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Adjustment and Protection of Shareholder Interests in the Closely-Held Corporation in Texas

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ADJUSTMENT AND PROTECTION OF SHAREHOLDER INTERESTS IN THE CLOSELY-HELD CORPORATION IN TEXAS

by

*Joseph Jude Norton**

CONTENTS

I. INTRODUCTION.....	783
II. PRELIMINARY CONSIDERATIONS	784
A. Models of Corporate Governance	784
B. Certain Basic Problems of the Closely-Held Corporation.....	785
1. Allocation and Maintenance of Equity Interests	785
2. Allocation and Maintenance of "Managerial" Control	786
3. Dispute Resolution	786
4. Other Related Problems.....	787
C. Available Contractual Solutions	788
D. Methodology of Approach.....	788
E. Comment on the TCCL	789
F. Comment on Fiduciary and Professional Responsibilities.....	791
III. BASIC DOCUMENTATION	792
A. Preincorporation Agreements and Subscription Agreements.....	792
B. Other Preincorporation Arrangements	794
C. Articles or Certificate of Incorporation	796
D. Bylaws	797
E. Organizational Minutes	797
F. Other Shareholder Contracts.....	797
IV. ALLOCATING AND MAINTAINING OWNERSHIP INTERESTS...	797
A. Equity Financing	798

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1. Common Stock	798
2. Preferred Stock	799
3. Options, Rights, and Warrants	800
4. Legal Capital Considerations	800
B. Debt Financing: Bonds, Debentures, and Other Notes ..	800
C. Leverage	801
D. Selective Legal Techniques for Maintaining Ownership Interests	802
1. Stock Classification	802
2. Preemptive Rights	802
3. Stock Transfer Restrictions	803
a. Purposes	804
b. Types	804
c. Legal Standards	805
d. Statutorily Permissible Restraints	806
e. Location of Restrictions	806
f. Parties	807
g. Other Practical Considerations	808
V. ALLOCATING AND MAINTAINING "MANAGERIAL" CONTROL	810
A. The Problems	810
B. Selective Legal Techniques	810
1. Stock Classification	810
2. Irrevocable Proxies	811
3. Cumulative Voting Rights	812
4. Higher Quorum and Voting Requirements	813
5. Voting Trusts	814
6. Shareholder Pooling Agreement	815
7. Shareholder Arrangements and the TCCL	817
8. Management Contracts	818
a. Statutory Provisions	818
b. Authority to Employ	818
c. Bylaw Limitations	818
d. Specific Term	819
e. Restrictive Covenants	819
f. Protection of the Employee	820
VI. EFFECTIVE DISPUTE RESOLUTION	820
A. Bases of Dispute	821
B. Contractual and Charter Solutions	821
1. Standby Trust or Irrevocable Proxy	821
2. Buy-Sell Arrangements	821
3. Contractual Appraisal Provisions	822
4. Special Class of Stock	822
5. Special Dissolution Provisions	822
6. Limited Corporate Life	822
C. Arbitration	822

D. Statutory Receivership and Dissolution.....	823
E. Approach Under the TCCL.....	824
VII. CONCLUSION	825

I. INTRODUCTION

APPROXIMATELY 275,000 active businesses are incorporated under the main enabling provisions of the Texas Business Corporation Act [TBCA].¹ Despite the availability of special close corporation provisions since 1973, virtually all closely-held corporations were incorporated under the main incorporation provisions of the TBCA prior to 1981. Since the 1981 enactment of revisions to the special close corporation provisions of the TBCA, now collectively referred to as the Texas Close Corporation Law [TCCL],² an increasing number of closely-held corporations are availing themselves of the TCCL. In any event, the vast majority of corporations incorporated in Texas under both the main TBCA provisions and the TCCL are closely-held corporations.³ Consequently, although representing the publicly-held corporation may be glamorous, the realities of business life and legal practice indicate that most practicing lawyers in Texas, both in large and small firms, encounter the problems of the closely-held corporation and its owners on a frequent basis.⁴

This Article addresses the fundamental legal problems of adjusting and protecting shareholder interests in the closely-held corporation. After discussing certain introductory matters and the basic corporate documentation affecting shareholders, this Article focuses on three fundamental problems of owners in a closely-held corporation and the various statutory and contractual techniques for addressing those problems. The first fundamental problem involves allocation and maintenance of equity control. Second, the Article examines the allocation and maintenance of "managerial" control on

1. TEX. BUS. CORP. ACT ANN. arts. 3.01-.06 (Vernon 1980 & Supp. 1985) [hereinafter cited as TBCA]. This figure represents the estimated number of domestic incorporated businesses as of March 1, 1985, as recorded in the Office of the Secretary of the State of Texas.

2. TBCA arts. 12.01-.03, 12.11-.14, 12.21-.23, 12.31-.39, 12.51-.54 (Vernon Supp. 1985) [hereinafter cited as TCCL]. The TCCL was enacted by an Act relating to close corporations, ch. 818, 1981 Tex. Sess. Law Serv. 3102 (Vernon), repealing the sections of the TBCA previously governing close corporations. See TBCA arts. 2.30-1 to -5 (Vernon 1980), repealed by an Act relating to close corporations, ch. 818, § 9, 1981 Tex. Sess. Law Serv. 3118 (Vernon).

3. A closely-held corporation is a non-publicly-held corporate enterprise owned by a small group of persons. W. CARY & M. EISENBERG, CORPORATIONS 281 (4th ed. 1980). According to the Texas State Securities Board, during the three-month period from September 1, 1984, through November 30, 1984, only 29 Texas corporations registered securities for public offering. Several of these registrations represented secondary securities offerings by already-public Texas corporations. Clearly, relatively few Texas corporations are publicly-held.

4. See generally D. HERWITZ, BUSINESS PLANNING ch. 1, § 3, at 50-67 (1966) (discussing peculiarities of close corporations and their advantages over partnerships); 1 F. O'NEAL, CLOSE CORPORATIONS: LAW AND PRACTICE §§ 1.02-.09 (2d ed. 1971 & Supp. 1984) (discussing attributes of close corporations and the distinctive business objectives that the close corporation form facilitates); W. PAINTER, CORPORATE AND TAX ASPECTS OF CLOSELY HELD CORPORATIONS ch. 2 (1981) (discussing tax consequences and benefits of forming close corporations).

both a shareholder and management level. Finally, the Article analyzes effective dispute resolution.

II. PRELIMINARY CONSIDERATIONS

A. *Models of Corporate Governance*

The legal model of corporate governance presented by state corporation codes is skeletal.⁵ These codes grant shareholders: (1) the right to manage the corporation through the election and removal of directors;⁶ (2) the right to participate in dividend distributions at the reasonable discretion of the board of directors;⁷ (3) the right to vote, often regardless of class, on certain fundamental corporate changes;⁸ and (4) the right to share in the net corporate assets upon dissolution.⁹ The directors, on the other hand, generally have the duty to manage the corporation.¹⁰ Little is said under the TBCA about the role of corporate officers,¹¹ who operate the corporation on a day-to-day basis.¹² The TBCA and most other state corporation codes do not address such fundamental problems of corporate governance as the legal standards respecting the duties and performance of the directors, officers, shareholders, and other controlling persons, and the accountability of the relationship between these various corporate actors in their respective capacities.¹³ The corporation codes have left these glaring gaps to the wisdom of the courts.

