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Protection of Shareholder Interests in California Closely Held and Statutory Close Corporations: A Practitioner's Guide

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Protection of Shareholder Interests in California Closely Held and Statutory Close Corporations: A Practitioner's Guide

Don Berger*

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I. INTRODUCTION

Both statutory close and closely held corporations¹ display an obvious difference from the publicly held corporation with its large

1. The organizers of a California corporation with thirty-five or fewer shareholders must make a choice. Section 158 of the California Corporations Code permits an eligible corporation to be formed as a so-called "close corporation." Substantive eligibility requires that the shares of the corporation be held of record by no more than thirty-five shareholders. Procedural requirements are that an appropriate limitation on the number of shareholders and the

number of shareholders who do not participate directly in the operation of the corporate enterprise. The small corporate enterprise is the quintessential example of either the owner-operated business or of the enterprise whose few non-managing shareholders keep a close watch on the managing shareholders. Such close personal association between management and the shareholders not only merits but mandates the consideration of infusing special protective control devices into the corporate structure.

Of paramount concern to present participants in this kind of corporate enterprise is the ability to control who will become associated with the enterprise in the future. Intertwined with this concern is the problem of assuring shareholders that their respective proportional ownership interests in the corporation will not be diluted through the sale of corporate shares to additional shareholders. The devices which can be utilized to achieve the kind of control and security desired by the shareholders of a closely held corporation are the focus of this article.

II. SPECIAL SHAREHOLDER QUALIFICATIONS

Section 204(a)(3) of the California Corporations Code provides that the articles of incorporation may require that only persons possessing special qualifications may become shareholders.² In the case of a statutory close corporation such a provision may be inserted in a shareholders' agreement rather than in the articles of incorporation.³

It is thus possible to limit the transferability of outstanding shares, and the issuance of newly authorized shares, previously authorized

statement, "This corporation is a close corporation," be expressed in the articles of incorporation. CAL. CORP. CODE § 158 (West Supp. 1989). The primary benefits of forming an eligible corporation as a close corporation are that voting or pooling agreements and shareholders' agreements executed by close corporation shareholders are given statutory validity. CAL. CORP. CODE § 706(a) (West 1977); CAL. CORP. CODE §§ 186, 300(b) (West 1977).

A corporation with no more than thirty-five shareholders does not automatically become a close corporation. Lack of the required additional provisions in the articles of incorporation leaves it a generic "closely held" corporation.

In order to make necessary distinctions in this article, corporations having elected "close corporation" status will be referred to as "statutory close" corporations. Other small corporations will be referred to as "closely held." See Berger, *Statutory Close or Closely Held Corporation?* 11 PAC. L.J. 699 (1980) (discussion of the advantages and disadvantages of forming an eligible corporation as a close corporation).

2. CAL. CORP. CODE § 204(a)(3) (West Supp. 1989).

3. CAL. CORP. CODE § 300(b), (c) (West Supp. 1989).

but unissued shares, and treasury shares,⁴ by providing that only persons having a specified educational or business background, or professional or vocational expertise, may become shareholders. This limitation is a potentially valuable device in a corporation conducting a specialized or unique type of business operation. To the extent that the imposition of such a special qualification is used in a corporation in which all of the shareholders are actively participating in the actual running of the enterprise, it may serve a useful purpose. Depending upon the nature of the enterprise, however, imposing special qualifications on shareholder status may prevent the corporation from raising needed capital in future years by unduly limiting the pool of potential investors.

If used in conjunction with the usual first-option transfer restriction,⁵ a shareholder qualification provision also has the potential effect of locking present shareholders into their investment since the decision by the corporation and/or the other shareholders not to purchase the shares of a fellow shareholder leaves the latter with the difficult task of finding a qualified purchaser for his⁶ shares. The ability to impose special shareholder qualifications should therefore be used only after careful analysis of the potential consequences and an explanation of these consequences by the attorney to the participants in the corporation. Since a provision requiring special qualifications for shareholder status is, in effect, a transfer restriction, its existence must be noted on the share certificates.⁷

III. SUPER-MAJORITY VOTING REQUIREMENTS

The issuance by a corporation of additional shares can have a drastic effect on the position of its shareholders. A shareholder who owns 1,000 of a corporation's 10,000 outstanding shares will have

4. Since its revision in 1977, the California Corporations Code no longer specifically refers to "treasury shares." Once outstanding shares which are reacquired by the issuing corporation are now considered authorized but unissued shares. CAL. CORP. CODE § 510(a) (West Supp. 1989). The term treasury shares is nevertheless used in this article as a generic term for once outstanding shares which as a result of a repurchase, redemption or otherwise have been reacquired and are presently held by the issuing corporation.

5. See *infra* text and accompanying notes 62-107 (Section VI discusses first-option transfer restrictions).

6. By use of words in the masculine gender, the author intends to include the feminine gender and intends no offense. The purpose of this usage is to be consistent with quotations from statutes and cases.

7. CAL. CORP. CODE § 418(a)(1) (West Supp. 1989).

his proportionate voting power reduced by fifty percent if that corporation issues 10,000 additional shares, unless of course he can purchase some of those additional shares. Similarly, the issuance of additional shares decreases each shareholder's proportionate dividend and liquidation distribution rights.

One method that can be utilized to protect shareholders against the dilution of their respective interests in the corporation, is to impose super-majority voting requirements as a prerequisite to the issuance of additional shares.⁸ Thus, higher than normal voting requirements can be required for shareholder approval of an amendment to the articles of incorporation which provides for an increase in the corporation's authorized shares,⁹ and also for approval by the board of directors for the issuance of previously authorized but unissued shares.¹⁰ In a statutory close corporation, such super-majority voting requirements can be inserted in a shareholders' agreement instead of in the articles of incorporation.¹¹

IV. PREEMPTIVE RIGHTS

The primary device used to protect present shareholders against the dilution of their respective proportionate interests in the corporation is embodied in the common law preemptive rights doctrine. Preemptive rights entitle each present shareholder to buy a sufficient number of the additional shares to be issued by the corporation to maintain his present proportionate ownership interest in the corporation. Thus, a ten percent shareholder must be given the opportunity to buy ten percent of the additional shares.

Reliance on the preemptive rights doctrine to protect the shareholders of a closely held or statutory close corporation is fraught with difficulties. First, a shareholder must be financially able to buy the shares when they are offered; inability to raise the necessary funds, in effect, makes the protection meaningless. In addition, the limited scope of the common law preemptive rights doctrine gives only partial protection, and careful drafting is necessary to devise a

8. *Id.* §§ 204(a)(5), 602(a) (West Supp. 1989).

9. *Id.* §§ 204(a)(5), 602(a) (West Supp. 1989).

10. *Id.* § 204(a)(5) (West Supp. 1989).

11. *Id.* Because the Secretary of State can refuse to accept for filing documents which do not conform to law, it is generally considered preferable to keep the articles of incorporation as simple as possible and to insert optional provisions in other corporate documents whenever legally permissible. *See generally id.* § 110(a) (West 1989).

provision that will enlarge that right to the maximum extent possible without stultifying the corporation in its legitimate attempts to raise capital when needed in future years.

Unlike some other states, California does not extend to corporate shareholders the protection of the preemptive rights concept as a matter of common law. Section 406 of the California Corporations Code provides that the board of directors may issue shares "without first offering them to shareholders" unless a provision to the contrary takes away that authority.¹² Such a provision to the contrary, in other words a preemptive rights provision, can be inserted in the articles of incorporation¹³ or, in the case of a statutory close corporation, in a shareholders' agreement.¹⁴ It is therefore crucial that an appropriate provision be drafted and set forth in the statutorily specified document.

Routine utilization of the traditional boiler-plate language to the effect that "shareholders shall have full preemptive rights as defined by law" is incomplete protection and constitutes an invitation to future litigation. A discussion of what constitutes an appropriate provision requires a brief excursion into the limitations of the common law doctrine of preemptive rights.

A. Preemptive Rights at Common Law

The common law preemptive rights doctrine only applies to newly authorized shares sold by the corporation for cash.¹⁵ It does not apply to the sale by a corporation of previously authorized but unissued shares, or of treasury shares,¹⁶ nor does it apply to the issuance of newly authorized shares used by the corporation to purchase property or facilitate a merger.¹⁷ Thus, inserting into the appropriate corporate document the kind of general boiler-plate language quoted in the preceding paragraph confers very limited protection to the shareholders. This is especially true because of the

12. CAL. CORP. CODE § 406 (West Supp. 1989).

13. *Id.* § 204(a)(2) (West Supp. 1989).

14. *Id.* § 204(a) (West Supp. 1989).

15. See, e.g., *Stokes v. Continental Trust Co. of City of New York*, 186 N.Y. 285, 78 N.E. 1090, 1094-95 (1906): "We are thus led to lay down the rule that a stockholder has an inherent right to a proportionate share of *new stock issued for money only* and not to purchase property for . . . the corporation or to effect a consolidation . . ." [emphasis added]. *Id.*

16. *Id.*

17. *Id.*

almost universal utilization of either first-option transfer restrictions and/or buy-out agreements, in the closely held or statutory close corporation. Both of these create a great likelihood that the corporation will reacquire some of its own shares which could be reissued in future years and would not normally be encompassed by the common law preemptive rights concept.

