) (1975). For an evaluation of the Maryland statute, which the author regards as the most successful close corporation legislation to date, see Bradley, *A Comparative Evaluation of the Delaware and Maryland Close Corporation Statutes*, 1968 DUKE L.J. 525.

115. Professor O'Neal's book on the subject of oppression and other forms of maltreatment of minority shareholders, O'NEAL - OPPRESSION *supra* note 101, provides a superb exposition and meticulous documentation of the underlying causes and techniques of the close corporation "squeeze-out" and other oppressive conduct. He notes that the traditional corporation statutory tilt in favor of the majority shareholders contributes a great deal to the problem. *Id.* § 1.03. The need for a lengthy book dealing with this dismal phenomenon displays the need for corrective legislation.

placed, at least in the close corporation, notions of democratic processes. Often this adds up to a legally sanctioned blueprint for the freeze-out. If the minority shareholders are to escape from this predicament, the planning onus is on them to gain voting vetoes or other protective devices as a particular statute might allow. This situation is part of the fallout from the fact that close corporation statutes have been structured with the widely-held corporation as the backdrop.

Close corporation statutes should take the great leap forward of defining close corporation status on a mandatory basis and of decreeing certain basic rights for all shareholders in those corporations. The objective would be to minimize oppression and unfairness while preserving the freedom of the parties to determine their own fates by contract.

A perspective on this proposal can be gained from a consideration of the approach taken in the Uniform Partnership Act. That statute imposes partnership status on relationships which possess the elements of the statutory definition.<sup>116</sup> Once the elusive "co-ownership" of a business is found to be present, partnership status attaches. At the same time, it will help to recall that the partnership statute contains a number of provisions which apply to the partnership as defined, either of the inadvertent variety, or the more common case, the consciously and deliberately formed partnership. Many of those provisions constitute ground rules designed to give each partner a fair shake. The wealth of common law gives fuller delineation to these presumed basic rights of each participant in the business. The partners, regardless of investment differences, stand on an equal footing with regard to management<sup>117</sup> and profit sharing,<sup>118</sup> absent an agreement otherwise. For example, all partners must consent to salaries.<sup>119</sup> The planning onus is on those who would have it otherwise. The risk of a situation involving little or no contractual coverage of these matters is not put on minority participants. Ordinary business matters are open to majority decision making, but extraordinary change cannot be wrought without unanimity.<sup>120</sup> In addition, new ownership interests cannot be created and existing partnership rights may not be transferred without the consent of all the partners.<sup>121</sup> The natural result of the contractual

---

116. UNIFORM PARTNERSHIP ACT §§ 6, 7.

117. *Id.* § 18(e).

118. *Id.* § 18(a).

119. *Id.* § 18(f).

120. *Id.* § 18(h).

121. *Id.* § 27.

close-knit and interdependent relationship is that the law confers substantial protection against a "freeze-out."

In contrast, the definitional approach adopted in the California statute leaves the status as a close corporation a matter of optional provisions in the articles. This remains the approach taken everywhere, except in one state which does not use the mandatory definition for any significant practical purpose.<sup>122</sup> Without a mandatory definition, close corporations-in-fact cannot be reached by statutory provisions which are designed to guarantee basic rights for all shareholders of a close corporation. Even as to those corporations which elect the status, the statute does not attempt to prescribe a set of basic rights to be enjoyed by all of its shareholders. Since the routine, or badly planned close corporation will doubtless recur with dreary frequency, that statutory omission is unfortunate. Majorities will continue to be able to make bread and butter crucial decisions with inadequate judicial protection against unfairness.<sup>123</sup> Moreover, the statutory provisions for involuntary dissolution are not a satisfactory answer.

Therefore it is the submission of this article that close corporation legislation should define a close corporation in a manner which impresses that legal status on all corporations which conform to that definition without resort to an option to elect the status. A definition of the close corporation might well take the form of the California definition with respect to the number of shareholders,<sup>124</sup> *i.e.*, that every corporation having no more than ten shareholders would be included. With that first essential step taken, the statute could then apply the au-

---

122. The Maine statute defines a close corporation as a corporation with shares formed under the laws of the state of Maine which "at any given time, has not more than 20 shareholders of all classes of shares, whether or not entitled to vote." ME. REV. STAT. ANN. tit. 13-A, § 102(s) (Supp. 1972). This definition is not qualified so as to make close corporation status a matter of optional provision in the articles.

The Maine statute permits a close corporation to establish management by shareholders. *Id.* § 701(2). The only other references to the close corporation in the statute relate to the power of incorporators, *id.* § 407(5), and the list of shareholders, *id.* § 607(2)(B).