5. State corporation laws generally provide the legal framework for: (1) the procedure for incorporation, *see, e.g.*, TBCA arts. 3.01-.06 (Vernon 1980); (2) the powers of the corporation as a separate legal entity, *see, e.g.*, TBCA arts. 2.02, 2.02-1, 2.03 (Vernon 1980 & Supp. 1985); (3) the rights and obligations of officers, directors, and shareholders, *see, e.g.*, TBCA arts. 2.21, 2.41-43 (Vernon 1980 & Supp. 1985); and (4) the basic requirements for lawfully conducting business within the state, whether or not a business is incorporated in that state, *see, e.g.*, TBCA arts. 2.05-.11 (Vernon 1980 & Supp. 1985).

6. *See, e.g.*, TBCA art. 2.32 (Vernon 1980); 2 W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS §§ 283-288 (rev. perm. ed. 1982); D. HERWITZ, *supra* note 4, at 29.

7. *See, e.g.*, TBCA art. 2.38 (Vernon 1980).

8. *See, e.g.*, TBCA art. 5.03 (Vernon 1980); *see also* D. HERWITZ, *supra* note 4, at 29 (discussing residual power of shareholders in matters involving fundamental corporate changes).

9. *See, e.g.*, TBCA art. 6.04, § A(3) (Vernon 1980).

10. MODEL BUSINESS CORP. ACT § 35 (1979); W. CARY & M. EISENBERG, *supra* note 3, at 118; 2 W. FLETCHER, *supra* note 6, § 505; D. HERWITZ, *supra* note 4, at 29. TBCA art. 2.31, § A (Vernon 1980) merely states that the "business and affairs of a corporation shall be managed by a board of directors." The Delaware General Corporation Law somewhat more elaborately states that the "business and affairs of every corporation . . . shall be managed by or under the direction of a board of directors . . ." DEL. CODE ANN. tit. 8, § 141(a) (1983).

11. TBCA art. 2.42, § A (Vernon 1980) defines the officers of a corporation as "a president, one or more vice-presidents as may be prescribed by the bylaws, a secretary, . . . a treasurer, [and any] other officers and assistant officers and agents as may be deemed necessary." The TBCA allows one person to hold two or more offices simultaneously. TBCA art. 2.42, § A (Vernon 1980).

12. The TBCA merely provides that officers "shall have such authority and perform such duties in the management of the corporation as may be provided in the bylaws, or as may be determined by resolution of the board of directors not inconsistent with the bylaws." TBCA art. 2.42, § B (Vernon 1980).

13. *See, e.g.*, W. CARY & M. EISENBERG, *supra* note 3, at 381 ("The directors' duties are, in the main, duties owed to the corporate entity as such rather than to the shareholders or

In terms of real models of corporate governance, corporations clearly differ from one corporate entity to the other by virtue of their size, nature, shareholder expectations, and management structure. State corporation codes generally fail to address these differences.¹⁴ I suggest, however, that despite the skeletal treatment of corporate interests within these state corporation codes, and notwithstanding the enactment in certain states of special provisions regarding the close corporation, the traditional legal model of governance that these codes present, when considered in conjunction with the permissible charter and contractual techniques available for forming, structuring, and managing a corporation, meets most of the fundamental governance needs of the closely-held corporation.

B. Certain Basic Problems of the Closely-Held Corporation

The following factors generally characterize a closely-held corporation:¹⁵ (1) a small number of shareholders; (2) lack of a public trading market for the corporation's stock; (3) a close relation between management and at least the principal shareholders; (4) a personal relationship among all or some of the shareholders; (5) shareholder knowledge about the corporation; (6) shareholder desire to exert some control over the corporate voting process; and (7) an informality in day-to-day management of the corporation.¹⁶ Also, due to the informality and personal relationships often existing within the close corporation, most legal arrangements between the various corporate actors will, unfortunately, be oral.¹⁷ Owners and prospective owners of a closely-held corporation consequently face the following problems.

1. Allocation and Maintenance of Equity Interests. One of the crucial considerations in incorporation planning is the proper allocation, by charter documents, contracts, and other legal devices, of ownership interests in the closely-held corporation. Complexities include the type of stock that the corporation will issue, the means by which an owner may increase stock ownership in specific situations, and the overall preservation of desired ownership interests during the life of the corporation.¹⁸

creditors individually, but they are in many, perhaps in most cases, enforced on behalf of the corporation in suits instituted by individual shareholders.”)

14. This inadequacy of the state codes is displayed most graphically in the context of the public corporation, a subject that is without the purview of this Article. See generally M. EISENBERG, *THE STRUCTURE OF THE MODERN CORPORATION* (1977).

15. The TCCL defines a close corporation as a domestic corporation, formed under the ordinary incorporation provisions of TBCA arts. 3.01-.06, that has elected close corporation status. TCCL art. 12.02 (Vernon Supp. 1985). One may elect close corporation status merely by including the following statement in the articles of incorporation: “This corporation is a close corporation.” TCCL art. 12.11 (Vernon Supp. 1985); see Lebowitz, *How to Use the Flexibility Afforded by the Close Corporation in Texas*, in TEXAS BAR ASSOCIATION ADVANCED CORPORATION SEMINAR (1984).

16. See *Donahue v. Rodd Electrotype Co.*, 367 Mass. 578, 328 N.E.2d 505, 511 (1975).

17. See 1 F. O'NEAL, *supra* note 4, § 2.23, at 92.

18. See generally D. HERWITZ, *supra* note 4, ch. 1, § 3 (1966) (discussing alternative methods of corporate capitalization and their impact on equity interests and control).

2. *Allocation and Maintenance of "Managerial" Control.* "Managerial" control may extend to the voting rights of shareholders and to the rights of the day-to-day corporate managers. Ownership ordinarily imparts an element of voting control over the corporation. This control extends to the election of directors and to the decision-making process that governs fundamental corporate matters and changes. An owner in a corporation, however, may have inferior or unequal voting rights, contractually restricted voting rights, or nonvoting stock and, therefore, no voting rights. Voting rights usually concern the selection of the directors and the effectuation of major changes within the corporation. The owner's voting rights normally may not legally entail managerial control over the day-to-day operations of the corporation. In practice, however, shareholder involvement in management of closely-held corporations varies. Some owners participate in day-to-day management of the corporation as officers or employees, whereas other owners take passive positions. Moreover, as the corporation matures and grows, a manager often may not have a significant ownership interest in the corporation, but he may exercise considerable control over corporate operations. This latter situation raises the corporate planning problem of simultaneously protecting the legitimate interests of nonowner managers and nonmanaging owners. The important practical problems involved in allocating and maintaining "managerial" control within the closely-held corporation include: (1) ensuring that shares are not transferred to outsiders who might be difficult to work with or have interests opposed to those of the other shareholders; (2) ensuring that each shareholder can elect at least one, and possibly more than one, director; (3) ensuring that shareholders may vote their shares together to elect several directors and thereby control the board; (4) ensuring that shareholder controls exist over certain director actions; and (5) ensuring that the expectations of the day-to-day managers are met.¹⁹

3. *Dispute Resolution.* Continuing existence and economic growth are key objectives in most large and small corporations. With respect to closely-held corporations, however, the possibilities for unanticipated events such as death of a "key" owner²⁰ or divisive disputes among owners or between owners and managers are great. Failure to make provision for such events or to resolve disputes at an early stage can lead to costly litigation, severe disruption of corporate business, and even liquidation of the corporation. Thus, providing a proper legal framework for the resolution of corporate disputes is essential to protecting and preserving shareholder interests and expectations.²¹

19. See 1 F. O'NEAL, *supra* note 4, § 2.23; W. PAINTER, *supra* note 4, § 1.7.

20. See W. CARY & M. EISENBERG, *supra* note 3, ch. 5, § 1 & n.2 (discussing difference between legal perpetuity of the close corporation and actual perpetuity of the close corporation; when the success of the close corporation depends heavily upon the efforts of a single person, his death or retirement may destroy the business even though the corporation continues to exist legally in perpetuity).