Case law has created a number of exceptions which have extended the protections of the preemptive rights doctrine to fact situations otherwise not covered by it. Thus, it has been held that shareholders have a preemptive right to purchase originally authorized but unissued shares when those shares are issued a substantial period of time after the corporation was originally organized.¹⁸ The rationale for this exception rests on the presumed intention of the organizing shareholders. Leaving a newly formed corporation with unissued shares is normally viewed as the expression of an intent that the originally planned capitalization consist of the potential issuance of all authorized shares. Thus, an initially purchasing shareholder is regarded as having acquiesced to gauging his proportionate ownership interest on the basis of all authorized shares, rather than on the basis of only the immediately issued shares. If those originally authorized shares are not issued for a long time, however, some courts have accepted the argument that the long-standing voting power distribution based on the issued shares has achieved such a fundamental status that the issuance later of originally authorized shares is equivalent in impact to the issuance of newly authorized shares — that is, it upsets what has become a traditional system of voting control and profit distribution.¹⁹ Obviously, the same reasoning can be used to support the argument that preemptive rights should apply to the issuance of treasury shares which were not cancelled by the corporation when reacquired and which are then proposed to be issued a substantial period of time after their acquisition by the corporation.

From a pragmatic viewpoint, however, it is foolhardy to rely for protection on such judicially created exceptions when organizing a

18. *Titus v. Paul State Bank*, 32 Idaho 23, 179 P. 514 (1919); *Carlson v. Ringgold County Mutual Telephone Co.*, 252 Iowa 748, 108 N.W.2d 478 (1961); *Hanny v. Sunnyside Ditch Co.*, 82 Idaho 271, 353 P.2d 406 (1960); *Humboldt Driving Park Assoc. v. Stevens*, 34 Neb. 528, 52 N.W. 568 (1892); *Morris v. Stevens*, 178 Pa. 563, 36 A. 151 (1897); *Glenn v. Kittanning Brewing Co.*, 259 Pa. 510, 103 A. 340 (1918). *Thurmond v. Paragon Colliery Co.*, 82 W. Va. 49, 95 S.E. 816 (1918).

19. See, e.g., *Yasik v. Wachtel*, 25 Del. Ch. 247, 17 A.2d 309 (1941); *Ross Transport, Inc. v. Crothers*, 185 Md. 573, 45 A.2d 267 (1946); *Dunlay v. Avenue M Garage & Repair Co.*, 253 N.Y. 274, 170 N.E. 917 (1930).

closely held or statutory close corporation in California. There appear to be no California cases on point, and cases from other states have, as is to be expected, differed in their interpretation of what length of time constitutes a sufficiently substantial period to justify this enlargement of the common law preemptive right.²⁰ In view of the fact that the issuance of additional shares is one of the traditional "squeeze-out" techniques used to get rid of minority shareholders, failure to draft an all-embracing preemptive rights provision because of the existence of this body of exceptional cases in effect means the likelihood of litigation in future years by shareholders who need this protection.

The preemptive rights problem is further complicated by the limitation, already mentioned, that the common law doctrine does not offer protection to shareholders unless the corporation is issuing the additional shares for cash. Shares, even newly authorized shares, are not subject to the common law preemptive right when issued in exchange for property or services,²¹ in cancellation of a debt owed by the corporation,²² or to effect a merger.²³ The justification for this limitation on shareholder protection is born of necessity — a corporation would be frustrated in its ability to obtain needed property or services, for example, if it has to sell the shares to shareholders rather than to the seller of the property or services. There is an unspoken assumption, of course, that the seller of the property needed or desired by the corporation is not willing to take cash but only shares; but with one exception,²⁴ the cases so far have not delved into the argument that preemptive rights can only be denied in such a case. This argument has merit. If the seller of property is willing to take cash, it would be more fair to sell shares to the present shareholders and to use the cash so generated to buy the property than to issue the shares to the seller of the property and thereby disturb the existing allocation of voting and economic rights in the corporation. The point once again is that careful drafting should fill the gap by specifying that preemptive rights do apply unless, for example, needed property cannot be obtained except for

20. See, e.g., *Yasik*, 25 Del. Ch. at 247, 17 A.2d at 309; *Ross Transport*, 185 Md. at 573 45 A.2d at 267; *Dunlay*, 253 N.Y. at 274, 170 N.E. at 917.

21. *Curtis v. Briscoe*, 129 So. 2d 450 (Fla. App. 1961); *Meredith v. New Jersey Zinc & Iron Co.*, 55 N.J. Eq. 211, 37 A. 539 (1897).

22. *Musson v. New York & Queens Elec. Light & Power Co.*, 138 Misc. 881, 247 N.Y.S. 406 (1931).

23. *Bingham v. Savings Investment & Trust Co.*, 102 N.J. Eq. 302, 140 A. 321 (1928).

24. *Fuller v. Krogh*, 15 Wis. 2d 412, 113 N.W. 2d 25 (1962).

the issuance of shares, or unless a debt instrument requires that the debt be extinguished through the issuance of shares to the creditor.

B. Drafting Preemptive Rights Provisions

In the publicly held corporation the existence of preemptive rights creates pragmatic problems. Having to offer additional shares first to present shareholders causes delays in the corporation's efforts to raise capital, limits its financial flexibility, and may increase the cost of underwriting. In addition, publicly held corporations often have more than one class of shares outstanding; and trying to unravel the mystery of which classes of shares have preemptive rights to the additional shares, or worse yet, to convertible debt instruments to be issued, may well be beyond the grasp of ordinary mortals.²⁵ Where state law permits, it is therefore the common practice to eliminate preemptive rights in publicly held corporations.

Such concerns have little if any applicability to the closely held or statutory close corporation, however, where different policy factors and pragmatic needs justify not only the retention but indeed the expansion of shareholder protection through carefully drawn preemptive rights provisions. As stated by a leading writer on close corporation law:

Most of the considerations that justify the elimination of preemptive rights in publicly-held corporations do not apply to closely-held corporations, at least not to those with a simple share structure . . . [S]hareholders in a close corporation are usually vitally interested in maintaining their proportionate control and their proportionate interest in dividends and assets. A shareholder's interest in a closely-held corporation is likely to be proportionately greater than the individual interest of a shareholder in a publicly-held corporation . . . Control is more important to a shareholder in a closely-held corporation . . . because control . . . often means employment, and the loss of control may result in a termination of employment . . . [I]f the business prospers, its growth is likely to be due largely to the energy and skill of its shareholders. Therefore, they should be in a position to purchase new shares of the corporation's stock and thus share in its expansion and prosperity.²⁶

25. 1 MODEL BUSINESS CORPORATION ACT ANNOTATED §§ 6.30(b)(4), (5) (1988) (possible statutory clarification of preemptive rights entitlement in a multi-class stock corporation is set forth). See also 1 F. O'NEAL & R. THOMPSON, O'NEAL'S CLOSE CORPORATIONS § 3.39 (3d Ed. 1986).

26. 1 F. O'NEAL & R. THOMPSON, *supra* note 25 at § 339.

In order to protect the justified expectations of shareholders in closely held and statutory close corporations, therefore, lawyers should consider the following matters when drafting the constitutive corporate documents.

1. Authorized Shares

It is normally advisable to limit the number of a corporation's authorized shares to those that will in fact be issued at the time of incorporation. The lack of authorized but unissued shares, which can be issued by the board of directors without shareholder approval, protects shareholders against the subsequent dilution of their interests. To issue additional shares in the future, the board of directors must obtain shareholder approval for an appropriate amendment to the articles of incorporation, a requirement that can be subjected to a super-majority voting requirement.²⁷ The newly authorized shares can and should be subjected to the shareholders' preemptive rights.

Sometimes, however, good reasons exist for authorizing more shares than will be initially issued. Perhaps it is foreseeable that additional capital will be required, for example, and the organizers want to avoid the necessity of having to amend the articles of incorporation. As mentioned above, such authorized but unissued shares are normally not within the preemptive rights doctrine. To protect shareholders under these circumstances, it is essential that the preemptive rights provision in the articles of incorporation (or in the shareholders' agreement) specify that shareholders have such a right with respect to newly authorized shares.

2. Reacquired Shares

Closely held and statutory close corporations normally use first-option transfer restrictions²⁸ which require a shareholder who wants to sell his shares to offer them first to the corporation or to the other shareholders before they can be sold to anyone else. Similarly,

27. See *supra* notes 8-11 and accompanying text (Section III discusses super-majority voting requirements).

28. See *infra* notes 62-107 and accompanying text (Section VI discusses first-option transfer restrictions).

such corporations often employ buy-out agreements²⁹ under which the shares of a deceased or retiring shareholder must be purchased by the corporation or by the other shareholders. The acquisition by a corporation of its own shares as a result of these devices poses a potential threat to the remaining shareholders since the reissuance of such shares can result in drastic reallocations of proportionate ownership interests. Reacquired shares are not subject to the traditional common law preemptive rights rule. Unless specific directions as to the cancellation or reissuance of reacquired shares are included in the transfer restriction provision or in the buy-out agreement, it is crucial that the preemptive rights provision be made expressly applicable to the reissuance of reacquired shares.

