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California’s New General Corporation Law: 
Close And Closely-Held Corporations

DON BERGER*

The evolution of American corporation law in the twentieth century has fragmented a once monolithic body of law. Commencing with the publication of Berle and Means’ historic work," the recognition of the separation of ownership from control in the publicly-held corporation has led to a now separate and incredibly complex securities regulation system designed to protect investors in publicly-traded securities. At the same time, a movement to decrease the regulatory and substantive impact of general corporation law on small, owner-operated corporations has found growing judicial and legislative support, resulting in the creation of an increasingly independent body of “close corporation law.”

Coming at a time when the very right to incorporate is under question, this latter development may seem surprising. Assuming that one

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2. The leading treatise is F. O’NEAL, CLOSE CORPORATIONS, 2 vols. (2d ed. 1971) (hereinafter cited as O’NEAL). A useful one-volume work with emphasis on tax planning is W. PAINTER, CORPORATE AND TAX ASPECTS OF CLOSELY HELD CORPORATIONS (1971) (hereinafter cited as PAINTER). Law review symposia include Symposium, The Close Corporation, 18 L. & CONT. PROB. 433-583 (1953); Symposium, Close Corporations, 1969 U. ILL. L.F. 1-73 (part I), 139-223 (part II). For references to law review articles on particular aspects of close corporation law, see the extensive footnote citations in O’NEAL.
3. See, e.g., Comment, Public Policy and the “Right” to Incorporate, 16 B.C. IND. & COMM. L. REV. 817 (1975).
of the basic purposes of the corporate form of conducting business originally was to attract "outside" capital for a venture which the main proponent was unable to finance himself, and that the conferral of limited liability was the price paid by society to attract such investment, it is indeed questionable whether the one-person, the family-owned, or the owner-operated enterprise should be allowed to incorporate. What benefit is bestowed upon society in return by an enterprise which undoubtedly would have been created even in the absence of limited liability? This question becomes even more pertinent now that the contemporary "close corporation" desires corporate limited liability as well as the operational flexibility, and often the income tax treatment, of the partnership form.

Despite these questions, the "incorporated partnership," as closely-held corporations are sometimes called, seems here to stay. With the enactment of A.B. 376, the California Legislature has joined the growing number of states recognizing by statute the "close corporation" as a special type of business form. Effective January 1, 1977, the new law creates opportunities as well as pitfalls and dangers for both the business community and its legal advisors.

The opportunities lie in the possibility of organizing a close corporation so as to minimize, and in some areas eliminate, the cumbersome rigidity and formalism of the traditional corporate hierarchical decision-making process. Proper use within statutory and judicial guidelines of a shareholder management agreement can result in a custom-made corporate structure which meets the needs of the particular business enterprise. Pitfalls and dangers, however, abound. It is to be expected that California courts will follow the judicial pattern in other states which insists, sometimes with unjustifiable harshness, that the statutory criteria designed for close corporations be observed punctiliously. That insistence imposes upon lawyers the obligation to acquire expertise in

5. Cal. Stats. 1975, c. 682 (effective January 1, 1977) [hereinafter all citations and references to the New General Corporation Law, enacted, Cal. Stats. 1975, c. 682, will be cited as or referred to as New Cal. Corp. Code or New Code; hereinafter all citations and references to the General Corporation Law enacted in 1947, Cal. Stats. 1974, c. 1038 (effective until January 1, 1977) will be cited as or referred to as Cal. Corp. Code or Old Code]. See generally Review of Selected 1975 California Legislation, this volume at 258 (General Corporation Law).
6. For a description of various state statutes pertaining to close corporations, see 1 O'Neal, supra note 2, §§1.14-1.14(c).
7. Thus, failure to insert a particular statutorily-permissible provision in the articles of incorporation and inserting it in the corporate bylaws may lead a court to invalidate the provision. See 1 O'Neal, supra note 2, §1.14(c).
8. See text accompanying notes 79-113 infra.
drafting close corporation documents. It also imposes upon the participants in a close corporation the obligation to operate the enterprise in conformance with the structure they have designed for themselves.

Close corporation status in California is elective, which raises another problem. If a small enterprise does not elect to become a "close corporation," is it automatically subject to all provisions applicable to publicly-held corporations? Or can such a "closely-held," but not statutory "close" corporation, still avail itself of some of the judicially recognized devices for small corporations? In attempting to answer these questions in relation to the various topics discussed in this article, the reader should carefully differentiate hereafter between the use of the terms "close" corporation, referring to the statutory close corporation, and "closely-held" corporation, referring to a corporation which has the factual characteristics of the close corporation but which has not made or is not eligible to make the necessary statutory election.

ELIGIBILITY FOR ELECTION AND TERMINATION OF CLOSE CORPORATION STATUS

A. Eligibility for Close Corporation Status

Pursuant to the New Corporations Code, a California corporation having no more than ten record holders of all classes of its issued shares is eligible to elect close corporation status. For the purpose of determining the number of shareholders of a corporation, a husband and wife are counted as one shareholder regardless of how the shares are held by either or both spouses. Similarly, a trust holding shares is counted as one shareholder regardless of the number of trustees or beneficiaries. A partnership, corporation, or business association holding shares is also counted as one. However, if a trust, partnership, corporation, or business association is formed for the primary purpose of acquiring or voting the shares, the number of beneficial interests in that trust or

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9. New Cal. Corp. Code §158(a). The original proposal developed by the Committee on Corporations of the State Bar of California and the Assembly Select Committee on the Revision of the Corporations Code specified that a corporation having no more than 35 shareholders could elect close corporation status. State Bar of California, Committee on Corporations, Exposure Draft: General Corporation Law §159(a) (1974) (hereinafter cited as Exposure Draft No. 1). It was retained in the Exposure Draft No. 2: General Corporation Law §159(a) (1974) (hereinafter cited as Exposure Draft No. 2) and in the early version of A.B. 376. The number of permitted shareholders was reduced to 20 in the May 1, 1975 amendment to A.B. 376 (§158(a)), and was further reduced to ten in the August 5, 1975 amendment to A.B. 376 (§158(a)), thus indicating a strong legislative intent to limit close corporation benefits to truly small enterprises.


entity is counted toward close corporation status eligibility. Hence, the holding company device is only of limited utility in the close corporation setting.

B. Election of Close Corporation Status

A newly organized California corporation electing to be a close corporation may accomplish that objective by including appropriate provisions in its articles of incorporation. First, the articles of incorporation must contain the statement “This corporation is a close corporation.” Second, the name selected for a close corporation must contain the word “corporation,” “incorporated,” or “limited,” or an abbreviation of one of these terms. These requirements serve to alert parties dealing with the close corporation of the obligation to inquire into the existence and scope of a shareholder voting or management agreement. Third, the articles of incorporation must contain a provision stating that all of the corporation’s shares shall be held of record by not more than a specified number of persons, not exceeding ten. Barring the existence of other factors, it would normally be advantageous to limit the number of shareholders to ten even though the actual number of original shareholders is less, thus obviating the necessity of future amendments to the articles of incorporation if additional shareholders are added.