21. See W. PAINTER, *supra* note 4, § 1.4, at 14 (discussing dangers of deadlock in disputes among shareholders or directors).

4. *Other Related Problems.* There are a number of problems related to the three fundamental problems referred to above that may need to be addressed when planning for the fundamental problems. For example, within a corporate organization, an owner's liability ordinarily extends only to his equity in the corporation. If an owner is also a manager, however, the owner may be exposed to liabilities to third parties and government authorities beyond his equity interest. This exposure raises questions of statutory²² or contractual corporate indemnification.

A corporation generates profits or losses through its operations. Through corporate planning, these profits and losses are allocated among the owners, and the allocation need not be in proportion to the owners' equity interests. For example, preferred stockholders may have priority in payments, whereas common stockholders may have a greater residual interest in profits. Moreover, a corporation may distribute profits to owners through means other than dividends, such as through a reasonable salary to an owner/manager. These nondividend distributions, however, must comply with various legal restrictions imposed by statutory provisions on legal capital and by the federal tax laws.²³

One of the most elusive, but most fundamental, concepts of corporate organization is valuation. Financial accounting statements indicate a book value of the corporation's assets, but this valuation may not be relevant for corporate planning purposes. For example, the book value of the corporate assets may be based largely on historical costs rather than actual replacement value. Moreover, the book value of a going concern may be less relevant in determining the value of the concern than the corporation's ability to generate earnings on a consistent and continuous basis. On the other hand, if the corporation encounters financial trouble and liquidates, the liquidation valuation may be considerably less than the book value.²⁴ Accordingly, owners and others having an economic interest in a corporation often find it very difficult to evaluate the worth of the enterprise. This dilemma may complicate the allocation of ownership and managerial interests within the corporation. The valuation issue may also provide a continuing basis for internal dispute. When such disputes arise, the question of valuation may be transferred to an arbitration forum, to a civil court of law, or, in the case of financially troubled corporations, to a bankruptcy court.²⁵

22. See TBCA arts. 2.02, § A(16), 2.02-1 (Vernon Supp. 1985); MODEL BUSINESS CORP. ACT § 5 (1979).

23. See V. BRUDNEY & M. CHIRELSTEIN, CORPORATE FINANCE pt. III (2d ed. 1979).

24. See generally J. BONBRIGHT, VALUATION OF PROPERTY (1937); O. BOWLIN, J. MARTIN & D. SCOTT, GUIDE TO FINANCIAL ANALYSIS (1980); V. BRUDNEY & M. CHIRELSTEIN, *supra* note 23, pt I; I A. DEWING, THE FINANCIAL POLICY OF CORPORATIONS 275-307 (5th ed. 1953); P. HUNT, C. WILLIAMS & G. DONALDSON, BASIC BUSINESS FINANCE 548-59 (4th ed. 1971) (discussing and comparing methods of valuation).

25. For two interesting judicial approaches to the corporate valuation problem, see *Weinberger v. UOP, Inc.*, 457 A.2d 701, 713 (Del. 1983) (in determining stock value, court may consider all relevant factors recognized in the financial community); *Piemonte v. New Boston Garden Corp.*, 377 Mass. 719, 387 N.E.2d 1145, 1148 n.3 (1979) (upholding trial court's valuation of corporate stock based upon an arbitrarily weighted average of the corporate stock's market value, the business's earnings value as a going concern, and the corporation's net asset

C. Available Contractual Solutions

One can address the above fundamental problems in planning for the closely-held corporation through provisions in charter documents or through ancillary contractual arrangements. This Article discusses the following selective techniques for dealing with these problems: (1) capitalization and classification of shares; (2) preemptive rights; (3) stock transfer restrictions; (4) irrevocable proxies; (5) voting trusts; (6) shareholder pooling arrangements concerning election of directors and other matters; (7) cumulative voting; (8) higher quorum and voting requirements; (9) management contracts; (10) buy-sell arrangements and other special contractual or charter arrangements for resolving disputes; (11) arbitration; and (12) statutory dissolution and receivership provisions.

D. Methodology of Approach

My thesis is that the good business attorney should start with the simplest approach and add sophistication only when necessary. When organizing a closely-held business, the attorney should ascertain first whether compelling reasons exist to incorporate the business; he should not assume incorporation is the best alternative.²⁶ If the attorney chooses the corporate form, he will often find that basic TBCA provisions or TCCL provisions, combined with appropriate drafting of the charter documents, adequately address the legitimate concerns of the owner/client.

Complexities, such as lengthy and convoluted shareholder contracts, often add more confusion than certainty and thereby imperil the objective of achieving an effective and enforceable realization of the owners' interests with a minimum of dispute. Notwithstanding the complexities, sophisticated agreements, such as subscription agreements, shareholder pooling arrangements, voting trusts, and buy-sell arrangements, may become necessary. Thus, when organizing a closely-held corporation the attorney may have to consider and interrelate: (1) the basic statutory provisions of the TBCA and, if chosen, the TCCL; (2) the basic shareholder "contracts," such as articles of incorporation, bylaws, organizational minutes, and stock certificates; and (3) the more sophisticated shareholder agreements.

In addition to starting from the simplest base of the corporation code and the charter documents, one useful approach to structuring a closely-held corporation and drafting the related documents is to scrutinize the situation

value); see also Hardee, *The Valuation of a Closely-Held Business*, 5 & 6 ALI-ABA COURSE MAT'LS J. pt. I, June 1981, at 35; pt. II, Aug. 1981, at 79; pt. III, Oct. 1981, at 83.

26. See, e.g., F. O'NEAL, *supra* note 4, § 2.04; W. PAINTER, *supra* note 4, § 1.5; Hazen, *The Decision to Incorporate*, 58 NEB. L. REV. 627, 628 (1979). The major advantages of not incorporating a closely-held business and operating under the sole proprietorship or partnership form include: (1) passthrough of early operating losses and related tax deductions from the business directly to the owner, see I.R.C. § 165 (1982); (2) avoidance of the double taxation of distributed corporate profits, see *id.* § 11 (net profit of corporation taxed at corporate tax rates); *id.* § 61(a)(7) (dividends distributed to shareholders included in gross income); and (3) avoidance of the formalities of incorporation, such as attending organizational meetings, drafting a corporate charter and bylaws, electing directors, and filing and reporting with state authorities.

from the perspective of a disgruntled party who would attack the validity of the structure and documents. A review of the case law indicates that such attacks generally involve one or more of the following claims: (1) noncompliance with statutory requirements;²⁷ (2) impairment of contractual rights or breach of contractual obligations;²⁸ (3) unreasonable alienation of fundamental shareholder property rights;²⁹ and (4) breach of fiduciary duties, including unfairness and overreaching by those in control of the corporation.³⁰ These four prongs of attack, in addition to tax considerations,³¹ form the boundaries within which most corporate planning for the closely-held corporation must occur.