Shares reacquired by a corporation are normally referred to as "treasury shares." In California, however, the concept of treasury shares has been statutorily abolished. Under section 510(a) of the California Corporations Code, when a corporation "purchases, redeems, acquires by way of conversion to another class or series, or otherwise acquires its own shares, those shares are restored to the status of authorized but unissued shares, unless the articles prohibit the reissuance thereof."³⁰ Thus, shares reacquired by a California corporation which are allowed to be reissued are technically included in a preemptive rights provision which applies to originally authorized but unissued shares. For the sake of clarity, however, it is advisable to provide specifically that reacquired shares are subject to preemptive rights, if that is desired, since the persons deciding on their reissuance are normally not cognizant of the legal classification of such shares.

3. *Shares Issued for Non-Cash Consideration*

A provision extending preemptive rights to originally authorized but unissued shares and to treasury shares still offers only partial protection to shareholders. As already mentioned, only shares issued for cash are subject to preemptive rights. Shareholder interests can still be diluted if the corporation issues additional shares in exchange for property, services or in payment of a corporate debt. For maximum shareholder protection, the preemptive rights provision should provide that shares can only be issued as consideration in a non-cash

29. See *infra* notes 108-123 and accompanying text (Section VII discusses buy-out agreements).

30. CAL. CORP. CODE § 510(a) (West Supp. 1989).

transaction if the property or services are not obtainable for cash and are truly needed by the corporation, or in the case of a debt payment, that the debt instrument requires the issuance of shares as payment for the debt.

4. Stock Option or Purchase Plans

Section 408 of the California Corporations Code authorizes corporations to adopt stock option and stock purchase plans for its employees and directors.³¹ An all-embracing preemptive rights provision might become an obstacle to the adoption and implementation of such incentive plans in future years. Consideration should therefore be given to drafting the preemptive rights provision in such a way as to allow the corporation to issue shares for an incentive plan free from preemptive rights. If necessary, a separate provision could be added requiring a super-majority vote of the board of directors for the adoption of an incentive plan. As an alternative, the adoption of an employee stock option or purchase plan could be subjected to the requirement of shareholder approval as well as board approval.

In short, careful consideration of the above discussed matters will protect shareholders from this dilution of their interest in the corporation and will preserve flexibility in the corporation for obtaining financing when needed.

V. SHARE TRANSFER PROHIBITIONS AND CONSENT RESTRAINTS

A. In General

To a large extent, the success of a small business depends upon the existence of harmonious relationships among its participants. Agreement among the participants on the operations and goals of the business is a necessary ingredient of that harmony. It is therefore not at all surprising that the shareholders of closely held and statutory close corporations, especially those who are actively engaged in running the business on a daily basis, wish to have control over who is allowed, by virtue of share ownership, to become a member of the enterprise in future years. To the extent that this concern is based

31. *Id.* § 408 (West Supp. 1989).

on the desire to allow only individuals possessed of specialized expertise, skills or education to join the business, this can be accomplished, as already mentioned,³² by adopting a requirement imposing specific qualifications upon shareholder status.

It is somewhat difficult, however, to devise pragmatically meaningful ways of assuring present shareholders protection against such amorphous qualities as obstreperousness, laziness, arrogance, lack of common sense or any of the myriad of other human foibles that can quickly poison an amicable working atmosphere in a business organization. To prevent individuals who possess undesirable qualities, or lack desirable ones, from becoming shareholders in the future is thus an important yet difficult task in the closely held and statutory close corporation.

An additional concern is the objective of preventing the number of participants from increasing beyond desirable or permissible limits. Thus, statutory close corporation status is lost if a legally effective transfer increases the number of shareholders in the corporation to more than the maximum number specified in the articles of incorporation;³³ Subchapter S tax treatment is lost if a transfer increases the number of shareholders beyond thirty-five.³⁴ The goal of keeping the closely held corporation closely held, the statutory close corporation close, and both of them harmonious requires that a method be used to limit the ability of all shareholders to sell or otherwise transfer shares to whomever they please.

One aspect of traditional American corporation law presents an obstacle to the attainment of that goal. Rightly or wrongly, wisely or not, corporate shares have been cast into the common law mold of "personal property" and have thus been endowed with the sanctity of unfettered alienability.³⁵ Thus, every shareholder has the right to transfer his shares to anyone, and some early cases invalidated restrictions imposed on that right by characterizing them as unreasonable restraints on alienation of personal property.³⁶ Free aliena-

32. See *supra* notes 2-7 and accompanying text (Section II discusses provisions for special shareholder qualifications).

33. CAL. CORP. CODE § 158(c) (West Supp. 1989).

34. I.R.C. § 1371 (1989).

35. See W. PAINTER, *CORPORATE AND TAX ASPECTS OF CLOSELY HELD CORPORATION* 107-109 (2d Ed. 1981) (an expression of the view that to regard restrictions on the right to transfer corporate shares as restraints on alienation and therefore undesirable or prohibited is an unrealistic, unwise and unnecessarily analytical approach).

36. See Annotation, *Construction and Application of Provisions of Articles, By-Laws, Statutes, or Agreements, or Agreements Restricting Alienation or Transfer of Corporate Stock*, 2 A.L.R. 2d 745 (1948).

bility of corporate shares is, of course, an absolute necessity from the viewpoint of an investor in a publicly held corporation. As one court has pointed out:

The purpose or reason underlying the policy favoring transferability of certificates reflecting corporate ownership is fundamental to our economic system. In theory and in practice, we are a commercial nation comprised of individuals who trade among themselves under a competitive, free-enterprise system. Certificates reflecting corporate ownership, even in close corporations . . . are a part of our commerce. Our laws abound with provisions which favor corporations and dealings in corporate securities and certificates. Indeed corporate certificates have become almost as negotiable as legal tender.³⁷

From the viewpoint of the closely held and statutory close corporation, however, the free alienability of shares is more in the nature of an Achilles' heel. Luckily the traditional flexibility of the common law has once again provided a workable accommodation. The fiat against the restriction on the alienability of corporate shares has, through an evolutionary process, been changed into a prohibition of only those restraints which are unreasonable. As a consequence, the increasing use of the corporate form by small enterprises has been accompanied by the search for share transfer restrictions which are reasonable and therefore enforceable.³⁸

B. The California Statute

The California Corporations Code provides that the articles of incorporation may impose "(r)easonable restrictions upon the right to transfer or hypothecate shares . . ."³⁹ A provision to this effect may be included in the bylaws.⁴⁰ A reasonable transfer restriction may also be included in a shareholders' agreement executed by the shareholders of a statutory close corporation.⁴¹ The existence of a transfer restriction must be conspicuously noted on the share certificates.⁴²

37. *Goldblum v. Boyd*, 341 So. 2d 436, 448 (La. App. 2d Cir. 1977).

38. W. PAINTER, *supra* note 35, at 110-11: "... so-called first option or first refusal type restrictions, giving an option to purchase the stock upon the happening of a specified condition, have been upheld if 'reasonable.' A survey of the cases indicates that nearly all restrictions of the latter type have been held reasonable . . ." *Id.*

39. CAL. CORP. CODE § 204(b) (West Supp. 1989).

40. *Id.* § 212(b)(1) (West Supp. 1989).

41. *Id.* § 300(b) (West Supp. 1989). See Note, *Separate Statutory Treatment of the Close Corporation in California: Progress and Problems*, 27 HASTINGS L.J. 433, 458-63 (1975).

42. CAL. CORP. CODE § 418(a)(1) (West Supp. 1989).

There is no statutory definition or guideline as to what constitutes a "reasonable" share transfer restriction. In a relatively recent California Supreme Court case involving the validity of a first-option transfer restriction contained in the corporation's bylaws, the court set forth the following criteria and reasoning:

The term "reasonable" imports a twofold requirement. The bylaw must not constitute an unreasonably restrictive curtailment of the right of alienation . . . , and it must not otherwise unreasonably deprive the shareholder of "substantial rights."

. . .

Bylaws restricting transfer in a close corporation are frequently essential to a successful enterprise; they perform an important function in precluding unwanted intrusion by outsiders; they preserve the integrity of the functioning entity.

In the light of the legitimate interests to be furthered by the bylaw, [the shareholder's] asserted right [to free alienation] becomes "innocuous and insubstantial." . . . The bylaw merely proscribes [the shareholder's] choice of transferees while insuring to her the price and terms equal to those offered by the outsider.⁴³

Basically, therefore, the "reasonableness" of a share transfer restriction depends upon a balancing of the public policy favoring the free flow of corporate securities against the more recently developed policy which seeks to accommodate the special needs of closely held and statutory close corporations.

Although lawyers tend to turn automatically to the first-option transfer restriction, it is not the only device that may be available. Absolute transfer prohibitions as well as so-called consent restrictions, used within strict limits, may be considered as reasonable transfer restrictions at times. A brief look at the judicial reaction to the various kinds of transfer restrictions, and the lessons to be gleaned therefrom by the drafter, is therefore in order to establish the probable parameters of this statutorily permissible device.

C. Transfer Prohibitions

The validity of a transfer prohibition is determined by its reasonableness under common law corporation law principles⁴⁴ as well as the California statute.⁴⁵ Although virtually all of the relatively few

43. *Tu-Vu Drive-In Corporation v. Ashkins*, 61 Cal. 2d 283, 286-87, 391 P.2d 828, 830, 38 Cal. Rptr. 348, 350 (1964).