A California corporation already in existence may elect close corporation status by adding the required statements noted above to its articles of incorporation by amendment. If amendment occurs after the issuance of shares, the affirmative vote of all shares of all classes, regardless of limitations or restrictions on voting rights, is required.

Finally, the share certificate of a close corporation, in addition to all other requirements, must contain on its face the following legend:

This corporation is a close corporation. The number of holders of record of its shares of all classes cannot exceed [a number not in excess of 10]. Any attempted voluntary inter vivos transfer which would violate this requirement is void. Refer to the articles,

13. New Cal. Corp. Code §158(d). The legislative intent to limit the statutory benefits of close corporation status to truly small corporations, already noted in note 9 supra, is further reflected in this section, which prevents utilization of other devices such as trusts or the formation of intermediate “shell” entities to circumvent the numerical restriction of section 158(a).
17. See the suggested forms in the Appendix infra.
bylaws and any agreement on file with the secretary of the corpora-
tion for further restrictions.\textsuperscript{20}

The draftsman of a close corporation must be careful to adhere to the
statutory requirements enumerated above. As noted in the introd-
uction, the courts traditionally have been very insistent that applicable
statutory criteria be observed. In addition, the New Corporations Code
is very specific as to the necessary elements. Therefore, it would seem
that a corporation which does not strictly conform to these require-
ments will not be treated as a close corporation, even though it desires to be
accorded such treatment.

C. \textit{Termination of Close Corporation Status}

A statutory close corporation may elect to terminate that status by
deleting from its articles of incorporation the statements required to
become a close corporation.\textsuperscript{21} If an amendment deleting these pro-
visions occurs after the issuance of shares, an affirmative vote of at
least two-thirds of each class of the outstanding shares is required.\textsuperscript{22}

Involuntary loss of close corporation status may also occur. For
example, failure to place the previously mentioned legend on the close
corporation's share certificate, followed by a voluntary inter vivos trans-
fer of shares which results in the corporation having more than the
number of shareholders permitted in its articles, will cause a forfeiture
of close corporation status.\textsuperscript{23} Similarly, if the number of shareholders
authorized in the articles of incorporation is exceeded as a result of a
transfer of shares by will or pursuant to the laws of descent and
distribution, loss of close corporation status occurs.\textsuperscript{24} The lawyer or-
ganizing a close corporation therefore must consider the utilization of
protective devices such as authorizing the corporation to have more than
the original number of shareholders if less than ten, the inclusion of
appropriate transfer restrictions, or even drafting appropriate will provi-
sions for the shareholders.\textsuperscript{25}

\textsuperscript{20} \textit{New Cal. Corp. Code} \textsection{418(c)}. Although not a prerequisite to achieving
close corporation status, compliance with this section may affect the corporation's ability
to maintain its close corporation status once acquired, and should therefore be included
in the factors considered during the organization procedure.

\textsuperscript{21} \textit{New Cal. Corp. Code} \textsection{158(c)}.

\textsuperscript{22} \textit{New Cal. Corp. Code} \textsection{158(c)}. However, the articles of incorporation may
require a lesser vote for such an amendment, but not less than a majority of the out-
standing shares; or they may deny a vote to any class, or both. \textit{New Cal. Corp. Code}
\textsection{158(c)}.

\textsuperscript{23} \textit{New Cal. Corp. Code} \textsection{158(e), 418(c)-(d)}.

\textsuperscript{24} \textit{New Cal. Corp. Code} \textsection{158(e)}.

\textsuperscript{25} See text accompanying notes 130-146 infra.
A close corporation having a partnership, another corporation, or a business association as a shareholder will lose its close corporation status if, as the result of the dissolution of such an entity and concomitant distribution of its assets, the close corporation's number of shareholders exceeds the permissible number specified in its articles. The same result obtains where the termination of a trust holding close corporation shares increases the close corporation's shareholders beyond the permitted number. Any increase in the number of a close corporation's shareholders beyond its permitted maximum caused by operation of law also results in revocation of close corporation status. Thus, if a close corporation has the maximum number of shareholders which includes a husband and wife counted as one, the dissolution of their marriage will result in a loss of close corporation status if both former spouses remain shareholders.

CONTROL DEVICES IN CLOSE AND CLOSELY-HELD CORPORATIONS

Although discussed more extensively by the treatise writers, the special needs of the close corporation have been succinctly identified by the Assembly Select Committee on the Revision of the Corporations Code (hereafter referred to as the Assembly Select Committee) in its report to the legislature:

Typically, a close corporation is a corporation with relatively few shareholders who wish to treat the corporation as if it were a partnership or who wish to structure control of the corporation so as to allocate management responsibilities in a way that . . . would be appropriate only between partners. For instance, typical characteristics of a close corporation include an emphasis on simplified and informal procedures, general participation by most or all shareholders in decision-making (which may even extend to the day-to-day operation of the business) and restrictions upon share transfer to limit shifts in shareholdings.

Under prior law the operation of a close corporation . . . [was] unnecessarily hindered by the failure of corporation statutes to recognize the unique attributes of these corporations. For example, shareholders of a closely held corporation often disregard the legal requirements and formalities for doing business in corporate form altogether and neglect to hold shareholders' and directors' meetings. Such practices may result in a court disregarding the separate personality of the corporation. The practical consequence of this potential loss of corporate status is a tendency to fabricate
the necessary documentation to preserve the image of compliance with corporate formalities.

The intent of the close corporation provisions in the new law is to statutorily recognize the unique characteristics of such corporate entities and permit tailoring of the traditional corporate form to the needs of these closely held enterprises.30

As previously mentioned, the ability to custom-design corporate structures places the California lawyer in a position requiring expertise and resourcefulness. The remainder of this article will attempt to describe and analyze various devices which may prove helpful in structuring flexible close and closely-held corporations under the provisions of the New California Corporations Code.

A. Less Formalism in the Traditional Structure

Every closely-held corporation may not wish to abolish the traditional corporate model in which decision-making is entrusted to the board of directors. For example, a corporation having ten or fewer shareholders may find it less cumbersome to operate with a board of directors than to turn decision-making over to the shareholders under a shareholder management agreement, especially if only some of the shareholders are actively engaged in the corporate enterprise. For this enterprise, regardless of whether it elects to become a statutory close corporation, the continued requirement that “the business and affairs of the corporation shall be managed and all corporate powers shall be exercised by or under the direction of the board”31 may be appropriate and desirable, even though the necessity of holding formal board meetings may occasionally limit the corporation's ability to reach a decision quickly. However, two devices described in the New California Corporations Code provide valuable flexibility in regard to the holding of board meetings. One provision allows corporate action requiring board approval to be taken without a board meeting if unanimous written consent for a particular action is obtained from all members of the board.32 Unlike the Old Code section,33 the new section does not require authority for the utilization of this device to be included in the articles of incorporation or bylaws; it exists unless expressly denied in the articles or bylaws.34

34. Inclusion of such authority in the articles and/or bylaws may nevertheless be advisable, if for no other reason than to remind corporate management of its existence.
Taking corporate action prior to obtaining the required written consents, of course, can be risky since all of the directors may not ultimately consent. To overcome this risk, reliance might instead be placed on a newly enacted code provision obviating the necessity of a board meeting which brings the directors physically together in one place. Section 307(h) of the New Code allows board members to participate in a “formal” board meeting “through use of conference telephone or similar communications equipment, so long as all members participating in such meeting can hear one another.”