E. Comment on the TCCL

The basic privilege that a close corporation election under the TCCL provides is an ability to operate under a shareholders agreement with the freedom of a partnership, but without the concern of personal or unlimited liability.³² The TCCL also sets forth the governing procedure in a close corporation,³³ the requisites of the shareholders agreement,³⁴ and the means for dispute resolution.³⁵ Even though the TCCL governs close corporations, however, all other provisions of the TBCA not inconsistent with the TCCL

27. See *Beach v. McKay*, 108 Tex. 224, 226, 191 S.W. 557, 558 (1917).

28. Compare *Ringling Bros.—Barnum & Bailey Combined Shows, Inc. v. Ringling*, 29 Del. Ch. 610, 53 A.2d 441, 447 (Sup. Ct. 1947) (upholding shareholder agreements that contract away shareholders' voting rights), with *Haldeman v. Haldeman*, 176 Ky. 635, 197 S.W. 376, 382 (1917) ("Although a stockholder may vote as he pleases, public policy forbids the enforcement of a contract by which a stockholder undertakes to bargain away his right to vote for directors according to his best judgment, and in the interest of the corporation. He has no right to disable himself by contract from performing this duty.").

29. See *Allen v. Biltmore Tissue Corp.*, 2 N.Y.2d 534, 541, 141 N.E.2d 812, 815, 161 N.Y.S.2d 418, 422, (1957) (plaintiff, deceased shareholder's representative, challenged corporation's contractual right of first refusal on decedent's shares as an unreasonable restraint on alienation).

30. See *Donahue v. Rodd Electrotyping Co.*, 367 Mass. 578, 328 N.E.2d 505, 511 (1975).

31. See *W. PAINTER*, *supra* note 4, § 2.1.

32. For an excellent discussion of the Texas Close Corporation Law, see *Lebowitz, supra* note 15. For a general background discussion of the TCCL, see *Blunk, Analyzing Texas Articles of Incorporation: Is the Statutory Close Corporation Format Viable?*, 34 Sw. L.J. 942 (1980). As a matter of philosophical bent, I remain skeptical of the need for special close corporation statutes. During the past thirty years an enormous expenditure of energy and talent has produced a marginal return in the area of close corporation statutes. See *Fessler, The Fate of Closely Held Business Associations: The Debatable Wisdom of "Incorporation,"* 13 U. CAL. DAVIS L. REV. 473, 473-75 (1980); *Roseberry, Traditional Corporate Concepts in Light of Demands for Elastic Norms for the Family or Closely Held Corporation*, 5 J. CORP. L. 455, 457 (1980). Nevertheless, an attorney has a duty to advise the client of the existence of close corporation provisions, and these special statutory provisions may offer a distinct advantage in at least three situations: (1) in a one- or two-person corporation; (2) when the desired corporate structure requires agreements that courts traditionally have held unenforceable as against public policy; and (3) when the client either cannot or will not maintain the corporate formalities required under the general provisions of the TBCA. This Article will concentrate on the main body of the TBCA and traditional corporate control and dispute resolution mechanisms, although cross-references to the TCCL will be made.

33. TCCL art. 12.31 (Vernon Supp. 1985).

34. TCCL arts. 12.32-.36 (Vernon Supp. 1985).

35. TCCL arts. 12.51-.54 (Vernon Supp. 1985); see *infra* notes 274-79 and accompanying text.

apply to a close corporation.³⁶

The TCCL offers both advantages and limitations to persons planning for the small corporation.³⁷ The advantages of the TCCL are numerous. First, the TCCL recognizes that the relationship among owners of a close corporation may resemble a partnership.³⁸ Second, the TCCL requires few of the traditional corporate formalities.³⁹ Third, participants in a close corporation enjoy relative autonomy under the TCCL to achieve desirable contractual arrangements.⁴⁰ Fourth, the TCCL offers several means for dispute resolution.⁴¹ Fifth, broad shareholder agreements that might otherwise be subject to attack may be more easily enforced under the TCCL.⁴² Finally, the TCCL provides limited statutory relief to close corporation owners from alter ego attacks.⁴³

Despite these advantages, several limitations remain in the TCCL. First, election of close corporation status under the TCCL still requires drafting specific provisions to the articles of incorporation, share restriction provisions, and often a shareholders' agreement. Second, although the TCCL provides greater flexibility in certain areas, substantially all of the ends that can be attained under the TCCL can also be accomplished under the general provisions of the TBCA in conjunction with the various techniques of control previously discussed. Third, notwithstanding the statutory relief available under TBCA article 12.37, section F, the encouragement of corporate informality under the TCCL places the close corporation on the edge of the alter ego doctrine.⁴⁴ Fourth, the advantages of the TCCL are provisional

36. TCCL art. 12.03 (Vernon Supp. 1985).

37. See generally Lebowitz, *supra* note 15; Lebowitz, *Texas Close Corporation Law*, 44 TEX. B.J. 51, 51-52 (1981).

38. TCCL art. 12.37, § F (Vernon Supp. 1985) recognizes that shareholders in a close corporation frequently treat themselves as partners and the business entity as a partnership. Article 12.37, § F specifically states that such treatment by the shareholders or the shareholders' failure to observe other corporate formalities shall not defeat the corporation's status as a close corporation.

39. TCCL art. 12.37, § F (Vernon Supp. 1985).

40. TCCL art. 12.38 (Vernon Supp. 1985).

41. TCCL arts. 12.51-.54 (Vernon Supp. 1985). The TCCL dispute resolution provisions pay the highest respect to the will of the shareholders at the time of the signing of the shareholders' agreement, while balancing the need of the corporation to continue as a viable entity without impediments such as deadlock. TCCL arts. 12.52, § A(2) & 12.53 (Vernon Supp. 1985) empower a competent court to appoint a provisional director, upon a showing of deadlock among voting directors, to act as an impartial vote to break the deadlock. TCCL art. 12.52, § A(5) & § B (Vernon Supp. 1985) provides for dissolution of the close corporation and the appointment of a receiver to conduct liquidation as a remedy of last resort. These and other court-imposed remedies are unavailable, however, unless the complaining shareholder has first exhausted all nonjudicial remedies provided in the shareholder agreement. TCCL art. 12.51, § E (Vernon Supp. 1985).

42. TCCL art. 12.35 (Vernon Supp. 1985). The TCCL provides that shareholder agreements are valid and enforceable, notwithstanding any provision that restricts the discretion or powers of the directors or managers. Texas courts traditionally have held agreements containing such provisions void and unenforceable. See *Burnett v. Word, Inc.*, 412 S.W.2d 792, 795 (Tex. Civ. App.—Waco 1967, writ *dism'd* by *agr.*).