44. H. HENN & J. ALEXANDER, *LAWS OF CORPORATIONS* 758 (3d ed. 1983).

45. CAL. CORP. CODE § 204(b) (West Supp. 1989).

cases involving the validity of absolute transfer prohibitions declared them invalid as unreasonable restraints on alienation,⁴⁶ there is support for the proposition that such a prohibition, if imposed for a specifically limited and relatively short period of time should be upheld if adopted for a legitimate business purpose or need which is reasonable under all of the surrounding factual circumstances.⁴⁷ For example, if the participants in a newly organized corporation rely simply on the protection afforded by a first-option transfer restriction, they run the risk that an exercise of the option to buy shares from a shareholder who wants to liquidate his investment in the first or second year of the corporation's existence will not be possible because of the lack of financial resources on the part of the option holder. Consequently, the shareholder desiring to sell would be free to sell to an outsider. Therefore, it may be advisable to adopt an absolute transfer prohibition which would terminate at the end of the first or second year of the corporation's existence.

There seems to be no judicial precedent clearly validating an absolute transfer prohibition. However, two New York decisions have upheld provisions which were equivalent to absolute transfer restrictions in a closely held corporation setting.⁴⁸ In the first case, 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.⁴⁹ The 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 second case, the court upheld an agreement whereby the promoters of a corporation placed a specified number of share certificates in trust for six months, the shares remaining in trust unless all promoters consented in writing to a withdrawal of the shares.⁵⁰ It is important to emphasize that in each of the two 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.⁵¹ Thus, if unusual circumstances call for the utilization of an

46. See Annotation, *Validity of Restrictions by Corporation on Alienation or Transfer of Corporate Stock*, 65 A.L.R. 1159 (1930), 61 A.L.R. 2d 1318 (1958); Annotations, *Validity of Restrictions on Alienation or Transfer of Corporate Stock*, 53 A.L.R. 3d 1272 (1973).

47. 2 F. O'NEAL & R. THOMPSON, *supra* note 25 at § 7.06; Hornstein, *Judicial Tolerance of the Incorporated Partnership*, 18 LAW & CONTEMP. PROB. 435, 447 (1953).

48. *Hey v. Dolphin*, 36 N.Y.S. 627 (1895); *Williams v. Montgomery*, 148 N.Y. 519, 43 N.E. 57 (1896).

49. *Hey*, 36 N.Y.S. at 632-33.

50. *Williams*, at 148 N.Y. at 519-20, 43 N.E. at 57-58.

51. *Id.* at 521, 43 N.E. at 59; *Hey*, 36 N.Y.S. at 631.

absolute transfer restriction, the drafter should identify with precision the purpose to be served, thereby supplying a potential basis for judicial validation in case of litigation. An absolute transfer prohibition should also be of very short duration.

In addition to the limitations applicable to transfer prohibitions under general corporation law just discussed, a corporation that must file an application for qualification by permit⁵² with the Commissioner of Corporations for the issuance of its shares faces an additional hurdle. The Corporate Securities Rules provide that a provision which absolutely prohibits the transfer of securities will only be permitted in unusual circumstances.⁵³ While not giving any specific guidelines, Corporate Securities Rule 260.140 provides a general criterion:

A variation from the standards stated in this Article will be granted at the request of the applicant in the case of a limited offering qualification if it is possible to find that the offer and sale will not be unfair, unjust or inequitable to the initial purchasers upon the basis of all of the facts and circumstances of the case.⁵⁴

Thus, the use of a transfer prohibition for a reasonable purpose and a limited time period would have to meet the criterion of Rule 260.140.

D. Consent Restraints

Provisions which make a shareholder's ability to transfer his shares conditional on obtaining the consent of the corporation's board of directors, or of a specified number of its shareholders, or of a specified percentage of its outstanding shares have often been declared invalid by American courts as unreasonable restraints on alienation.⁵⁵ However, the more recent trend towards judicial recognition of the special needs of closely held corporations has yielded a growing number of cases in which such consent restraints have been held valid and enforceable.⁵⁶ In a number of cases courts have expressly

52. "It is unlawful for any person to offer or sell in this state any security in an issuer transaction . . . unless such sale has been qualified . . ." CAL. CORP. CODE § 25110 (West 1977).

53. 10 CAL. CODE REGS. § 260.140.8 (1989).

54. *Id.* § 260.140 (1989).

55. Numerous cases are cited in W. PAINTER, *supra* note 35, at 110, n. 10 and 2 F. O'NEAL & R. THOMPSON, *supra* note 25, at § 7.08 n. 2.

56. *See, e.g.*, Schaffer v. Below, 278 F.2d 619 (3d Cir. 1960); Mason v. Mallard Tel. Co., 213 Iowa 1076, 240 N.W. 671 (1932); Colbert v. Hennessey, 351 Mass. 131, 217 N.E.2d 914 (1966); Gray v. Harris Land & Cattle Co., 737 P.2d 475 (Montana 1987); Ling & Co. v. Trinity Savings & Loan Ass'n, 482 S.W.2d 841 (Tex. 1972).

stated that the desire of exerting control over who becomes a shareholder of a closely held corporation is a reasonably necessary characteristic of that type of corporation which justifies a subordination of the policy against restraints on alienation.⁵⁷ Some cases have upheld the validity of consent restraints where the language of the restrictive provision provided protection against the unreasonable or arbitrary withholding of consent,⁵⁸ or where such protection was provided de facto.⁵⁹ The fact that a consent restraint will be upheld only if it is a reasonable restraint points out once again the need to set forth in clear terms the purpose for which it is imposed.

A corporation that must file an application for qualification by permit⁶⁰ with the Commissioner of Corporations for the issuance of its shares is limited, beyond the general corporation factor just discussed, by the California Corporate Securities Rules which provide that a consent restraint will not be approved except in unusual circumstances.⁶¹ As quoted above, Rule 260.140 indicates that an exception may be made if the existence of such a consent restraint would not be unfair, unjust or inequitable to the initial purchaser of the shares.

VI. FIRST-OPTION TRANSFER RESTRICTIONS

Without question, the most pervasively used transfer restriction in the closely held and statutory close corporation setting is the so-called first-option, or right of first refusal, restriction. Unlike the previously discussed transfer prohibition and consent restraint, which involve the potential of a shareholder being prevented from selling his shares, the first-option transfer restriction merely controls who the buyer of the shares will be. It basically provides that a shareholder who wants to sell his shares must first offer them to a specified buyer, usually the corporation or the other shareholders. Only if that specified option holder decides not to purchase the proffered shares

57. See, e.g., *Mason v. Mallard Tel. Co.*, 213 Iowa 1076, 240 N.W. 671 (1932); *Longyear v. Hardman*, 219 Mass. 405, 106 N.E. 1012 (1914); *Fayard V. Fayard*, 293 So. 2d 421 (Miss. 1974); *Wright v. Iredell Tel. Co.*, 182 N.C. 308, 108 S.E. 744 (1921).

58. *Rafe v. Hindin*, 29 App. Div. 2d 481, 288 N.Y.S.2d 662, *aff'd*, 23 N.Y.2d 759, 296 N.Y.S.2d 955, 244 N.E.2d 469 (1968).

59. *Carlson v. Ringgold County Mutual Tel. Co.*, 252 Iowa 748, 108 N.W. 2d 478 (1961); *In Re West Waterway Lumber Co.*, 59 Wash. 2d 310, 367 P.2d 807 (1962). Cf. *Mowatt v. 1540 Lake Shore Drive*, 385 F.2d 135 (7th Cir. 1967).

60. See *supra* note 52.

61. 10 CAL. CODE REGS. § 260.140.8 (1989).

is the shareholder free to sell them to anyone else. Drafting a properly comprehensive option transfer restriction involves many considerations which will be addressed in the following sections.

A. Location of Restriction

A first-option transfer restriction may be included either in the articles of incorporation,⁶² in the bylaws,⁶³ or in a shareholders' agreement.⁶⁴ Prevalent California practice apparently is to include such a provision either in a shareholders' agreement or in the bylaws rather than in the articles of incorporation.⁶⁵

B. Purpose Clause

As is the case with other types of transfer restrictions, a first-option restriction is only valid and enforceable if it is reasonable. The case law dealing with the reasonableness of transfer restrictions, in balancing the need for such protection against the public policy against restraints on alienation, has consistently emphasized the relevance of the purpose for which a transfer restriction is adopted.⁶⁶ It is therefore important that the drafter express with reasonable detail the function of the transfer restriction in the particular factual setting in which it used. Thus, statements indicating that the restriction is for the purpose of maintaining a particular share ownership pattern, or of allowing only persons with special expertise to become shareholders, or to maintain harmony and compatibility among the shareholders, joined with an expressed objective of thereby serving the best interests of the corporation, should be set forth in the purpose clause. While obviously not conclusive on the issue of reasonableness, the presence of a well-drawn purpose clause can be

62. CAL. CORP. CODE § 204(b) (West Supp. 1989).

63. *Id.* § 212(b)(1) (West Supp. 1989).

64. *Id.* § 300(b) (West Supp. 1989).