Designed to assure group discussion, this statutory specification seemingly precludes the device of obtaining the informal consent of individual directors through a series of bilateral contacts. Although some early California cases and cases from other jurisdictions have validated corporate action taken on the basis of informal consent by a majority of the board of directors of a closely-held corporation, it is questionable whether these decisions will still be considered authoritative in California as the new legislative authorization of two specific devices to overcome the requirement of a formal board meeting probably can be considered to have preempted the subject matter.

B. Control of Shareholder Voting

Should the only concern among the participants in a closely-held enterprise be control of the way in which shareholders vote their shares on matters within the traditional ambit of shareholder action, several devices are available to achieve that goal. For example, execution of irrevocable proxies, creation of a voting trust, and execution of a shareholder voting agreement may serve the needs of the particular enterprise. In addition, all of these devices may be used by closely-held as well as close corporations.

1. Irrevocable Proxies

The least complex device used to control a shareholder’s exercise of his voting power is a delegation of that power through the execution of a proxy. However, if the objective in a closely-held or close corporation is

37. See, e.g., Sherman v. Fitch, 98 Mass. 59 (1867).
38. See Village of Brown Deer v. City of Milwaukee, 16 Wis. 2d 206, 213-14, 114 N.W.2d 493, 497 (1962).
to achieve a transfer of shareholder voting power to one or several designated persons, usually the "management" group, the transfer must not be one that can be easily terminated by the shareholder-transferor. Thus, the problem of proxy revocability arises.

Under the common law view, a proxy is revocable unless it is a "proxy coupled with an interest." The New California Corporations Code basically follows this rule by providing that a proxy may expressly state that it is irrevocable for a fixed period of time; however, irrevocability is permitted only in specifically designated situations. The statutory enumeration is in effect a list of situations which courts have traditionally recognized as involving proxies coupled with an interest. Thus:

1. A proxy may be expressly made irrevocable for a specified period of time in favor of a pledgee of the shares covered by the proxy. This proxy becomes revocable upon the termination of the specified period of irrevocability or when the pledge is redeemed, whichever occurs first;

2. A proxy may be expressly made irrevocable for a specified period of time in favor of a person who has purchased, who has agreed to purchase, or who holds an option to purchase, the shares covered by the proxy. Such proxy becomes revocable upon the termination of the specified period of irrevocability or when the option or agreement to purchase is terminated, whichever occurs first;

3. A proxy may be expressly made irrevocable for a specified period of time in favor of a creditor of the corporation or of the shareholder, provided credit was given in consideration for the proxy, and provided the proxy so states. This type of proxy becomes revocable upon the termination of the specified period of irrevocability or when the debt is paid, whichever occurs first;

4. A proxy may be made expressly irrevocable for a specified period of time in favor of a person who has contracted to perform services as an employee of the corporation, provided the employment contract expressly requires the proxy, and provided the proxy expressly states the name of the employee, the period of employment, and that it was given in consideration for the employment contract. This proxy becomes revocable upon the termination of the specified period of irrevocability.

40. New Cal. Corp. Code §705(a), (b), (e).
or when the period of employment provided for in the employment contract has terminated, whichever occurs first.44

Of these various types of proxies, only the last would normally be of help to a closely-held or close corporation. For example, if only three of the eight shareholders of a hypothetical corporation are actively engaged in operating the enterprise, the voting power of any or all of the inactive shareholders might be transferred to any or all of the active shareholders through an irrevocable proxy, executed in conjunction with the execution of employment contracts between the corporation and the employee-shareholders.45

Following the enumeration of the specific situations of proxy irrevocability just discussed, Section 705(e) of the New Code also contains the following general provision:

In addition to the foregoing clauses . . . a proxy may be made irrevocable . . . if it is given to secure the performance of a duty or to protect a title, either legal or equitable until the happening of events which, by its terms, discharges the obligations secured by it.46

The legislative intent behind this language, as expressed by the Assembly Select Committee, is quite broad: "This provision is intended to preserve any situation not specifically enumerated in which a proxy could be considered as 'coupled with an interest.' "47

Depending upon the willingness of California courts to follow a liberal rather than the more traditional and conservative interpretation of what constitutes an "interest," closely-held and close corporations may be able to use the proxy device for voting control. The traditional interpretation requires that the proxy holder's interest must be "a charge, lien or some property right in the shares themselves," or "a security interest given to protect the proxy holder for money advanced or obligations incurred."48 Under this view, an interest on the part of the proxy holder in the corporation generally, or in the voting power represented by the shares, is not a sufficient interest to make the proxy irrevocable.

However, some cases have taken a more liberal approach to the

45. The matter of employment contracts in a closely-held enterprise is beyond the scope of this article. However, the consensus is that these contracts offer valuable protection to shareholder-employees and should be utilized extensively. See generally 1 O'Neal, supra note 2, at §§6.01-6.14; Painter, supra note 2, at 140-41; Wetzel, Employment Contracts and Noncompetition Agreements, 1969 U. Ill. L.F. 61, 69-73 (1969).
47. Assembly Report, supra note 30, at 85-86.
48. 1 O'Neal, supra note 2, §5.36.
matter of irrevocable proxies, either by eliminating the requirement of the existence of an interest as described above or by expanding the interest concept to include a proxy holder's general interest in the corporation and its welfare. Of particular interest is a Washington case in which the court held that a proxy would be recognized as irrevocable if the proxy holder had an interest in the subject matter of the proxy. A Pennsylvania case involving a Delaware corporation is in accord, the court stating that:

We know of no decision in Delaware . . . which holds that the interest necessary to make a proxy irrevocable must be in the stock itself rather than a general interest in the corporation or in what the exercise of the proxy may accomplish or secure. The rule in general is that the interest which will support an irrevocable proxy need not be in the stock itself but any property interest in the proxy holder for which the stock is held as security.

Thus, if the shareholders of a California closely-held or close corporation agree, for the purpose of allowing some shareholders to control the corporation, that the "outside" shareholders will execute irrevocable proxies to the "managing" shareholder-employees, it could be forcefully argued that the interest of the proxy holders in achieving the agreed control allocation and their property interest in the corporation generally constitutes a sufficient interest to support irrevocability. Whether California courts will be willing to apply this liberal approach to Section 705(e) of the New Code, quoted above, remains to be seen. Until such time, the California lawyer must recognize the limited usefulness of the proxy device.