43. TCCL art. 12.37, § E (Vernon Supp. 1985).

44. See *Roylex, Inc. v. Langson Bros. Constr. Co.*, 585 S.W.2d 768, 772 (Tex. Civ. App.—Houston [1st Dist.] 1979, writ *ref'd n.r.e.*), for a discussion of Texas's application of the alter ego doctrine. I believe that the alter ego doctrine remains a relevant concern for the close

because termination of closely-held status reverts the corporation and any shareholder agreements into the purview of the general corporation laws.⁴⁵ Fifth, the TCCL does not specifically address the protection of minority interests, which is *the* fundamental problem in close corporations. Finally, unlike the general provisions of the TBCA, the TCCL does not have a body of case law to interpret its special provisions and thereby guide practitioners.⁴⁶

F. Comment on Fiduciary and Professional Responsibilities

Planning for the closely-held corporation raises several very difficult questions concerning the fiduciary duties of the various corporate actors and the professional responsibility of the corporate attorney. First, since a closely-held corporation is akin to a partnership,⁴⁷ the strict fiduciary duties existing between partners should also exist between the actors within a closely-held corporation.⁴⁸ Public policy considerations cast doubt upon the ability of parties contractually to diminish these fiduciary duties within a closely-held corporation.⁴⁹ Second, possession of corporate control may itself raise special fiduciary responsibilities.⁵⁰ Third, an attorney who structures a close corporation may confront ethical problems with respect to conflict of interest and overreaching. For example, in a close corporation the attorney often represents all of the interested parties. On the other hand, if the attorney

corporation because informality can often lead to commingling of funds and other practices that suggest that the corporate entity is a mere instrumentality or conduit of its owners.

45. TCCL art. 12.23, § A (Vernon Supp. 1985).

46. Prior to the 1981 enactment of the TCCL, many practitioners were hesitant to use the TBCA close corporation provisions, primarily because of: (1) the confusion surrounding the 1973 and 1975 TBCA amendments; (2) the unknown flirtation with the alter ego doctrine; (3) the marginal practical advantages for using the special close corporation form; and (4) the absence of case law on the subject. With the 1981 amendments, practitioners may be more open to use the special close corporation status.

47. The TCCL expressly permits such a corporation to be treated effectively as a partnership. TCCL art. 12.37, § F (Vernon Supp. 1985).

48. See *Donahue v. Rodd Electrotype Co.*, 367 Mass. 578, 328 N.E.2d 505, 512 (1975); Scott, *The Fiduciary Principle*, 37 CALIF. L. REV. 539 (1949); Winter, *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251, 277 (1977); Comment, *Exploitation Among Close Corporation Shareholders: A Philosophical Change and Its Consequences*, 16 LAND & WATER L. REV. 747, 751-52 (1981). See generally F. O'NEAL, "SQUEEZE OUTS" OF MINORITY SHAREHOLDERS § 7.14 (1975) (shareholders in closely-held corporation often intend to run the corporation as a partnership).

49. For a discussion of this issue in the context of bankruptcy, see *In re Reading Co.*, 711 F.2d 509, 517-20 (3d Cir. 1983).

50. Commentators have proposed that corporate control imposes a fiduciary duty based on any one of the following theories: (1) control constitutes a corporate asset; (2) the exercise of control is a corporate action; (3) the position of controlling shareholder resembles that of a strict trustee; and (4) to impose such a duty on a controlling shareholder is fundamentally fair. See O'Neal, Hayes, Hazen & Santoni, *Symposium: Sale of Control*, 4 J. CORP. L. 239, 282-83 (1979); Comment, *Should Texas Courts Impose a Fiduciary Duty on Controlling Shareholders in the Use, Sale and Transfer of Their Shares?*, 3 TEX. TECH L. REV. 353, 358 (1972); cf. *Thompson v. Hambrick*, 508 S.W.2d 949, 954 (Tex. Civ. App.—Dallas 1974, writ ref'd n.r.e.) (majority shareholder, who was paid substantial premium for his shares due to amount of control, under no obligation to minority shareholders or corporation to account for such profits so long as majority shareholder acts in good faith and has no reason to suspect purchaser will loot the corporation).

only represents the controlling parties, the minority party often will not be represented by independent counsel. Another example involves offers by the corporation and its promoter to reimburse the attorney for his services through the issuance of stock in the corporation. This offer presents a potentially unacceptable conflict of interest. Finally, planning for small corporations can be more complex than planning for large corporations. The small corporation client, however, cannot always afford the legal fees involved in sophisticated corporate planning. Consequently, the attorney may face a choice between providing a service that the client can afford and providing competent representation.⁵¹

III. BASIC DOCUMENTATION

A. *Preincorporation Agreements and Subscription Agreements*

Typically, closely-held corporations are organized and incorporated based on a business bargain among the prospective participants that is never reduced to a written preincorporation agreement. Instead, the parties proceed to draft and execute the articles of incorporation or charter and bylaws, hold the organizational meeting of the incorporators and directors, and deliver the required money and property to the corporation within a short time. If the business bargain on which the incorporation effort proceeds is merely a vague understanding, however, the participants may not fully realize or appreciate the ramifications of the deal. In these circumstances a preincorporation agreement can clarify and memorialize the understanding between the parties before resources are irrevocably committed.

Preincorporation agreements are most useful in the following situations: (1) when organization of the corporation will require a considerable amount of time; (2) when the business bargain contemplates extensive financial commitments prior to actual incorporation; (3) when the participants desire to bind one or more of their number to commitments for future financing; and (4) when the business bargain involves a promise to one or more of the participants of future employment in the corporation. After the corporation is organized, the corporation should formally approve and adopt the preincorporation agreement, especially if the agreement purports to obligate the corporation in any way.⁵² Because scant Texas law exists on preincorporation agreements, however, the attorney may have to consult other jurisdictions to find assistance on the subject.⁵³

A preincorporation subscription agreement is a contract in which a prospective investor promises the promoter to purchase a specified number of unissued shares of the to-be-formed corporation at a specified price and pursuant to specified terms. A preincorporation subscription agreement is useful, but not always necessary, to secure the initial venture capital for the new

51. See Olson, *Adequate Representation of Multiple Clients During the Formation of a Business*, 1979 LEGAL MALP. REV. 1.

52. See F. O'NEAL, *supra* note 4, § 2.23.

53. See 19 R. HAMILTON, BUSINESS ORGANIZATIONS ch. 10 (Texas Practice 1973 & Supp. 1982); Comment, *Preincorporation Agreements*, 11 SW. L.J. 509 (1957).

corporation.⁵⁴ A subscription agreement need not be in writing to constitute a formal contract. As a practical matter, however, use of a written agreement will preserve the expectations of the parties and avoid future disputes and litigation. Furthermore, certain corporation codes require a written agreement for the subscription to be legally enforceable.⁵⁵ Under Texas law, a subscription must be in writing to fall within the TBCA provisions dealing with subscription agreements.⁵⁶

The common law does not clearly indicate whether a preincorporation subscription agreement is a continuing offer to the prospective corporation and, therefore, revocable prior to incorporation and effective corporate action, or whether the agreement is irrevocable from the date of subscription.⁵⁷ Most modern corporation codes, including the TBCA, provide that a subscription is irrevocable for six months unless the agreement provides otherwise or all subscribers consent to revocation of the subscription.⁵⁸

Most corporation codes, including the TBCA, also provide that a subscription for shares must be paid in full at the time of subscription or in such installments as the board of directors determines unless the agreement states otherwise. Failure to pay an installment provides the corporation with the same remedies available for collecting any other debt due to the corporation.⁵⁹ The subscribed shares cannot be issued, however, until the corporation comes into legal existence and normally not until the corporation has received the full amount of the consideration for such shares.⁶⁰ Some states permit the issuance of partly paid shares, subject to call for the remainder of the consideration. Some of these states even permit the issuance of partly paid shares as fully paid and nonassessable if the partial consideration at least equals the minimum stated capital legally attributable to the shares and if the remaining consideration is subject to a binding obligation to pay.⁶¹

A major legal consideration surrounding the subscription process is that the subscription agreement constitutes a security under federal and most

54. See generally Winton, *Private Corporate Stock Subscription Agreements*, 33 S. CAL. L. REV. 388 (1960) (discussing various rationales for and benefits of preincorporation subscription agreements).