65. The long-standing practice to keep articles of incorporation as simple and short as is legally permissible is partially based on the Secretary of State's authority under California Corporations Code section 110(a) to refuse to file a submitted document if it does not conform to law. CAL. CORP. CODE § 110(a) (West 1977). Since share transfer restrictions are only valid if "reasonable," potential differences of opinion as to what constitutes the required reasonableness can initially be avoided by putting such restrictions in documents that do not have to be filed with the Secretary of State.

66. W. PAINTER, *supra* note 35, at 113.

of valuable assistance to a court facing that issue in subsequent litigation.

C. Scope of Transfer Restriction

Many a transfer restriction of the type under discussion has failed to provide subsequent protection because insufficient attention was devoted in the drafting stage to the question of its intended scope of application. A transfer restriction which by its terms gives a first-option to the corporation to buy the shares of a shareholder in case of a proposed "sale" has been held not to prevent that shareholder from transferring the shares through a testamentary bequest free of the restriction.⁶⁷ In addition to the need to make first-option transfer restrictions applicable to all testamentary transfers, whether by a specific or a residual bequest, transfers resulting from intestacy should also be included. And in the area of inter vivos transfers, the specific applicability of the transfer restriction to such potential events as gifts, pledges of shares and sales of pledged shares by the pledgee, and transfers in connection with bankruptcy proceedings, should be covered by express language to avoid the need for future litigation.

Another consideration in determining the appropriate scope of a first-option transfer restriction is whether the objective of the provision is to keep outsiders from becoming shareholders or to maintain a proportionate voting control allocation. In case of the former, the transfer restriction can be made applicable only to proposed transfers to non-shareholders; in case of the latter, the provision should be made applicable to all proposed transfers.

D. Choosing the Option Holder or Holders

Obligating a shareholder who wants to transfer his shares to offer them first to the corporation before he can transfer them to someone else is, in one sense, potentially incomplete protection. The ability of a corporation to make such a purchase is not only dependent upon the availability of sufficient cash at the time the option is to be exercised but is also subject to the existence of the statutorily specified financial condition⁶⁸ prescribed for corporate distributions

67. *Glenn v. Seaview Country Club*, 380 A.2d 1175, 1177 (N.J. Super. 1977).

68. CAL. CORP. CODE § 501 (West Supp. 1989).

to shareholders.⁶⁹ If either of these two prerequisites is lacking, the corporation is not permitted to purchase its own shares and the shareholder is free to transfer his shares to whomever he wishes.

Within limits, of course, precautionary measures can and should be taken to give reasonable assurance that the corporate treasury will have sufficient funds on hand to exercise an option at the appropriate time. Thus, a sinking fund can be established to which a specified sum or percentage of corporate income is deposited annually. The available balance in such a fund is subject to the vagaries of the corporation's financial success, especially in the early years of its existence. Nevertheless, a sinking fund offers some potential protection as well as an opportunity to accumulate a limited amount of corporate earnings without, it is hoped, running afoul of the accumulated earnings tax.⁷⁰ Additional assurance of having sufficient funds available to purchase shares can be obtained by having the corporation take out life insurance on its shareholders so that the policy proceeds can be used by the corporation to purchase the shares of a deceased shareholder.⁷¹ While these two devices may serve to cure, or at least ameliorate, the potential problem of a lack of ready cash, there remains the unavoidable risk that the corporation has neither sufficient retained earnings⁷² nor the required ratio of assets to liabilities⁷³ to permit a repurchase of shares.

Attempting to avoid this potential dilemma by giving the option to the other shareholders, rather than to the corporation, avoids the legal restraints imposed upon corporations in the purchase of their own shares, but creates a new problem. While individual shareholders are under no statutory limitation with respect to the money used to purchase another shareholder's shares, they may be under the pragmatic limitation of an empty wallet. This can be an especially serious problem if some shareholders can, and others cannot, exercise their option, thus giving rise to a potential restructuring of the previously existing voting structure in the corporation.

69. *Id.* § 166 (West Supp. 1989).

70. *See* I.R.C. §§ 531-535 (1988). *See also* B. BITTKER & J. EUSTACE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* § 8.07 (5th ed. 1987).

71. While the ability of a corporation to insure the lives of its employees and shareholders is limited by the traditional requirement that it must have an insurable interest in the life of the insured, the relative importance of each individual in a closely held or statutory close corporation, whether employee and shareholder or just shareholder, should suffice to satisfy that prerequisite.

72. CAL. CORP. CODE § 500(a) (West Supp. 1989).

73. *Id.* § 500(b) (West Supp. 1989).

There simply is no way to give absolute assurance that a first-option transfer restriction will in fact result in the attainment of the desired and needed protection for shareholders. In order to reduce the chances of the designated optionee's inability to exercise the option, many lawyers draft transfer restrictions which give successive options so that the shareholder can only transfer his shares to an outsider if both the corporation and the shareholders fail to exercise their respective options. While this gives maximum potential protection to the corporation and to the shareholders collectively, the price paid is a potential increase in the time consumed in settling the matter of whether the shareholder who wants to transfer his shares, often in as speedy a manner as possible, can do so and to whom.

E. Partial Exercise of Option

A potential problem that should not be left unresolved is the question of whether the designated optionee of a first-option transfer restriction must exercise the option in full, if at all, or whether a partial exercise of the option is permissible. That matter can assume large dimensions since the specified purchase could, under the right circumstances, leave the selling shareholder with a minority interest which would be difficult to dispose of if the purchaser could retain or acquire majority control by merely partially exercising the option.

F. Option Period

Time is often of the essence to a shareholder who wants to sell his shares, and for his protection, the time period given to the designated optionee for the exercise of the option should be limited. In fairness to the corporation or the other shareholders holding the option, the period should be sufficiently long to allow making the necessary financial arrangements. Option periods of up to ninety days have been impliedly found reasonable in cases litigated in other states.⁷⁴ The California Commissioner of Corporations seemingly frowns upon option periods which substantially exceed thirty days.⁷⁵

74. *Data Consultants, Inc. v. Traywick*, 593 F. Supp. 447, 456 (D. Md. 1983), *aff'd* 742 F.2d 1448 (4th Cir. 1984); *Cimo v. National Motor Club of Louisiana, Inc.*, 237 So. 2d 408, 413 (La. Ct. App. 1970).

75. No specific written policy has been adopted by the Commissioner of Corporations.

Thus for corporations whose first-option transfer restriction will be scrutinized by that administrative agency under the California securities law provisions, a total option period beyond thirty days is probably only permissible in the case of successive options to the corporation and the other shareholders.

G. Disposition of Purchased Shares

The acquisition by a corporation of its own shares raises the problem of what will happen to those shares. If the corporation's board of directors is free to issue them again, a control allocation problem may arise. For example, if those acquired shares are sold to one of the remaining shareholders, that purchaser's proportionate voting power is increased and this may result in a shift of majority control.

Shares reacquired by a corporation legally revert to the status of authorized but unissued shares under Section 510(a) of the California Corporations Code and thus are subject to subsequent issuance by the board of directors unless otherwise restricted.⁷⁶ It is therefore advisable to provide that such reacquired shares must be cancelled or that they are to be offered to the remaining shareholders pro rata on the basis of preemptive rights.

H. Purchase Price—In General

Without doubt the most difficult part of devising a first-option transfer restriction is the selection of an appropriate pricing formula. Since the potential exercise of the option will occur at an unspecified time in the future, no reliable information is available at the time of organizing the corporation that would indicate the future value of the shares. It is obviously inadvisable to leave the matter of the purchase price unresolved and subject to negotiation at the time of the purchase since the selling shareholder is not normally in a

Secondary authority, apparently based on informal observations, is contradictory. See e.g. 1 H. MARSH & R. VOLK, PRACTICE UNDER THE CALIFORNIA SECURITIES LAWS § 8.02(k)(iv) (1988) (the old 30-day limit has been replaced by a more flexible standard that may permit option periods for 60 or even 90 days depending upon the particular circumstances of the involved corporation). But see W. PAINTER, *supra* note 35, at 128 ("current [California] administrative practice . . . indicates that a restriction will ordinarily be considered objectionable if its total duration substantially exceeds 30 days.").

76. CAL. CORP. CODE § 510(a) (West Supp. 1989).

favorable bargaining position. A pricing formula should, therefore, be incorporated in the transfer restriction provision. A surprisingly large number of different pricing methods have been utilized in the past. As will be seen in the subsequent pages, however, many of the theoretically available methods have pragmatic drawbacks or face legal hurdles, especially in the wake of the impact of the California Corporate Securities Law of 1968.⁷⁷

I. Purchase Price—Securities Law Impact

Occasionally cited cases suggest that a first-option transfer restriction will be judicially enforced even though the price realized by the selling shareholder is substantially below the shares' market value.⁷⁸ Whatever vitality such cases may have in the realm of general corporation law, their impact has been substantially reduced as a result of California securities law provisions which are applicable to many small corporations. The specific applicability of these provisions can be summarized as follows:

1. Exempt Close Corporations

A corporation which is eligible, in accordance with the criteria of section 25102(f) or (h) of the California Corporations Code⁷⁹ and the pertinent Corporate Securities Rules,⁸⁰ for an exemption from the qualification requirement for the issuance of its shares, is subject only to general corporation law concepts with respect to first-option transfer restriction pricing methods.