2. Voting Trusts

The revocability of a proxy not coupled with a sufficient interest to make it irrevocable results from the fact that the proxy device, probably unjustifiably, is regarded as a special form of agency. To achieve the same goal of acquiring voting control in a different manner, "[a]droit lawyers . . . have invented the ingenious device of a voting trust to give to what is in essence a joint irrevocable proxy for a term of years the 'protective coloring' of a trust, so that the trustees may vote as owners.

52. 1 O'NEAL, supra note 2, §5.36.
rather than as mere agents.\textsuperscript{53} The shareholders of a closely-held or close corporation therefore may execute a voting trust agreement whereby they turn over to the trustee their share certificates and in return receive voting trust certificates. The shares are registered in the name of the trustee who as legal owner has the right to exercise the voting power of the shares. The voting trust agreement may instruct the trustee to vote the shares in a specified manner on specific issues, and may identify the person(s) for whom the shares must be voted in director elections.\textsuperscript{54}

Thus, pursuant to the New Code, the five inactive shareholders of the hypothetical corporation mentioned above may execute a voting trust agreement naming one or all of the three active shareholder-managers as trustees. This trust may be created for a specified period which cannot exceed ten years. This specified period may be extended at any time during the last two years of the current period, such extension, and each subsequent extension, being limited to a maximum of ten years.\textsuperscript{55} A voting trust extension, of course, only binds those beneficiaries who agree thereto. Consequently, unless the initial period of the trust's validity accomplishes the needs of the particular corporation, the inability to ensure voting control beyond the initial period limits the long-range utility of this device.

Two other factors bear on the decision of whether to use a voting trust for voting control purposes. Creation of a voting trust may adversely affect the liquidity of the participants' investment since voting trust certificates, though alienable, simply are not as marketable as share certificates. In addition, voting trust certificates are securities and, unless exempt, are subject to the qualification requirements of the California Corporate Securities Law of 1968.\textsuperscript{56} Hence, if a voting trust is not exempt, there may be additional paperwork, delay, and expense in organizing the enterprise.

3. \textit{Shareholder Voting Agreements}\textsuperscript{57}

Although the traditional allocation of decision-making power in the
corporation gives primary authority to the board of directors,\(^5\) so-called "fundamental changes" in the corporate status require shareholder as well as board approval. Among these are proposed dispositions of all or substantially all of the corporate assets,\(^6\) amendments to the articles of incorporation,\(^7\) mergers,\(^8\) and voluntary dissolutions.\(^9\) In addition, the shareholders, of course, elect the board of directors.\(^1\)

Due to the limitations mentioned earlier in relation to the use of proxies and voting trusts, shareholders may want to enter into a contractual agreement as to the way each will vote his shares. This type of agreement does not involve the transfer of voting power, but simply obligates each contracting shareholder to abide by the terms of the agreement in voting his own shares. It is of course possible to provide in the agreement that the contracting parties' shares shall not be voted in a certain way but that a designated person, either an outsider or one of the contracting parties, will cast the actual votes. In the latter case, a proxy has obviously been incorporated into the voting agreement.

These voting agreements, sometimes referred to as shareholder pooling agreements, have had a troublesome history in American corporation law. Early cases held such agreements invalid on either one of two public policy grounds. One ground was that the previous contractual commitment to vote a certain way discouraged full discussion at the shareholders' meeting, thereby depriving other shareholders who were not parties to the agreement of the benefit of all the shareholders voting on the basis of independently reached judgments.\(^4\) By the same token, where a proxy device was also used, the courts invalidated the agreement because the voting power of the stock was separated from the ownership of the shares.\(^5\)

As American corporations increased in size during the early part of this century, these reasons lost their validity. Shareholder meetings involving large numbers of shareholders rarely afford the opportunity for meaningful discussion on the matters to be voted upon. In addition, separation of voting power from ownership has become a necessity since

\(^{58}\) New Cal. Corp. Code §300(a).
\(^{59}\) New Cal. Corp. Code §1001(a).
\(^{60}\) New Cal. Corp. Code §§902(a), 903(a), (c), 904.
\(^{63}\) New Cal. Corp. Code §301(a).
\(^{65}\) See Morel v. Hoge, 130 Ga. 625, 61 S.E. 487 (1908); Harvey v. Linville Improvement Co., 118 N.C. 693, 24 S.E. 489 (1896); see also Painter, supra note 2, at 109.
proxies are needed to meet quorum requirements. As a result, judicial hostility has abated as to voting agreements which are limited to proper shareholder concerns. Increasingly, these agreements are upheld "if for a reasonable business purpose, not fraudulent in character, nor oppressive to minority shareholders."^66

a. Application to Close Corporations

The New California Corporations Code expressly recognizes the validity of voting agreements concluded between or among the shareholders of a close corporation.^67 The flexibility of voting agreements under Section 706(a) of the New Code is remarkable, as they may extend to any matter as to which shareholder decision-making is permitted.^68 An agreement may specify how each shareholder shall vote his shares on specific matters. It may require that each shareholder vote his shares on certain matters as a specified majority, either of the parties or of their shares, determines. It may provide that all parties will vote their shares in accordance with an arbitrator's decision. It may compel the contracting shareholders to transfer their shares to a third party who has authority to vote the shares in accordance with the terms of the agreement.^69 It also may provide that a third party will vote all the shares owned by the contracting shareholders in accordance with the terms of the agreement, thereby creating a proxy which is statutorily designated as irrevocable.^70

Section 706(a) also solves the problem encountered in earlier cases as to the specific enforcement of voting agreements.^71 It expressly states that a close corporation's shareholder voting agreement "shall not be denied specific performance by a court on the ground that the remedy at law is adequate or on other grounds relating to the jurisdiction of a court of equity."^72 In addition, a voting agreement executed under the authority of Section 706(a) remains valid as long as the corporation retains its close corporation status, or until the termination of the period of validity specified in the agreement, whichever occurs first.

^68. As to an agreement affecting matters over which shareholders normally have no decision-making power, see text accompanying notes 79-104 infra.
^69. "No agreement made pursuant to subdivision (a) shall be held to be invalid or unenforceable on the ground that it is a voting trust which does not comply with subdivision (b)." New Cal. Corp. Code §706(c). See text accompanying notes 52-56 supra.
It is important to note that while no reference thereto is made in Section 706(a), one judicially developed exception to the validity of shareholder voting agreements undoubtedly remains in force in California. It has generally been held that a shareholder may not "sell" his voting power; that is, he may not enter into an agreement to vote his shares a certain way in return for a purely personal benefit. For example, a shareholder's promise to vote his shares as his creditor directs him in return for forgiveness of his debt is invalid.\(^7\)

b. Application to Closely-Held Corporations

New California Corporations Code Section 706(a) specifically validates voting agreements "between two or more shareholders of a close corporation."\(^7\) This raises the problem of the validity of a voting agreement concluded by the shareholders of a closely-held corporation which has not elected to become a close corporation, or which, because it has more than ten shareholders, is ineligible for such status. Unfortunately, no direct evidence exists either in the wording of the statute or in the Assembly Select Committee Report as to the validity of a voting agreement other than one falling directly within the scope of Section 706(a).