55. See, e.g., DEL. CODE ANN. tit. 8, § 166 (1983).

56. *Jatoi v. Park Center, Inc.*, 616 S.W.2d 399, 401 (Tex. Civ. App.—Fort Worth 1981, writ ref'd n.r.e.). TBCA art. 1.02, § A(5) (Vernon 1980) states: "Subscription means a memorandum in writing, executed before or after incorporation, wherein an offer is made to purchase and pay for a specified number of theretofore unissued shares of a corporation."

57. Compare *Collins v. Morgan Grain Co.*, 16 F.2d 253, 254 (9th Cir. 1926) (subscription to purchase stock does not become an enforceable contract until the proposed corporation is organized, and the subscriber may revoke his offer), with *Coleman Hotel Co. v. Crawford*, 3 S.W.2d 1109, 1109-10 (Tex. Comm'n App. 1928, opinion adopted) (subscription agreement constitutes a binding contract by the subscribers to become stockholders upon fulfillment of condition that corporation be formed, and as such is irrevocable from the date of subscription absent unanimous consent of other subscribers).

58. TBCA art. 2.14, § A (Vernon 1980); see Cataldo, *Conditions in Subscriptions for Shares*, 43 VA. L. REV. 353, 360-65 (1957).

59. TBCA art. 2.14, § D (Vernon 1980).

60. TBCA art. 2.16 (Vernon 1980 & Supp. 1985).

61. See, e.g., DEL. CODE ANN. tit. 8, §§ 152-156 (1983).

state securities laws.⁶² Consequently, the subscription agreement, as well as the underlying security, are subject to the general registration requirements of these laws unless an exemption from registration can be shown.⁶³ Accordingly, the subscription process is practical only for transactions in which an exemption from registration is available. Even if an exemption is available, the promoter and others facilitating the process will remain subject to general antifraud liability under the securities laws.⁶⁴

B. Other Preincorporation Arrangements

In addition to soliciting venture capital to finance the corporation, a promoter will often arrange for the necessary physical facilities, equipment, and personnel to commence business and engage the necessary legal and accounting services to complete the incorporation. These arrangements require the promoter to enter into a series of formal and informal contracts prior to actual incorporation. The resulting contracts pose legal concerns for the promoter, who wants to avoid personal liability, for the other contracting party, who may not know the circumstances, and for the proposed corporation, which may ultimately become obligated under the contracts. In a post-incorporation situation many of these problems would be addressed under traditional agency principles. In a yet-to-be-formed corporation, however, an agency relationship between the promoter and the non-existent corporation is impossible.⁶⁵

Most problems with promoter contracts will arise either: (1) when the contract is executed in the name of the yet-to-be-formed corporation; or (2) when the contract indicates that the corporation has not yet been formed.⁶⁶ First, when the contract is entered into in the name of the yet-to-be-formed corporation, the promoter creates the appearance in his dealings with the third party that the corporation is in existence. Although this rule often produces a windfall for the third party who believes he or she was dealing with a corporate entity, the general rule is that, absent a properly drafted agreement reflecting the contrary, the promoter is personally liable on such contracts. This result is based either on the theory of misrepresentation by the promoter⁶⁷ or on the theory that the promoter is the principal.⁶⁸ If the corporation comes into being and adopts the contract, however, the promoter may argue that any misrepresentation has been corrected; and,

62. Securities Act of 1933, § 2, 15 U.S.C. § 77b(1) (1982) (current version); e.g., Texas Securities Act, TEX. REV. CIV. STAT. ANN. art. 581-4, § A (Vernon 1964). See generally 1A W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 188.1 (rev. ed. 1983) (all promoters' contracts must be drafted in accordance with federal securities laws).

63. See, e.g., Securities Act of 1933, §§ 3, 4, 15 U.S.C. §§ 77c, 77d (1982) (current version); Texas Securities Act, TEX. REV. CIV. STAT. ANN. arts. 581-5, -6 (Vernon Supp. 1985).

64. See, e.g., Securities Act of 1933, §§ 11, 17, 15 U.S.C. §§ 77k, 77g (1982) (current version); Texas Securities Act, TEX. REV. CIV. STAT. ANN. art. 581-33 (Vernon Supp. 1985).

65. See 1A W. FLETCHER, *supra* note 62, § 190; Ehrich & Bunzl, *Promoter's Contracts*, 38 YALE L.J. 1011, 1012 (1929).

66. See R. HAMILTON, *supra* note 53, § 325.

67. See *Union Bank v. Jones*, 138 Vt. 115, 411 A.2d 1338, 1343 (1980).

68. See *Cavaness v. General Corp.*, 272 S.W.2d 595, 598 (Tex. Civ. App.—Dallas 1954), *aff'd on other grounds*, 155 Tex. 69, 283 S.W.2d 33 (1955).

since the third party was originally content in dealing with a corporation, the adoption constitutes a novation. Normally, however, a novation can arise only with the express consent of the third party.⁶⁹

In the second situation, when the contract indicates that the corporation is yet to be formed, the third party knows that the corporation does not yet exist. The third party thus cannot claim misrepresentation. The question remains, however, whether the promoter continues to be liable until incorporation and adoption. Some courts have held that the third party intends someone to be liable at all times, and that until the corporation comes into existence and effects a novation the promoter remains liable.⁷⁰ Other courts have looked to the intent of the parties and determined from the circumstances that the promoter had no liability at all.⁷¹

A corporation will not be held liable on a promoter's contract unless the corporation adopts the contract. In certain circumstances a newly formed corporation may, however, claim rights based on a contract formed prior to incorporation.⁷² Generally, a corporation may adopt a contract by written agreement or corporate resolution.⁷³ Adoption, however, may be implied from the acts of the corporation or from the fact that the enterprise receives and retains the benefits of the contract.⁷⁴ For example, if the promoter employs a person and the new corporation subsequently retains the employee, a court would probably hold that the corporation informally adopted the employment contract.⁷⁵ As a practical matter, properly drafted contractual provisions and corporate documentation can avoid these various legal pitfalls.

A promoter has fiduciary concerns in addition to his contractual concerns. For example, co-promoters, are considered the same as partners and are, therefore, fiduciaries with respect to each other.⁷⁶ Moreover, a promoter occupies a fiduciary position that requires at least fair dealing and good faith with respect to the proposed corporation and future shareholders.⁷⁷ As a result, the promoter owes a duty of full disclosure concerning preincorporation promoter activities and contracts to the new corporation, to the directors, and to the original shareholders and subscribers if these parties are not independent. This duty of disclosure may also extend to future shareholders.⁷⁸ As previously mentioned, another promoter concern involves liability

69. See *Jacobson v. Stern*, 96 Nev. 56, 605 P.2d 198, 201 (1980).

70. See, e.g., *McDaniel v. Service Feed & Supply, Inc.*, 271 Md. App. 371, 316 A.2d 800, 803 (Md. Ct. Spec. App. 1974); *Cannon Ball Truck Stop, Inc. v. Mobil Oil Corp.*, 501 S.W.2d 927, 929 (Tex. Civ. App.—Houston [14th Dist.] 1973, writ ref'd n.r.e.).