2. Qualifying Corporations—Charter Document Restriction

A corporation which is not an "exempt close corporation" and which therefore must qualify the issuance of its shares with the Commissioner of Corporations⁸¹ is subject, with respect to the per-

77. 1968 Cal. Stats. ch. 88, sec. 2, at 243, (enacting CAL. CORP. CODE 33 25000-25220).

78. See, e.g., *In re Estate of Brown*, 130 Ill. App. 2d 514, 264 N.E.2d 287 (1970); *Allen v. Biltmore Tissue Corp.*, 2 N.Y.2d 534, 141 N.E.2d 812, 161 N.Y.S.2d 418 (1957); *Renberg v. Zarrow*, 687 P.2d 465 (Okla. 1983).

79. CAL. CORP. CODE § 25102(f), (h) (West Supp. 1989).

80. 10 CAL. CODE REGS., §§ 260.102.4-260.102.14 (1989).

81. CAL. CORP. CODE § 25110 (West 1977).

missibility of a pricing formula, to Corporate Securities Rule 260.140.8⁸² if the transfer restriction is contained in any of the corporation's charter documents. Rule 260.140.8 provides:

No open qualifications will be approved to issue securities the transfer of which is subject to any restrictions imposed by the charter documents of the issuer or the indenture or other instrument pursuant to which the securities are issued. Limited offering qualifications may be approved for the issuance of securities subject to such restrictions, provided they are not of such a nature as to unfairly prejudice the opportunity of the holder to realize a reasonable price for his securities. Provisions which base the price at which the corporation or the other shareholders may purchase the securities, in the event of a desire to sell by the holder, upon the offer received from a third party, upon the appraised value of the securities, or upon the book value (except in the case of a type of business where book value is not a significant indication of the value of the securities) are presumptively reasonable. Provisions which base the price upon the par value or original purchase price . . . will only be permitted in unusual circumstances.⁸³

Charter documents, in addition to the articles of incorporation and the bylaws, include a shareholders' agreement executed by all of the shareholders of a statutory close corporation; a shareholders' agreement executed by shareholders of a closely held corporation is not considered a charter document.⁸⁴

3. *Qualifying Corporations—Private Agreement Restriction*

A first-option pricing provision contained in a private agreement, rather than in a charter document, is technically not subject to the criteria of Corporate Securities Rule 260.140.8, if that rule is construed grammatically. However, a private agreement containing a transfer restriction, such as a shareholders' agreement executed by shareholders of a closely held corporation, must be submitted to the Commissioner of Corporations as a required exhibit to the application for the qualification of securities by permit.⁸⁵ The price formula in the transfer restriction thus comes under the Commissioner's scrutiny for the purpose of determining whether the proposed issuance of

82. 10 CAL. CODE REGS. § 260.140.8 (1989).

83. *Id.*

84. *Id.* § 260.001 (1989).

85. *Id.* 260.113 (1989).

securities is "fair, just and equitable"⁸⁶—an examination which is more than likely to focus on whether the initial purchaser of the securities is given the opportunity to realize a reasonable price when he has to offer them to the transfer restriction option holder at a later date.

J. Purchase Price—Third Party Offer

A provision requiring the corporation or the other shareholders purchasing shares under a first-option transfer restriction to match the price which the selling shareholder has been offered by a third party will, in the absence of collusion, generally tend to generate a purchase price which reasonably approximates the economic value of the shares. This pricing method is presumptively reasonable under California securities law.⁸⁷

The major problem with such a pricing formula, however, is a practical one. It requires the existence of a third party who is willing to make a bona fide offer to purchase the shares. A shareholder who wants to liquidate his investment but has no potential buyer is in the unenviable position of either remaining locked into his investment, if the designated option holder does not want to buy the shares, or of having to negotiate a purchase price with the option holder from a weak bargaining position.

A slight variation of this pricing method that can be employed as an alternative is to require a shareholder who wishes to sell his shares to offer them to the specified option holder at the price for which he is willing to sell them and that, if the option holder declines to exercise the option, the shareholder is free to sell the shares to anyone at that or a higher, but not a lower, price. The difference in the procedural sequence, however, does not cure the pragmatic problem that the potential market for the shares of a closely held or statutory close corporation, especially for shares constituting a minority interest, is a limited one.

K. Purchase Price—Appraisal

The pricing method which offers the greatest potential for a selling shareholder to receive a fair price for his shares from the option

86. CAL. CORP. CODE § 25140(b) (West 1977).

87. 10 CAL. CODE REGS. § 260.140.8 (1989).

holder is the appraisal method, a method specified as a presumptively reasonable price formula under California securities law.⁸⁸ Typically, an appraisal provision names who the appraisers shall be (in which case a provision for choosing successors should be included) or provides that the selling shareholder and the option holder shall each designate one appraiser and the two so selected shall appoint a third appraiser. To avoid future differences of opinion among the appraisers regarding the standards to be employed in the appraisal process,⁸⁹ the transfer restriction should set forth the applicable standards to be employed—for example, whether corporate assets shall be valued as they appear on the corporate books rather than at their market value, whether good will is to be included in the appraisal, etc. In addition to the problem of finding individuals qualified to appraise corporate shares which have no active trading market, the financial impact—which can be substantial—of appraisers' fees must be considered in selecting this pricing mechanism.

L. Purchase Price—Book Value

With respect to the use of book value as a pricing formula, it is difficult to improve upon the following statement:

The method perhaps most frequently used is to set the price of shares at their book value. This method's disarming appearance of simplicity probably accounts for the frequency of its use. In some respects, however, it is one of the most unsatisfactory ways of determining the value of shares.⁹⁰

This potential unsatisfactoriness, discussed in more detail below, explains why the California Corporate Securities Rules qualify the presumptive reasonableness of book value pricing by limiting it to situations where the business is of a type in which book value is a significant indication of the value of the shares.⁹¹

88. *Id.*

89. See *Brown v. Allied Corrugated Box Co.*, 91 Cal. App. 3d 477, 154 Cal. Rptr. 170 (1979). Although occurring in an involuntary dissolution setting, *Brown* is a good illustration of the extent to which appraisers can differ in the valuation of stock based upon the use of different appraisal factors. *Id.* at 481, 154 Cal. Rptr. at 172-73. Of three court-appointed appraisers, two agreed on a valuation of \$27,195 for a minority shareholder's shares, while the third appraiser filed a minority report with the court valuing the same shares at \$147,596. *Id.*

90. 2 F. O'NEAL & R. THOMPSON, *supra* note 25, at § 7.30.

91. 10 CAL. CODE REGS. § 260.140.8 (1989).

The book value of the shares of a corporation having one class of stock is determined by subtracting the corporation's liabilities from its assets and dividing the resulting net worth by the number of its outstanding shares. The nature of the business conducted by the particular corporation as well as the way in which corporate balance sheets are constructed make it likely that the book value of corporate shares will not be closely related to their economic value. For example, a corporation deriving its income and profits primarily from performing services rather than manufacturing and selling products, may have little in the way of assets, and the book value of its shares is not very likely to be reflective of its earnings potential. In this type of situation, even case law precedent upholding the validity of a first-option transfer restriction utilizing a book value price formula⁹² is irrelevant for a qualifying corporation because this is precisely the kind of setting in which the Commissioner of Corporations would deny a permit to issue the shares because that formula would be employed in "a type of business where book value is not a significant indication of the value of the securities."⁹³

Even if the particular corporation is not primarily a service-rendering enterprise but one which has substantial tangible assets, such as manufacturing equipment, buildings, inventory, etc., it is highly questionable whether the value of these assets as carried on the corporate books corresponds closely to their true economic value. If prepared in accordance with "generally accepted accounting principles" as required by statute,⁹⁴ the balance sheet will generally carry corporate assets at a valuation that is below the current market or replacement value. For example, "generally accepted accounting principles" require that inventory be carried at the lower of cost or market value; corporate assets such as buildings or real property which have increased in value cannot be "written up" on the corporate books under the prohibition against the recognition of unrealized appreciation. In addition, the depreciation of fixed assets, especially under accelerated depreciation methods for tax purposes, is likely to cause those assets to be listed on the corporate books at understated economic values. Good will, an elusive figure at best, will often be carried at either a nominal or an inflated figure that does not truly reflect the earnings potential of the enterprise.

92. *See, e.g.* *Vannucci v. Pedrini*, 217 Cal. 138, 17 P.2d 706 (1932).

93. 10 CAL. CODE REGS. § 260.140.8 (1989).