It is arguable that voting agreements among other than close-corporation shareholders will be subject to traditional common law rules. However, according to the Assembly Select Committee, Section 706(a) is based on Section 218(c) of the Delaware General Corporation Law, the latter statute being applicable to all shareholder voting agreements.\(^7\) By taking the substance of the Delaware section, but making it applicable only to close corporations, the California Legislature may have expressed an intent to permit no other shareholder voting agreements. But policy reasons reflected in the case law of the last fifty years militate against an all-embracing prohibition of shareholder voting agreements. The previously mentioned judicial fiat against separation of the voting power of shares from their ownership died a justifiable death.\(^7\) The idea that shareholders should come to the shareholders' meeting and, on the basis of full discussion, reach independent decisions is becoming equally outdated. As stated by one leading writer:

[although a few cases have held shareholder pooling agreements invalid on the ground that parties to such an agreement should not

\(^{73}\) For a collection of cases supporting this view, see W. CARY, CASES AND MATERIALS ON CORPORATIONS 376-77 (4th ed. 1969). For an opposing view, see Manne, Some Theoretical Aspects of Share Voting, 64 COLUM. L. REV. 1427 (1964).

\(^{74}\) Palmbaum v. Magulsky, 217 Mass. 306, 104 N.E. 746 (1914).

\(^{75}\) New CAL. CORP. CODE §706(a) (emphasis added).

\(^{76}\) ASSEMBLY REPORT, supra note 30, at 86.

\(^{77}\) See text accompanying note 66 supra.
be able to restrict their discretion to cast their votes in the best interests of the corporation, this is a naive and unrealistic concept of how shareholders behave, particularly in a closely held corporation. Even if there be some analogy between a meeting of a board of directors and a meeting of a deliberative governmental body such as a legislature or legislative committee . . ., the notion that a shareholders’ meeting is a deliberative body exercising its dispassionate discretion for the corporate good is outdated, to put it mildly. Hence shareholders should be able to agree in advance as to how they shall vote their shares.\textsuperscript{78}

In light of the uncertainty as to the validity of a voting agreement executed by the shareholders of a corporation which is not a close corporation, shareholders of a closely-held corporation which is eligible to become a close corporation clearly should take the appropriate statutory steps to achieve close corporation status if they wish to enter into a voting agreement that will be valid and enforceable. Shareholders of a closely-held corporation which is not eligible to become a close corporation, however, face an as yet unresolved problem. If they desire to enter into a shareholder voting agreement, the lawyer drafting it would be well-advised to state in detail the purpose of the agreement and to try to make all of the shareholders parties thereto. Unanimous shareholder participation and the existence of a reasonable business purpose may be determinative if litigation arises as to the validity and enforceability of the agreement.

\textbf{C. Shareholder Management Agreements}

The discussion in the previous sections was limited to devices which can be used to control shareholder voting. More often, however, the major concern of the shareholders of a closely-held corporation is to control or influence the management process directly. Rather than leave corporate decision-making to the board of directors, the shareholders may wish to limit the directors’ discretionary authority or transfer part or perhaps even all of it to themselves. Although the use of multiple classes of stock may achieve these purposes to some extent, the consequences of becoming ineligible for the close corporation exemption under the California Corporate Securities Law\textsuperscript{79} and the inability to elect Subchapter S federal income tax treatment\textsuperscript{80} are often sufficiently adverse to cause incorporators of a small enterprise to search for an alternative management control device.

\textsuperscript{78} \textit{Painter}, supra note 2, at 110.
\textsuperscript{79} \textit{Cal. Corp. Code} §25102(h).
\textsuperscript{80} \textit{Int. Rev. Code} of 1954, §1371 \textit{et seq}.
The so-called shareholders' agreement, hereafter referred to as the shareholder management agreement, is one device which has often been used in lieu of a multi-class stock structure. The major and obvious problem with the shareholder management agreement is that its utilization violates the traditional common law concept, now generally expressed as a statutory norm, that corporate decision-making is a function of the board of directors. Many cases have invalidated these agreements because they interfered with, limited, or effectively abolished directorial power. Over the years, however, judicial recognition, or at least reluctant acceptance, of the closely-held corporation as sui generis has resulted in limited validation of shareholder management agreements. If agreed to unanimously by the shareholders of a truly closely-held corporation, or if only limited rather than extensive inroads are made upon the directors' authority, such agreements have increasingly been upheld as valid and enforceable. Nevertheless, sufficient uncertainty concerning the basic recognition of closely-held corporations as sui generis, and differences of opinion as to what constitutes a minor rather than a major limitation upon directorial power, have made it difficult for the California lawyer to assure his clients that a shareholder management agreement will be enforced by California courts.

With respect to close corporations, that uncertainty has now been removed to a large extent by the enactment of Section 300(b) of the New Code. Provided it is in writing and all of the shareholders of the close corporation are parties thereto,

[n]o shareholders' agreement, which relates to any phase of the affairs of a close corporation . . . shall be invalid as between the parties thereto on the ground that it so relates to the conduct of the affairs of the corporation as to interfere with the discretion of the board or that it is an attempt to treat the corporation as if it were a partnership or to arrange their relationship in a manner that would be appropriate only between partners.

While the basic validity of shareholder management agreements is therefore clear, the permissible scope of these agreements is in doubt

82. See 1 O'Neal, supra note 2, Ch. 5 passim.
83. See id.
87. It has been suggested that the negative phrasing of the statute creates a new problem; that is, even though a court cannot invalidate a shareholder management agreement on the grounds specified in the statute, it could invalidate the agreement on another ground not specified in the statute. See Note, Separate Statutory Treatment of the Close Corporation in California: Progress and Problems, 27 Hast. L.J. 433, 448 (1975).
to some extent. Section 300(b) validates two specific kinds of agreements. First, an agreement which relates to the division of corporate profits is valid even though the discretionary authority of the board of directors over corporate dividend policy is thereby limited or abolished.\textsuperscript{88} Thus, the shareholders may provide in the agreement that they, rather than the board, will decide whether to declare a dividend;\textsuperscript{89} that dividends shall be declared only if certain specified conditions exist;\textsuperscript{90} or that dividends will be distributed in a manner disproportionate to the amount of individual shareholdings.\textsuperscript{91} Second, shareholders' agreements may limit or transfer board authority in relation to the distribution of corporate assets on dissolution, or provide for specific ways of distributing such assets.\textsuperscript{92}

In addition, the new statute provides that shareholder agreements relating to the management of the business shall be valid.\textsuperscript{93} Thus, any agreed method of structuring the corporate entity for management purposes, even though it turns the enterprise into an "incorporated partnership," is valid and enforceable. Space limitations prevent itemization of the literally dozens of types of provisions from which the incorporators of a close corporation may choose.\textsuperscript{94} Suffice it to say that any management device which changes the traditional corporate decision-making power allocation would fall into this category. Thus, to name only a few possibilities, shareholders may provide that designated individuals will hold and retain specified corporate positions such as president, vice president, or secretary-treasurer; create protective mechanisms for the compensation to be paid to such individuals; provide that specified policy decisions shall require shareholder rather than board approval; allocate disproportionate decision-making authority over specified matters to specified individuals; provide that the corporation will be dissolved upon the happening of specified events; or provide for dispute-solving methods such as arbitration.