123. The unwillingness of the courts to deal with this problem persists. Dissolution was recently withheld despite a showing that a professional corporation was being continued for the purpose of paying a salary and bonus to the majority while dividends had ceased. *Horne v. Radiological Health Services, P.C.*, 83 Misc. 2d 446, 371 N.Y.S.2d 948 (Sup. Ct. 1975). For further discussion of the dissolution aspect of this problem, see O'NEAL - OPPRESSION *supra* note 101, §§ 9.04 - .14.

124. GCL, *supra* note 1, § 158(a).

For a discussion of the definitional problem and a defense of the ten-shareholder approach in a mandatory definition, see Bradley, *Toward a More Perfect Close Corporation—The Need for More and Improved Legislation*, 54 GEO. L.J. 1145, 1189-95 (1966).

thorizations for shareholders' agreements on a broad scale to all such corporations.<sup>125</sup> The final step would be to declare a set of minimum rights to be enjoyed by all shareholders of the close corporation. For the most part, the statutory ground rules would be subject to the agreement of the parties.

A program conferring basic rights for all shareholders of a close corporation should give the highest priority to an equality of rights with regard to management and profit division. The traditional corporate practice conditions persons to think in terms of rights attaching to shares of stock instead of to people. Once again that is the result of focusing on the corporation as the form of business organization appropriate for the business owned by a great many persons, most of them possessing rather small proportionate interests, whose identities matter little and who tend to be nomadic. The principle that each participant in a close corporation is presumptively entitled to an equal share of the profits and an equal voice in management accords with the personal, contractual and fiduciary relationship which characterizes that form of business unit. Of course, profit division and management would be subject to the agreement of the parties, but the planning onus would be to establish by agreement of all of the participants some arrangement other than equality as to management and profits. As in the partnership, salaries to partners would be deemed to be merely the receipt of that participant's share of the profits absent agreement.

The compelling need and logic for steps analogous to the recommendations made in this article have been persuasively argued by commentators with respect to piecemeal statutory provisions designed to protect minority shareholders of the close corporation. The most eminent writer on the problems of the close corporation has urged a statute which compels the payment of a dividend.<sup>126</sup> While this suggestion may not meet with universal assent,<sup>127</sup> the idea has cogent force behind it and it represents the kind of minimum right which could be debated

---

125. There is a precedent in the California statute for using a mandatory definition to apply provisions to only certain corporations. Section 2100 applies to a foreign corporation doing intrastate business. Section 2115(a) and (b) sets forth a formulaic definition which singles out some foreign corporations and applies some of the provisions of the general corporation statute to those corporations. For example, section 708 which mandates cumulative voting applies to those covered corporations. GCL, *supra* note 1, §§ 2100, 2115(a), 2115(b), 708.

126. O'NEAL - OPPRESSION, *supra* note 101, § 9.06.

127. Professor Folk disagrees with this proposal. Folk, *Revisiting the North Carolina Corporation Law: The Robinson Treatise Reviewed and the Statute Reconsidered*, 43 N. CAR. L. REV. 768, 842-45 (1965).

as properly includible in a statute which mandates close corporation status for the purpose of conferring minimum rights. Another well-reasoned proposal recommends legislation conferring upon close corporation shareholders a special dissolution right.<sup>128</sup> Another matter highly eligible for this kind of treatment would be the right to information about the business and affairs of the close corporation.<sup>129</sup> These and other rights would be affirmed in a statute of the type proposed after considered discussion of the needs of minority shareholders and the rights of majorities. The decision would then have to be made concerning to what extent to make these matters in the alternative subject to the agreement of the parties.

A mandatory definitional approach in a close corporation statute would also serve the very important purpose of providing a launching pad for a statutory declaration that a stringent fiduciary duty adheres to the close corporation relationship. The judicial recognition of that fiduciary duty is evidenced by the recent case of *Donahue v. Rodd Electrotype Co.*<sup>130</sup> The Massachusetts Supreme Judicial Court describes the fiduciary duty among close corporation shareholders as more insistent than the traditional director duty and as similar to the fiduciary duty among partners.<sup>131</sup> Another recent case adds the important point that in the close corporation it is the personal relationship which creates the duty of loyalty and not merely the capacity as officer or director.<sup>132</sup> Hence the duty not to compete is endemic to the relationship among the shareholders and not merely an adjunct of the representative status.<sup>133</sup>

---

128. Hetherington, *Special Characteristics, Problems, and Needs of the Close Corporation*, 1969 U. ILL. L.F. 1, 22.

Partners are afforded an analogous dissolution power. UNIFORM PARTNERSHIP ACT §§ 31 and 38(2)(a)(II).

129. A recent case declined enforcement of a shareholders' agreement on the ground that the shareholder had proceeded without complete information. *Dresden v. Willock*, 518 F.2d 281 (3d Cir. 1975).

130. 328 N.E.2d 505 (Mass. 1975). Judge Fuld's dissent in *Kruger v. Gerth*, 263 N.Y.S.2d 1, 3, 210 N.E.2d 355, 357 (1965) is a very insightful description of the close corporation fiduciary relationship.