94. CAL. CORP. CODE § 114 (West Supp. 1989).

These potential discrepancies do not argue for the categorical unsuitability of the book value formula in a first-option transfer restriction, however. Instead, they stand as a challenge to the drafter to write a pricing formula based on book value specifying with sufficient detail and clarity that, for purposes of the transfer restriction, certain types of assets shall be valued in a particular manner. Thus, the provision can specifically require that certain corporate assets shall be valued at replacement value and that other specified assets shall be valued by taking unrealized appreciation into account. With such preventive adjustment, book value pricing formulas can be shaped to yield a fair price to the selling shareholder and to meet the California securities law requirements of either Corporate Securities Rule 260.140.8 or of section 25140(b) of the California Corporations Code.⁹⁵

Outside the realm of securities law limitations, use of a book value pricing formula may be upheld under general corporation law principles. For example, a California case, *Yeng Sue Chow v. Levi Strauss & Co.*,⁹⁶ using language drawn partially from a New York case, stated that:

[A]ppellant's position is that this court should rewrite the option contract so that it provide for the repurchase of corporate shares at the market price rather than the agreed on book value of the shares. This we cannot do. . . . [T]he overwhelming weight of authority is to the effect that the validity of a restriction on transfer does not rest on any abstract notion of intrinsic fairness of price. To be invalid, more than mere disparity between the option price and the current value of the stock must be shown. Since the determination of the price for repurchase is a contractual matter agreed upon by the parties, the court's scope of inquiry is limited to testing the reasonableness of the price formula . . . [T]he courts can have no concern with the wisdom or folly of a contract, made . . . without fraud where the parties are competent to contract and enter into the same fairly and understandingly. The mere fact that the property has increased or diminished since the contract was concluded will not warrant a refusal to carry out its terms in the absence of circumstances indicating fraud or bad faith.⁹⁷

95. "The Commissioner may refuse to issue a permit under Section 25113 unless he finds that the proposed plan of business of the applicant and the proposed issuance of securities are fair, just, and equitable . . ." CAL. CORP. CODE § 25140(b) (West 1977).

96. 49 Cal. App. 3d 315, 122 Cal. Rptr. 816 (1975).

97. *Yeng Sue Chow*, 49 Cal. App. 3d at 329, 122 Cal. Rptr. at 824-25.

M. Purchase Price - Par Value; Original Purchase Price

Two pricing methods which have occasionally been used in first-option transfer restrictions allow the designated option holder to purchase the shares at their par value or at their original purchase price. Apart from the fact that these pricing methods are simple and yield a definite price, it is hard to imagine any other redeeming value. The probability that a price so specified will bear any reasonable relationship to the economic value of the shares at the time the option is exercised is slim indeed, since it presumes that the business is worth no more and no less than at the time of its incorporation. Even if permissible, such a pricing formula should therefore only be considered if the normal goal of a fair price to the selling shareholder has been replaced or is outweighed by other considerations.

For "exempt close corporations"⁹⁸ the permissibility of using such a pricing method depends only upon general corporation law concepts. Surprisingly, a number of appellate decisions have upheld the validity of such pricing formulas even where their application resulted in a great disparity between the specified price and the economic value of the shares.⁹⁹ For example, in one leading case the court enforced a first-option transfer restriction which entitled the corporation's remaining shareholders to purchase, for \$1 per share, shares which were worth no less than \$1,060 per share at the time of the exercise of the option.¹⁰⁰ The court emphasized that as long as the parties had agreed to the formula knowingly, without overreaching, fraud or deceit, a discrepancy between sale price and actual value was irrelevant in view of the purpose of the restriction—to keep the corporation close. Similarly, the New York Court of Appeals has stated:

[T]he validity of the restriction on transfer does not rest on any abstract notion of intrinsic fairness of price. To be invalid, more than mere disparity between option price and current value of the

98. See *supra* notes 78-86 and accompanying text (Section VI, discusses the impact of securities law on purchase price restrictions for exempt close corporations).

99. See, e.g., *Martin v. Graybar Electric Co.*, 285 F.2d 619 (7th Cir. 1961); *Palmer v. Chamberlin*, 191 F.2d 532 (5th Cir. 1951); *Allen v. Biltmore Tissue Corp.*, 2 N.Y.2d 534, 161 N.Y.S.2d 418, 141 N.E.2d 812 (1957); *In Re Mather's Estate*, 410 Pa. 361, 189 A.2d 586 (1963).

100. *Allen v. Biltmore Tissue Corp.*, 2 N.Y.2d 534, 161 N.Y.S.2d 418, 141 N.E.2d 812 (1957).

stock must be shown . . . Since the parties have in effect agreed on a price formula which suited them, and provision is made freeing the stock for outside sale should the corporation not make, or provide for, the purchase, the restriction is reasonable and valid.¹⁰¹

Although involving a book value pricing formula, a recent California case expresses the same general attitude.¹⁰² It is reasonable to assume that the growing judicial recognition of the special nature and needs of the closely held corporation, as exemplified in the quotation above, could cause a court to validate such a pricing formula under similar factual circumstances in California.

With respect to the use of such a pricing formula in a non-exempt, qualifying corporation,¹⁰³ the situation is more complex. While subject to the corporation law norm just discussed, such a corporation is further limited by Corporate Securities Rule 260.140.8, which states that "(p)rovisions which base the price upon the par value or original purchase price . . . will only be permitted in unusual circumstances."¹⁰⁴ Given the protective nature of the substance and application of California securities law, it is doubtful that the Commissioner of Corporations would equate the general desire to keep close corporations close, with the unusual circumstances specified in Rule 260.140.8. Some additional, more specific need for such a pricing formula would probably have to be shown to obtain securities law approval. A possible example of sufficiently unusual circumstances, as described in the leading treatise on California securities law, might be

the situation where securities are sold to an employee at a price equal to par value or at market price pursuant to an agreement wherein the employee commits to serve the employer for a given period of time and, should the employee leave voluntarily prior to the expiration of the agreed period of service, the employing corporation has the right to repurchase the securities at the original purchase price.¹⁰⁵

A second possibility for obtaining approval of a par value or original purchase price formula exists for a corporation which must

101. *Id.* at 543, 161 N.Y.S. at 424, 141 N.E.2d at 817.

102. *See* Yeng Sue Chow v. Levi Strauss & Co., 49 Cal. App. 3d 315, 122 Cal. Rptr. 816 (1975).

103. *See supra* notes 82-86 and accompanying text (Sections VI.I 2 and 3 discuss the impact of securities law on purchase price restrictions for non-exempt, qualifying corporations).

104. 10 CAL. CODE REGS. § 260.140.8 (1989).

105. H. MARSH & R. VOLK, PRACTICE UNDER THE CALIFORNIA SECURITIES LAWS 8-23 (1988).

qualify the issuance of its shares. Even in the absence of unusual circumstances, the Commissioner of Corporations may grant a variation from the otherwise applicable standards "if it is possible to find that the offer and sale will not be unfair, unjust or inequitable to the initial purchasers upon the basis of all of the facts and circumstances of the case."¹⁰⁶

N. Purchase Price—Periodically Fixed Price

The pricing mechanism, which calls for the periodic (usually annual) formulation of the value of the corporation's shares, is neither specifically mentioned in the Corporate Securities Rules as presumptively reasonable nor as only permissible under unusual circumstances. Committed either to the board of directors, or to all of the shareholders collectively, or to designated individuals or appraisers, the price determination, based upon specified criteria, then remains in effect until the next scheduled price adjustment and applies to all purchases under the transfer restriction during that interval. Since periodically adjusted prices are reasonably likely to reflect the fair value of the shares, the formula should normally be approved under both securities and general corporation law principles.

The practical problem with this kind of pricing formula is that all too often the periodic price adjustment does not in fact take place, sometimes not for a substantial number of years. The result is that a shareholder who has to offer his shares to the corporation or to the other shareholders is faced with an outdated price which must now be revised under pressure of time, possibly when the selling shareholder is not in a strong bargaining position, or when the breakdown of amicable relationships in the enterprise may have an adverse impact on the supposedly neutral process of price determination.

O. Purchase Price—Capitalization of Earnings

Also not specifically mentioned in the Corporate Securities Rules as either presumptively reasonable, or as only permissible under unusual circumstances, is the capitalization of earnings approach.

106. 10 CAL. CODE REGS., § 260.140 (1989).

The underlying rationale of this valuation method is that the value of a corporation's shares should be measured by its ability to earn profits.

Capitalization of earnings is not a highly recommended valuation technique for use in first-option transfer restrictions. The reasons for this have been stated as follows:

In the first place, the drafting of provisions governing the calculation of corporate earnings and providing for abnormal years, unusual business conditions, and nonrecurring items of profit and loss is extremely difficult. Secondly, in a representative closely held corporation, since most profits are absorbed in salaries, corporate books do not reflect the real earning power of the business. Thirdly, withdrawal from the business of the shareholder whose shares are being transferred may materially affect the corporation's earning power . . . Finally, capitalization of earnings is not a satisfactory device for placing a price on shares transferred during the early years of a corporation. Earnings during a corporation's first years are usually not indicative of its ultimate earning power.¹⁰⁷

Of course, some of these factors may not always be applicable. For example, if a sole proprietorship or a partnership with a relatively long business history is being transformed into a corporation, the previous profits of that enterprise may give a reasonably accurate indication of future profits. The predicted future profits would be expressive of the enterprise's true earning capacity, and adjustments for salary payments could be expressly required in the valuation formula.

The first-option transfer restrictions device discussed above protects the corporation and its participants by conferring upon the specified option holder a right, but not an obligation, to purchase the shares of a shareholder who, for whatever reason, wants to dissociate himself from the enterprise. From the viewpoint of each individual shareholder, however, that device offers incomplete protection with respect to those situations in which the shareholder may want assurance that his shares will, rather than might, be purchased by the corporation or the other shareholders. Often shareholders want assurance that their shares will be purchased at the time of their retirement or upon their death. Such a mandatory purchase, of course, also protects the corporation and the other shareholders by preventing a sale of the shares to outsiders. It is therefore common

107. 2 F. O'NEAL & R. THOMPSON, *supra* note 25 at § 7.33.

practice in closely held and statutory close corporations to execute buy-out agreements which provide that the corporation or the remaining shareholders must purchase the shares of a fellow shareholder upon the happening of specified events. Where a buy-out agreement is decided upon, it is possible to incorporate into it a first-option transfer restriction device, so that mandatory purchases occur upon specified occurrences and optional purchases are specified for other events.