While theoretically correct, such a view ignores practical reality. The reasons previously given by courts to invalidate shareholder management agreements are all included in the statute. With the one exception relating to the permissible scope of shareholder management agreements, validity is established by the statute. See text accompanying notes 88-110 infra.

\textsuperscript{88.} New Cal. Corp. Code \S 300(b).
\textsuperscript{89.} The statutorily required corporate financial condition for the declaration of any dividend, however, cannot be dispensed with. See Cal. Corp. Code \S\S 300(c), 500, 501. See Comment, California's New General Corporation Law: Dividends and Reacquisitions of Shares, this volume at 645.
\textsuperscript{90.} See New Cal. Corp. Code \S 300(c).
\textsuperscript{91.} See generally 1 O'Neal, supra note 2, \S 5.20.
\textsuperscript{92.} New Cal. Corp. Code \S 300(b).
\textsuperscript{93.} New Cal. Corp. Code \S 300(b).
\textsuperscript{94.} For a discussion of the various devices and provisions which are often utilized in the closely-held enterprise, see 1 O'Neal, supra note 2, Ch. 5 passim; Ghinger, Shareholders' Agreements for Closely Held Corporations: Special Tools for Special Circumstances, 4 U. Balt. L. Rev. 211 (1975).
Hence, a close corporation seemingly may emasculate the board of directors by either severely limiting its traditional discretionary decision-making power or by transferring that power to the shareholders or officers. Unlike some other states, however, California does not expressly permit the outright abolition of the board of directors. It remains to be determined, therefore, whether California courts will permit the indirect abolition of boards of directors by upholding shareholder management agreements which transfer all decision-making power to the shareholders and maintain only a sham board.

It is important to note that specific statutory limitations on the scope of shareholder management agreements do exist. The New California Corporations Code expressly provides that shareholders' agreements may not alter or waive the statutory provisions concerning restrictions upon distributions to shareholders, involuntarily dissolution proceedings, corporate records and reports, rights to inspection of corporate books and records, crimes and penalties, required filings with the Secretary of State, the definition of close corporation status, and specified voting requirements relating to mergers and reorganizations. In addition, as with shareholder voting agreements, the shareholder management agreement is valid for the period specified therein, or, more importantly, until the corporation loses its close corporation status, whichever occurs first.

Increasingly in recent years, courts have deprived the shareholders of closely-held corporations of the protection of limited personal liability if they have failed to observe statutorily required formalities in operating the corporate enterprise. To the extent that formalities such as shareholders' and directors' meetings are dispensed with in accordance with the terms of a shareholders' management agreement, the New


98. New Cal. Corp. Code §§300, 301; see text accompanying note 89 supra.
108. 1 O'Neal, supra note 2, at §1.09(a).
California Corporations Code now provides that failure to hold these meetings "shall not be considered a factor tending to establish that the shareholders have personal liability for corporate obligations."\textsuperscript{109} However, since failure to hold these meetings traditionally has been only one of many factors relating to piercing a corporation's veil, statutory elimination of this particular ground for piercing has a somewhat limited effect on the close corporation shareholder's overall risk of being subjected to personal liability for corporate obligations. Thus, inadequate capitalization of the enterprise, failure to segregate corporate and personal funds, use of corporate funds for personal purposes, and failure to take steps to establish the functional as well as the legal existence of the corporation,\textsuperscript{110} may still cause a close corporation's veil to be pierced.\textsuperscript{111} Hence, corporate operations should still be planned so as to avoid these pitfalls.

In planning a close corporation's structure, it must also be recognized that the transfer of managerial responsibility from the board of directors to the shareholders in accordance with the provisions of a shareholder management agreement is accompanied by a statutory transfer of liability from the directors to the shareholders for those acts or omissions to act.\textsuperscript{112} This provision will undoubtedly be an important factor in the shareholders' decision as to the scope of their management agreement, or whether they wish to execute an agreement at all.

As noted above,\textsuperscript{113} agreements between or among shareholders as to how their shares will be voted are now valid as a matter of general law, absent fraud, oppression, or the attainment of a personal as opposed to a group benefit. On the other hand, a shareholder management agreement is in violation of the traditional rule that corporate decision-making power rests with the board of directors. Therefore, it is to be expected that these agreements among the shareholders of a closely-held, as opposed to a close corporation, will not be valid in California because they will not fall within the scope of the new provisions which apply only to close corporation shareholder agreements. Hence, if the participants in a closely-held enterprise wish to achieve a nontraditional

\begin{itemize}
  \item \textsuperscript{109} \textit{New Cal. Corp. Code} §300(e).
  \item \textsuperscript{110} The "legal" corporate existence commences when the articles of incorporation are filed by the Secretary of State. \textit{New Cal. Corp. Code} §200(c). Limited personal liability, however, arises only when the corporation has been established as a properly functioning entity, \textit{i.e.} by appointment of duly authorized agents (officers and directors) to act on its behalf, issuance of shares, opening of corporate books, etc. \textit{See Automotriz Del Golfo De Calif. v. Resnick}, 47 Cal. 2d 792, 306 P.2d 1 (1957).
  \item \textsuperscript{111} \textit{See} \textit{Note, Separate Statutory Treatment of the Close Corporation in California: Progress and Problems}, 27 HAST. L.J. 433, 469-72 (1975).
  \item \textsuperscript{112} \textit{See New Cal. Corp. Code} §300(d).
  \item \textsuperscript{113} \textit{See text accompanying notes} 39-78 \textit{supra}.
\end{itemize}
decision-making structure they will probably be well-advised to attempt to achieve their objective through utilization of a multi-class stock structure.

MAINTAINING CONTROL IN CLOSE AND CLOSELY-Held CORPORATIONS

Once the specific management and control structure has been selected for a close or closely-held corporation, a new problem must be considered: protecting that structure against subsequent change. While the utilization of some of the previously discussed devices incorporates basic protection against alterations of the status quo, some danger of future upheaval remains. Other devices are therefore often used, either in conjunction with or as an alternative to the control mechanisms alluded to earlier.