131. 328 N.E.2d 505, 512 (1975). For a discussion of the fiduciary duty among partners, see J. CRANE & A. BROMBERG, *LAW OF PARTNERSHIP* § 68 (1968).

132. *Cain v. Cain*, 334 N.E.2d 650 (Mass. Ct. App. 1975). The court held that competition by a stockholder was discordant with the duty of loyalty among the close corporation associates regardless of the competitor's status as an officer, director or merely as a stockholder.

133. Although the stress in this article is upon the problem of majority oppression of minority shareholders, that should not be understood as being based on a view that the close corporation fiduciary duty is a one-way street. Obviously, it rests upon each

The legislative proposal advanced in this article would seem to be the logical extension of the principle that the close corporation is an incorporated partnership. Unfortunately, that principle is sometimes misunderstood. That misunderstanding finds form in the objection that if the business participants are to have their partnership cake they must eat limited liability. But surely that is merely the tired and discredited argument that to be worthy of treatment as a corporation the shareholders must obey corporation norms and rituals. The California statute, as does a great quantity of legislation today, already confounds those arguments in section 300(b) by validation of far-reaching partnership-like agreements and practices in the close corporation.

The Texas close corporation reform embodied a mandatory definition of the close corporation when it first appeared.<sup>134</sup> The statute was soon amended, however, so that it now makes close corporation status optional. When it was first enacted any corporation which met the definition was a close corporation. The willingness of the parties was irrelevant and the status was assumed irrespective of an option. But those who ride herd on the Texas statute decided that accidental birth was not a good idea. The fact that the substantive provisions were all permissive would make it appear that the mandatory definition really didn't matter that much. The decision to amend the statute and make close corporation status optional was based on a variety of reasons, according to the Comment of the Bar Committee which now accompanies the new version of the statute.<sup>135</sup> The first reason was to allow fewer than all of the shareholders to enter into agreements which do not constitute "significant variations from the statutory norm." As pointed out earlier in this article in the discussion of section 706(a), acceding to that reason may have been based on the erroneous view that shareholder voting agreements among less than all of the share-

---

participant and is a fully reciprocal duty. See Hetherington, *The Minority's Duty of Loyalty in Close Corporations*, 1972 DUKE L.J. 921. For an application of the duty of a minority shareholder, see *Helms v. Duckworth*, 249 F.2d 482 (D.C. Cir. 1957). Judge Burger wrote:

In an intimate business venture such as this, stockholders of a close corporation occupy a position similar to that of joint adventurers and partners. While courts have sometimes declared stockholders "do not bear toward each other that same relation of trust and confidence which prevails in partnerships," this view ignores the practical realities of the organization and functioning of a small "two-man" corporation organized to carry on a small business enterprise in which the stockholders, directors and managers are the same persons.

*Id.* at 486 (footnotes omitted).

134. See TEX. REV. CIV. STAT. ANN. art. 2.30-1 (Cum. Supp. 1975), Comment of Bar Committee.

135. *Id.*



holders do not pose a serious threat to minority shareholders. Hence, it is submitted, with great deference to the draftsmen of the most admirable Texas close corporation provisions, that it would have been appropriate to allow the statute to have the effect of requiring that in all close corporations in fact, so to speak, all of the shareholders must consent to agreements affecting director discretion to any degree or shareholder voting. The other reasons for the amendment to the Texas statute to make the status optional do not seem to have required that drastic step but could have been responded to by other statutory corrections and clarifications.<sup>136</sup> Had the statute not been amended, the experiment could have been undertaken to extend minimum rights to all of the shareholders of the close corporation as statutorily defined.

### VIII. CONCLUSION

The great need to establish a friendly legal environment for close corporation planning has been treated in the California statute and elsewhere by a wholesale liberation of the contractual planning right. The ultimate quest is still unrealized. A broadside statutory attack upon unfairness and oppression in the close corporation is now needed. It is a highly worthwhile social objective.

---

136. The other reason assigned for dispensing with the mandatory definition was that the close corporation shareholders' agreement is required by the statute to be in the articles or bylaws so that if it is not, worry arises over its validity. *Id.* But, of course, the solution is simply to do as is done in California and provide that the agreement may be contained in a separate shareholders' agreement apart from any formal corporate document such as articles or bylaws. Purchasers of stock are protected by legend requirements on the share certificates, if they do not have actual notice which they aren't likely to get from the articles or bylaws anyway. Another reason was concern that under the mandatory definition of a close corporation, its shareholders could block a public offering or any effort to sell more shares. *Id.* The answer to that objection is clearly that a shareholders' agreement may provide for the issuance of new stock on the vote of a majority of the shares if that is what the parties want. The final objection was that the provisional director provision applied to all close corporations. *Id.* But that could be taken care of without abandoning the mandatory definition. The provisional director provision is of very marginal utility, for that matter, and it would have been better to scrap it instead.