71. See *Quaker Hill, Inc. v. Parr*, 148 Colo. 45, 364 P.2d 1056, 1058 (1961).

72. See *Joyner v. Alban Group, Inc.*, 541 S.W.2d 292, 293 (Tex. Civ. App.—Houston [1st Dist.] 1976, no writ).

73. An adoption is different from ratification under agency law since ratification assumes the existence of the principal at the time of the original contract.

74. See *DeCarlo v. Gerryco, Inc.*, 46 N.C. App. 15, 264 S.E.2d 370, 375 (1980). *But see* *Weatherford, M.W. & N.W. Ry. v. Granger*, 86 Tex. 350, 352, 24 S.W. 795, 796 (1894).

75. See *McArthur v. Times Printing Co.*, 48 Minn. 319, 51 N.W. 216, 216 (1892).

76. *Sheridan v. McBaine*, 564 S.W.2d 540, 544 (Mo. App. 1978).

77. See *Duncan v. Brookview House, Inc.*, 262 S.C. 449, 205 S.E.2d 707, 710-11 (1974).

78. See *Morehead & Guleke, How Long is an Arm?: Business Transactions Other Than at*

under the disclosure provisions of the securities laws in connection with soliciting venture capital.⁷⁹

C. Articles or Certificate of Incorporation

The basic charter document required by the TBCA is the articles of incorporation. The articles are filed with the appropriate state official, which is usually the secretary of state. This document, at least by analogy, constitutes the basic shareholder contract. Matters covered by the articles of incorporation include: (1) the corporation name; (2) the period of the corporation's duration, which may be perpetual; (3) the purpose or purposes for which the corporation is organized; (4) the aggregate number of shares that the corporation has authority to issue, the classes of those shares, and their respective par values; (5) the designation of each class of shares and their respective preferences, limitations, and relative rights; (6) the provisions concerning preemptive rights; (7) the name and address of the corporation's registered agent; (8) the minimum capitalization required before commencing business; (9) the number of directors constituting the initial board of directors, and the names and addresses of the persons who are to serve as directors until the first annual meeting of shareholders or until their successors are elected; and (10) the statement, if the corporation is to be a close corporation under the TCCL, that "This corporation is a close corporation."⁸⁰

Although many practitioners tend to approach the articles of incorporation in a rather cavalier manner, the importance of the articles as the fundamental charter document vis-à-vis the state and the basic "contract" between the shareholders and the corporation must not be overlooked.⁸¹ Moreover, the articles may not be readily amendable in the future. Accordingly, the attorney should take extreme care in drafting this document.⁸²

Arm's Length, 44 TEX. B.J. 1234, 1236 (1981) (discussing developments in Texas case law). Compare *Old Dominion Copper Mining & Smelting Co. v. Lewisohn*, 210 U.S. 206, 217 (1908) (promoter held not liable to corporation or to shareholders subscribing after the manipulative transaction because promoters represented all the stock at time of transaction and corporation fully consented to terms), with *Old Dominion Copper Mining & Smelting Co. v. Bigelow*, 203 Mass. 159, 89 N.E. 193, 204-05 (1909) (promotor held liable to present and future shareholders of corporation for breach of fiduciary duty that had ongoing impact on corporate capitalization).

79. See *Miller v. San Sebastian Gold Mines, Inc.*, 540 F.2d 807, 809-10 (5th Cir. 1976).

80. The articles of incorporation may also include any other provision, not inconsistent with law, such as provisions concerning regulation of the corporation's internal affairs. TBCA art. 3.02 (Vernon 1980 & Supp. 1985).

81. Frequently, the attorney preparing and filing the articles is the incorporator. In this capacity the attorney may hold certain rights and responsibilities, such as the ability to call the organizational meeting and the ability to dissolve the corporation prior to the issuance of shares or commencement of business. TBCA arts. 3.01 (Vernon 1980), 6.01 (Vernon Supp. 1985).

82. To appreciate the complexities that drafting a corporate charter may involve, see Bromberg, *Corporate Organizational Documents & Securities—Forms & Comments Revised*, 30 Sw. L.J. 961, 963-77 (1976).

D. Bylaws

Bylaws are the provisions that the corporation enacts to regulate its internal actions, including the formal activities of and relationships among the corporation's officers, directors, and shareholders. The bylaws, which are usually not filed in any public office, may contain any provisions for the regulation and management of corporate affairs that are not inconsistent with law or the articles of incorporation. In this sense, the bylaws form another basic shareholder contract. The owners thus should carefully consider the contents of the bylaws and the procedure necessary for their amendment, which is by directors' resolution unless provided otherwise.⁸³

E. Organizational Minutes

The organizational minutes are the records of the various meetings held by the directors or shareholders of the corporation.⁸⁴ The corporate secretary traditionally has the duty of recording the minutes. After the state issues a certificate of incorporation, most corporation codes require an organizational meeting of directors to adopt bylaws, elect officers, and transact any other necessary matters.⁸⁵ Possible other matters include the following corporate formalities: (1) adoption of a share certificate form and issuance of initial shares; (2) adoption of a special tax status or plan; (3) adoption of a corporate seal; and (4) adoption of preincorporation agreements and acceptance of subscriptions.⁸⁶ The other matters transacted at the organizational meeting might also include the following operational matters: (1) opening a bank account; (2) retaining corporate attorneys and accountants; (3) appointing board committees; (4) setting officers' and directors' compensation; (5) filing authorizations to do business in other states; (6) reimbursing preincorporation expenses; and (7) selecting a fiscal year.⁸⁷ The organizational meeting, as other formal meetings of directors or shareholders, may be held in person or, depending upon the flexibility of the state corporation law, by either unanimous written consent in lieu of a meeting or by a telephonic conference in which all parties can hear each other.⁸⁸

F. Other Shareholder Contracts

Other incorporation agreements involving the shareholders may include preferred stock certificates, option agreements, shareholder pooling agreements, voting trusts, and buy-sell agreements.

IV. ALLOCATING AND MAINTAINING OWNERSHIP INTERESTS

A fundamental consideration in planning the closely-held corporation is

83. See TBCA arts. 2.02, § A(13) (Vernon Supp. 1985), 2.23 (Vernon 1980); Bromberg, *supra* note 82, at 981.

84. TBCA arts. 2.44, 3.06 (Vernon 1980).

85. TBCA art. 3.06 (Vernon 1980).

86. Bromberg, *supra* note 82, at 1009.

87. *Id.*

88. TBCA art. 9.10 (Vernon 1980).

how to allocate and maintain the desired corporate ownership interests. The corporate form, through the availability of various types of investment securities, offers considerable flexibility for devising a capital structure that is consistent with the objectives of each investor/owner. The type of capital structure chosen, however, not only represents the means by which the corporation will raise funds for operations and growth, but also determines the method used to allocate profits, risk of loss, ownership, and control of the business. The capital structure of a corporation consists of various types of permanent and long-term financial claims in the corporation, including both equity and debt. Within minimum statutory structures, corporate capitalization is essentially a contractual matter and, therefore, can take nearly an infinite number of forms.⁸⁹

A. Equity Financing

1. *Common Stock.* Common stock represents the basic equity in a corporation.⁹⁰ Each share, which in Texas may or may not be evidenced by a certificate,⁹¹ reflects an initial capital contribution to the corporation and represents a set of legal rights concerning residual assets on liquidation, earnings, and voting. These rights, which may be contractual, property, statutory and/or equitable in nature, are embodied in the corporation's charter or articles of incorporation, the corporation's bylaws, and the corporation code and case law of the state where the corporation is incorporated. A shareholder receives an economic return on his investment in common stock through dividends, if declared by the board of directors, and through the appreciation realized upon sale of the stock. Upon corporate liquidation, a common shareholder is last in priority of payment, after secured creditors, unsecured creditors, and preferred shareholders.⁹²

Common shareholders, since their equity interest is junior to the interests of holders of corporate debt and preferred stock, bear the greatest risk of loss if the corporation fails. The common shareholders, however, generally have the controlling or sole voting rights in the corporation. The common shareholders thus are able to exercise control over the corporation's destiny primarily through the election of directors and votes on major corporate changes. Moreover, because the common shareholders' economic interest in the corporation is not fixed, as with debt holders or preferred shareholders, the common shareholders have the greatest opportunity for economic gain if the corporation is successful.