A. High Quorum and Voting Requirements

In some cases minority shareholders of a closely-held enterprise may wish to have veto power over specific matters which are of particular concern to them. For example, a particular director-shareholder who will not be a salaried employee of the corporation may not be willing to invest in the corporation unless he can be given effective assurances that corporate profits will not be depleted by overly generous salary or bonus payments to the employee-shareholders. Assuming that he is one of five directors, it could be provided that a quorum for a board meeting at which salaries are considered shall consist of all five directors, and that the affirmative vote of all five directors shall be required for passage of an employee salary resolution. Similarly, a shareholders owning twenty percent of the corporation’s voting shares could be given a veto power by providing that, as to a specified corporate matter such as a proposed merger, the necessary quorum at the shareholders’ meeting shall be 81 percent of the outstanding shares and that the affirmative vote of at least 81 percent of the outstanding shares shall be required for shareholder approval. Requirements for these “super-majority” or “veto” provisions can be established in both closely-held and close corporations in California under the New Code. However, while such a provision may be contained either in the articles of incorporation or in a shareholder management agreement in the case of a close corporation, a closely-held corporation must include it in the articles of incorporation.  

High quorum and vote requirements can serve a useful purpose.\textsuperscript{116} They can also become a tool of virtual extortion in the hands of an unscrupulous minority shareholder or board member and, if the requirements have been made applicable to too many corporate matters, corporate paralysis may result. For these reasons, they should be used with the utmost care and only after other alternatives are considered.

B. Preemptive Rights

One of the primary concerns of shareholders in a closely-held enterprise quite often is maintenance of the proportionate voting rights as they existed at the time the enterprise was formed. The issuance of additional shares, however, can drastically alter the corporate voting structure. Since additional shares may be authorized by the affirmative vote of a majority of all outstanding shares entitled to vote,\textsuperscript{117} minority shareholders who individually or collectively hold less than fifty percent of the corporation's outstanding voting shares could have their proportionate voting control reduced by majority authorization to issue newly created shares.

There are two methods available to protect minority shareholders against this potential dilution of their voting power. The first is to provide that the issuance of new shares shall require the affirmative vote of a specified “super majority” of the corporation's outstanding voting shares. Thus, a 20 percent shareholder can be protected by requiring the affirmative vote of 81 percent of the outstanding voting shares. Pursuant to the New Code, in the case of a closely-held corporation, this type of provision must be contained in the articles of incorporation to be valid.\textsuperscript{118} In the case of a close corporation, the provision may be inserted either in the articles of incorporation or in a shareholder’s management agreement.\textsuperscript{119} If a “super-majority” provision is included in the articles of incorporation, however, care must be taken to provide that the same “super-majority” is also required to amend such a vote requirement since otherwise a simple majority of the outstanding voting shares could delete the “super-majority” requirement from the articles of incorporation in the future.

The second method is provision for preemptive rights in the shareholders. Unlike most other states, California does not confer preemptive rights unless they are expressly provided for.\textsuperscript{120} In fact, an express

\textsuperscript{116} See Painter, \textit{supra} note 2, at 127-31; 1 O'Neal, \textit{supra} note 2, Ch. 4.
\textsuperscript{117} See New Cal. Corp. Code §§152, 902(a).
\textsuperscript{118} See New Cal. Corp. Code §204(a)(5).
\textsuperscript{119} See New Cal. Corp. Code §§186, 204(a).
\textsuperscript{120} See New Cal. Corp. Code §204(a)(2).
grant of preemptive rights must be contained in the articles of incorporation in the case of a closely-held corporation. On the other hand, they may be inserted in either the articles of incorporation or in a shareholders' management agreement in the case of a close corporation. 

The traditional common law preemptive rights doctrine is of limited scope, granting to each shareholder the right to purchase a portion of newly authorized shares which are being issued for cash, proportionate to his present shareholdings. The doctrine does not apply to newly authorized shares to be issued by the corporation in return for property or services other than cash; to effect a corporate merger; or in payment of a corporate debt. In addition, the doctrine does not apply to previously authorized but unissued shares, or to previously issued shares reacquired by the corporation. Although some courts have granted preemptive rights with regard to previously authorized but unissued shares and to treasury shares under exceptional circumstances, reliance on these exceptions is primarily an invitation to litigation. 

In drafting a preemptive rights provision the attorney must be cognizant of these potential problems. The use of traditional “boiler-plate” language to the effect that “shareholders shall have full preemptive rights as defined by law” in many instances may create unnecessary difficulties which could easily have been avoided with more precise draftsmanship. Thought should therefore be given at the time of incorporation to the question of whether preemptive rights ought to be conferred in certain situations by an express provision. For example, applying preemptive rights to mergers or to corporate acquisitions of property may hamper the corporation's ability to consummate such transactions, and on the balance this may be too high a price to pay to maintain the shareholder's proportionate voting power. On the other hand, if a corporation is organized with an authorization to issue more

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121. See New Cal. Corp. Code §204(a).
127. See Lattin, supra note 123, at 494.
128. See Borg v. International Silver Co., 11 F.2d 147 (2d Cir. 1925).
129. See Lattin, supra note 123, at 495-96.
shares than in fact will be issued initially, and if the purpose is to have unissued shares that may subsequently be used to raise additional capital, it would seem most desirable to expressly provide that shareholders have preemptive rights in these shares. In addition, due to the frequent use of first-option transfer restrictions in the closely-held and close corporation, there is a high likelihood that the corporation will reacquire some of its own shares. Unless a provision exists for the mandatory retirement of reacquired shares, an express grant of preemptive rights should be considered in the event they are reissued.

C. Stock Transfer Restrictions

The success of a small business depends partly upon the existence of harmonious relationships among its participants, which are best ensured when there is substantial agreement as to the goals and operational methods of the enterprise. It is therefore not surprising that the shareholders of a close or closely-held corporation generally wish to control who becomes part of the enterprise. One aspect of traditional American corporation law presents an obstacle to the attainment of this shareholder desire. The alienability of corporate shares, based upon their legal characterization as personal property, gives to each shareholder the power to transfer his shares to anyone willing to pay the purchase price. While this alienability is an absolute necessity from an investment viewpoint with regard to the publicly-held corporation, it is a serious problem for the close and closely-held corporation. Hence, the increasing use of the corporate form by small enterprises has been accompanied by the development of control devices designed to limit the ability of shareholders to transfer their shares.

The New California Corporations Code provides that the articles of incorporation or the bylaws may contain reasonable restrictions upon the right to transfer corporate shares. Arguably, a transfer restriction may also be inserted in a shareholder management agreement in the case of a close corporation. There is no statutory definition, however, of what constitutes a reasonable share transfer restriction. Consequently, a brief survey of the judicial treatment of various transfer restrictions is needed to establish the probable parameters of this statutory.