VII. BUY-OUT AGREEMENTS

A. In General

Agreements which require a corporation to purchase the shares of a shareholder upon the happening of a specified event are often referred to as "buy-out," "stock purchase," "stock retirement," or "stock redemption" agreements. Agreements which require the other shareholders to purchase the shares of a fellow shareholder upon the happening of a specified event are usually referred to as "buy-sell" or "cross-purchase" agreements. For the sake of simplicity the term "buy-out" agreement will be used here to refer to both types of agreement.

B. General Validity

Obligating a shareholder or his estate to sell shares upon the occurrence of a specified event, while not a restraint on alienation in the usual sense, is nevertheless a limitation on the choice of buyers. In that sense, the buy-out agreement is a transfer restriction and, under general corporation law principles, must be reasonable to be valid and enforceable. As in the case of other types of transfer restrictions, reasonableness is determined by reference to the purpose of the restriction and all of the surrounding factual circumstances.¹⁰⁸ Buy-out agreements which obligate the estate of a deceased shareholder to sell his shares have been consistently upheld as valid against the charge that they are testamentary in character and therefore

108. See *supra* notes 39-43 and accompanying text (Section V.A. discusses the reasonableness requirement for restrictions on alienability of corporate stock).

invalid unless executed in compliance with the statutory requirements for the execution of wills.¹⁰⁹

C. California Securities Law Impact

1. Exempt Close Corporations

There is no securities law impact with respect to the utilization of a buy-out agreement in connection with the issuance of shares by an exempt close corporation.¹¹⁰ The validity of the buy-out agreement depends solely upon the general corporation law criteria mentioned in the preceding paragraph. The shares issued by an exempt close corporation cannot normally be transferred by the original purchaser without the approval of the Commissioner of Corporations.¹¹¹ However, such transfers to the issuing corporation, or to other holders of the same class of shares, are exempt from that approval requirement.¹¹² Consequently, the buy-out provisions are not subject to the Commissioner's approval authority either at the time of the original issuance of the shares or at the time of the sale by the original holder to the specified buyer in the buy-sell agreement.

2. Qualifying Corporations

Buy-out provisions, contained in a charter document of a corporation which must qualify the issuance of its shares, need the approval of the Commissioner of Corporations.¹¹³ Charter documents are the articles of incorporation, the bylaws and, in the case of a statutory close corporation, a shareholders' agreement.¹¹⁴ Apart from certain considerations with respect to purchase price determination, discussed below, the Corporate Securities Rules provide that provisions "which give an option to the corporation or the other shareholders to purchase regardless of the desire of the holder to sell" will be permitted "for a limited time upon termination of employment in

109. See cases cited in 2 F. O'NEAL & R. THOMPSON, *supra* note 25 at § 7.10, n. 8.

110. See *supra* notes 79-80 and accompanying text (Section VI.I.1 discusses the impact of securities law on purchase price restrictions for exempt close corporations).

111. 10 CAL. CODE REGS., § 260.141.11(b) (1989).

112. *Id.*

113. CAL. CORP. CODE § 25110 (West Supp. 1989).

114. 10 CAL. CODE REGS., § 260.001(a) (1989).

the case of employees of the issuer, or for a limited time upon the death of a holder.”¹¹⁵ Since these are the two events which usually constitute triggering events for buy-out arrangements, California securities law seemingly poses no obstacles in this area. Beyond the two specified situations, the Corporate Securities Rules provide that buy-out provisions will only be permitted in unusual circumstances.¹¹⁶

Buy-out provisions contained in a private contractual agreement rather than in a charter document, while not subject to the already cited securities rule if the rule is construed grammatically, are nevertheless subject to scrutiny by the Commissioner of Corporations under Securities Rule 260.113¹¹⁷ if they specify the corporation as the share purchaser. The application form which is filed by an applicant for a permit to issue shares requires that a “copy of any contract made or to be made by the issuer affecting . . . transferability of the securities” be attached to the application.¹¹⁸ The provisions of such a contract thus come within the Commissioner’s statutory authority to refuse a permit if the proposed issuance of securities is not “fair, just and equitable.”¹¹⁹ Similarly, buy-out provisions, contained in a contractual agreement which specifies that the other shareholders (rather than the corporation) are the share purchasers, must be attached to the permit application¹²⁰ and are thus subject to the same statutory approval criteria.

D. Location of Buy-Out Provisions

Buy-out provisions can be inserted in the articles of incorporation, in the bylaws, or in a separate contractual agreement. Prevalent practice is to incorporate such provisions in the shareholders’ agreement in a statutory close corporation and in a separate contractual agreement in a closely held corporation. This practice is probably to a large extent the result of concern on the part of practicing attorneys that including such provisions in articles of incorporation subjects them to the sometimes overly zealous scrutiny of the Secretary of State’s office.¹²¹ An additional reason is that protection afforded by

115. *Id.* § 260.140.8 (1989).

116. *Id.*

117. *Id.* at § 260.113 (1989).

118. *Id.* § 260.113, Item 21.C (West 1989).

119. CAL. CORP. CODE § 25140(b) (West 1977).

120. 10 CAL. CODE REGS., § 260.113, Item 21.D (1989).

121. See *supra* note 65 and accompanying text.

buy-out provisions contained in the articles of incorporation or in the by-laws could conceivably be nullified by shareholders having sufficient voting power to amend those corporate documents. While super-majority voting requirements could be imposed to reduce or eliminate such potential amendments, it is less cumbersome to utilize a contractual agreement that is not subject to amendment without the unanimous consent of the contracting parties. The scope and complexity of a buy-out agreement also make it somewhat unwieldy for inclusion in the articles of incorporation.

E. Purpose Clause

The validity of a buy-out agreement depends upon its reasonableness. It is thus advisable to specify as succinctly as possible the purpose for which the agreement is adopted. A statement indicating that the corporation is a statutory close or a closely held corporation, and that its participants wish to preserve its closeness by, for example, restricting share ownership to persons actively engaged in the business, can form the basis of a judicial finding of reasonableness in case of subsequent litigation.

F. Triggering Events

The events which trigger the obligation of the shareholder to sell and the obligation of the named buyer to purchase shares must be clearly specified. Normally, these events are the death, retirement, resignation, disability or expulsion of a shareholder-employee. Whether or not to make the mandatory buy-out provision applicable to all or only some of these events is very much dependent upon the particular facts of each case. If a particular shareholder has no spouse or descendant able and willing to participate actively in the business, it is normally in the best interest of the corporation and the other shareholders to purchase his shares as soon as his relationship to the corporation is terminated. Permitting his shares to be transferred to someone who will not be actively participating in the enterprise, raises the generally undesirable prospect of having inactive shareholders whose interests may conflict with those of the active shareholders. For example, while active employee-shareholders are normally desirous of distributing available corporate profits (for tax reasons, by way of salaries and fringe benefits) and of expanding the business

through reinvestment of corporate capital, inactive shareholders tend to look at the declaration of dividends for their share of corporate profits. On the other hand, it may be advantageous to the corporation and to the other shareholders to permit a shareholder to bequeath his shares to a family member who is already active in the business or who is capable of taking his place at the time of the shareholder's death or retirement. In the latter situation, the combination of a mandatory buy-out provision limited to the involuntary termination of the shareholder's employment, and an optional sale of the shares upon his death or retirement, might be appropriate.

Occasionally, triggering events other than the ones mentioned are desired for a mandatory buy-out agreement by the participant. It should be kept in mind that, with respect to corporations which need to qualify the issuance of their shares under the California securities law, triggering events other than death or termination of employment will only be permitted under unusual circumstances or if their impact is not considered unfair, unjust or inequitable by the Commissioner of Corporations.

G. Choosing the Designated Buyer or Buyers

The designated buyer of shares subject to a buy-out agreement can be the corporation or the other shareholders. Whom to designate involves the same problems discussed previously in connection with designating the option-holder under a first-option transfer restriction.¹²²

H. Purchase Price

Available options with regard to the determination of the price at which shares are purchased under a buy-out agreement are the same as discussed previously in connection with first-option transfer restrictions.¹²³

122. See *supra* notes 68-73 and accompanying text (Section VI.D. discusses choosing the option holder).

123. See *supra* notes 87-107 and accompanying text (Sections VI.J-O discusses various methods for setting the purchase price in transfer restrictions).

VIII. CONCLUSION

The substance of this article has dealt with the pragmatic considerations involved in protecting the shareholders of closely held and statutory close California corporations in two respects. The first is the maintenance of proportional voting and financial interests and their protection against dilution. The second is the maintenance of control over who is allowed to become a member of what is usually a close-knit group. In adopting any of the devices described in this article, one final cardinal rule needs to be observed. Careful drafting is essential. If prepared forms obtained from printed kits or form books are used, they must be carefully analyzed so that changes, additions and deletions appropriate to the facts and circumstances of the particular business enterprise are utilized.