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130. For the view that regarding stock transfer restrictions as restraints on alienation, and therefore undesirable or prohibited, is an unrealistic, unwise, and unnecessarily analytical approach, see Painter, supra note 2, at 84-85.
rily permissible device.\textsuperscript{134}

1. Absolute Transfer Prohibition

Absolute prohibitions on the transfer of shares have generally been held invalid.\textsuperscript{135} In a few cases, however, absolute transfer prohibitions imposed for a specifically limited time period of short duration have been upheld.\textsuperscript{136}

Unfortunately, no California cases dealing with this issue have been found. However, two older New York decisions have validated absolute transfer restrictions in the closely-held corporation setting. In one case,\textsuperscript{137} the court upheld a restriction upon shares of stock which were transferred by the corporation to two inventors of a machine in exchange for their invention. That restriction provided that the stock was to be held jointly and was inalienable for ten years unless both shareholders consented to a transfer. In the other case,\textsuperscript{138} the court upheld an agreement whereby the promoters of a corporation placed a specified number of stock certificates in trust for six months, the stock remaining in trust unless all the promoters consented in writing to withdraw the shares. It is important that in both cases the court noted that the purpose of the transfer restriction was to place the shareholders on an equal footing as to control and that the agreement was made for the benefit of all parties. Thus, it would be highly advisable for the draftsman of an absolute transfer restriction to identify the purpose behind the imposition of the restriction, thereby providing a court with a concrete reason for upholding such a device.

2. Consent Restrictions

Provisions which permit a shareholder to transfer his shares only with the consent of the corporation or of the other shareholders traditionally have been disfavored by American courts.\textsuperscript{139} However, recent cases seem to uphold these restrictions if they serve a reasonable business need which is identified in the restriction and if protection is given against arbitrary or unreasonable withholding of consent.\textsuperscript{140} Therefore, a carefully drafted consent-to-transfer provision may be upheld, especially if accompanied by a first-option provision, which is discussed below.

\textsuperscript{134} For detailed treatment, see 2 O'NEAL, supra note 2, Ch. 7; Bradley, Stock Transfer Restrictions and Buy-Sell Agreements, 1969 U. ILL. L.F. 139 (1969).
\textsuperscript{135} For a collection of cases, see 2 O'NEAL, supra note 2, at §7.06 n.2.
\textsuperscript{136} Hornstein, Judicial Tolerance of the Incorporated Partnership, 18 LAW & CONTEMP. PROB. 435, 446-47 (1953).
\textsuperscript{137} Hey v. Dolphin, 92 Hun. 230, 36 N.Y.S. 627 (1895).
\textsuperscript{138} Williams v. Montgomery, 148 N.Y. 519, 43 N.E. 57 (1896).
\textsuperscript{139} See PAINTER, supra note 2, at 86.
\textsuperscript{140} See 2 O'NEAL, supra note 2, at §7.08 n.3, 5 and 6.
3. **First-Option Provisions**

The share transfer restriction most often employed, generally upheld as reasonable by the courts, and normally sufficient to achieve the desired corporate goal, is the so-called "first-option" device. It provides that a shareholder who wishes to sell his shares must first offer them to the corporation or to the other shareholders; the shareholder may sell them to an outsider only in the case where the designated optionee decides not to buy the shares. In order to be upheld, this type of provision must limit the option time to a reasonable period.\(^\text{141}\) In addition, it must be drafted carefully so as to encompass all potential transfers of shares, inter vivos and testamentary, as well as transfers by operation of law.\(^\text{142}\) To avoid future disputes over the purchase price, the restriction should specify either a purchase price or a method or formula to determine that price.\(^\text{143}\)

4. **Buy-Out Agreements**

Another provision which may be utilized obligates the corporation or its shareholders to buy the shares upon the happening of a specified event, usually a shareholder's retirement or death.\(^\text{144}\) This type of provision is of particular utility where the shareholders are all active participants in the operation of the corporation. If used properly, either singly or sometimes in combination, all of the aforementioned devices can give substantial control over the transfer of shares and thus over the membership of a closely-held enterprise. It must be stressed that a myriad of problems which are beyond the scope of this article, such as the assurance of funding and possible tax consequences, must be carefully considered by the attorney when drafting transfer restriction provisions.

5. **Qualification of Shareholders**

The New California Corporations Code also provides that the articles of incorporation may impose special qualifications on the ability to become a shareholder.\(^\text{145}\) In the case of a close corporation, such a qualification provision may be included in the articles of incorporation or in a shareholder management agreement.\(^\text{146}\) It would thus be possible to limit the transferability of shares by providing that only persons

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\(^\text{141}\) *Id.* at §7.19.

\(^\text{142}\) See Painter, supra note 2, at 92.

\(^\text{143}\) *Id.* at 93-98. See 10 Cal. Admin. Code §260.140.8.

\(^\text{144}\) See O'Neal, supra note 2, §7.10.


\(^\text{146}\) New Cal. Corp. Code §204(a).

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having specified educational or business backgrounds, or professional or vocational expertise, may become corporate shareholders. Therefore, this device may be indispensable to a corporation conducting a specialized or unique type of business operation.

CONCLUSION

Statutory recognition in California of the close corporation as a form of business association distinguishable from the publicly-held corporation is a realistic law reform. Undoubtedly many small business enterprises will avail themselves of this alternate form of business association. The major benefit of close corporation status unquestionably is the ability to adopt shareholder management agreements and thereby design a control and operational structure meeting the needs of the particular enterprise and its participants.

The statutory validation of such devices as shareholder voting and management agreements also allows California attorneys to feel more secure that these intra-corporate arrangements will be safe from attack. At the same time, the close corporation statutory provisions undoubtedly will result in increased litigation in some areas. The permissible scope of shareholder management agreements is unclear under the statute; that limit will surely be sought through litigation. The proper role and permissible activities of closely-held corporations, falling between the close and the publicly-held corporation, surely will also have to be determined. However, it is undeniable that much of the uncertainty that existed before enactment of the New Corporations Code has been removed by the California Legislature.
Appendix. Skeleton Articles of Incorporation
of a Close Corporation

ARTICLES OF INCORPORATION
of

I.
The name of this corporation is ________________________.

II.
This is a close corporation.

III.
The issued shares of this corporation shall be held of record by no more than ____ persons.

IV.
The purpose of this corporation is to engage in any lawful act or activity for which a corporation may be organized under the General Corporation Law of California other than the banking business, the trust company business, or the practice of a profession permitted to be incorporated by the California Corporations Code.

V.
The corporation's agent for service of process is ___________, whose address is ___________, ___________, California.

VI.
The corporation is authorized to issue _____ shares, all of one class.

VII.
The persons appointed to act as initial directors of this corporation are:

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IN WITNESS WHEREOF, the undersigned, being the persons hereinabove named as the initial directors of this corporation, have executed these Articles of Incorporation this ____ day of ____________, 19____.

________________________

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