Corporate statutes are normally flexible with respect to the rights, powers, and preferences that a corporation may attribute to its various classes of common stock.⁹³ Frequently, a corporation will have two or more classes of common stock with different voting rights to ensure certain shareholders of

89. See generally 1 A. DEWING, *supra* note 24, ch. 3 (describing the various forms of capital and their impacts on the financial structure of a corporation).

90. *Id.* at 55-57.

91. See TBCA art. 1.02, §§ A(4), (20), (21) (Vernon Supp. 1985).

92. H. HENN & J. ALEXANDER, *LAW OF CORPORATIONS* ch. 8 (3d ed. 1983).

93. See TBCA art. 2.12 (Vernon 1980).

control or veto power over specific corporate actions.⁹⁴ For example, a passive shareholder may contribute more capital than another shareholder who will be actively involved in the operation of the corporation. Through a split share structure involving voting and nonvoting shares, the shareholders can maintain equal voting rights even though the passive shareholder receives a greater equity interest than the active shareholder. Tax planning may also influence the capital structure of the corporation. For example, to be eligible for Subchapter S tax status under the Internal Revenue Code, the corporation's capital structure must consist of only one class of stock.⁹⁵

2. *Preferred Stock.* Preferred stock is equity stock with a preference as to dividends, net assets upon liquidation, or both. Thus, like bonds and other forms of corporate indebtedness, preferred shares have a priority over common shares with respect to corporate distributions. Unlike interest on indebtedness, however, a corporation may not deduct distributions to preferred shareholders when computing its tax returns. The amount of a preferred stock dividend is normally fixed on an annual basis and stated as either a percentage of the preferred stock's par value or a dollar amount per share per year. Unlike holders of a true debt security, however, the preferred shareholders generally have no right to a return of their investment at some definite time in the future, unless the terms of the stock specifically grant such a right.⁹⁶ Furthermore, the preferred shareholders share in net assets upon liquidation after creditors, although before common shareholders.⁹⁷

Preferred stock is largely a creature of contract.⁹⁸ A variety of rights, powers, and preferences may be given in preferred stock. The basic considerations in structuring preferred stock, other than the rate of dividends, includes: (1) whether and to what extent the dividends will be cumulative;⁹⁹ (2) whether the stock will be redeemable; (3) whether the stock will participate in corporate earnings beyond the stated dividend; (4) whether, and on what terms and conditions, the stock may be converted into common stock; (5) whether the stock will have any voting rights; and (6) whether the stock will have a preference in the assets of the corporation upon liquidation.¹⁰⁰ Being neither a true equity instrument nor a true debt instrument, preferred stock is an unusual security from a strictly financial perspective.¹⁰¹ Preferred stock, however, maintains significance in attempts to adjust

94. See *Honigman v. Green Giant Co.*, 309 F.2d 667, 671 (8th Cir. 1962).

95. I.R.C. § 1361(b)(1)(D) (West 1984); see *infra* text accompanying note 122.

96. See 1 A. DEWING, *supra* note 24, at 152.

97. *Id.* at 149-51.

98. *Id.* at 124; see Buxbaum, *Preferred Stock—Law and Draftsmanship*, 42 CALIF. L. REV. 243, 243 (1954).

99. A dividend is cumulative if when the corporation is unable to pay a dividend during a dividend period, the shareholder has a priority right to future available funds for that arrearage.

100. See TBCA arts. 2.12 (Vernon 1980), 2.13 (Vernon 1980 & Supp. 1985). See generally 1 A. DEWING, *supra* note 24, at 123-67 (discussing origins and implications of various forms of preferred stock).

101. A. CONARD, *CORPORATIONS IN PERSPECTIVE* 265-66 (1976).

debt/equity ratios on the corporate balance sheet, in mergers, and in estate planning involving owners of close corporations.¹⁰²

3. *Options, Rights, and Warrants.* Although options, rights, and warrants normally constitute securities under federal and state securities laws, these instruments are not stock. Such instruments do not represent equity ownership, but are merely contractual rights to purchase stock in the future on specified terms and at a set price.¹⁰³ The documentation underlying these instruments is contractual in nature and can take differing forms. Although the terminology for these instruments is interchangeable, options are more closely associated with employee rights to acquire stock under a plan, rights are identified with the rights of existing shareholders in future issuances of stock, and warrants usually relate to a public offering of securities.¹⁰⁴

4. *Legal Capital Considerations.* When issuing stock, a corporation must comply with the legal capital scheme set forth in the relevant state corporation code. This scheme generally encompasses the composition of the capital accounts,¹⁰⁵ the quality and quantity of consideration given for the shares,¹⁰⁶ and the conditions in which the corporation may pay dividends¹⁰⁷ and repurchase its own stock.¹⁰⁸

B. Debt Financing: Bonds, Debentures, and Other Notes

Bonds and debentures represent commitments of funds by creditors to a corporation for a relatively long period of time, usually five years or more. A bond is a secured corporate obligation, whereas a debenture is unsecured. The maturity date of these securities is the date when the corporation must pay the principal sum. The face or par value of a bond or debenture, customarily expressed in multiples of \$1,000, is the amount that the corporation must pay to the holder on the maturity date. In addition to paying the principal at the maturity date, the corporation must also pay to the holder a fixed amount of interest at regular intervals, normally semiannually.¹⁰⁹

The issuance of bonds and debentures is very similar to a loan. The corporation borrows money from the purchasers of the securities. In return, the

102. See Donaldson, *In Defense of Preferred Stock*, 40 HARV. BUS. REV., July-Aug. 1962, at 123.

103. Options, rights, and warrants have a wide range of uses such as employee incentives, as a companion sweetener in public debt offerings, and as a device to maintain shareholder goodwill and interest in the corporation.

104. See Reiling, *Warrants in Bond-Warrant Units: A Survey and Assessment*, 70 MICH. L. REV. 1411, 1411-20 (1972). For a discussion on the use of options in closely-held corporations, including tax implications, see W. PAINTER, *supra* note 4, ch. 10.

105. See TBCA art. 2.17 (Vernon 1980 & Supp. 1985).

106. TBCA arts. 2.15 (Vernon 1980), 2.16 (Vernon 1980 & Supp. 1985).

107. TBCA arts. 2.38, 2.39 (Vernon 1980).

108. TBCA art. 2.12, § B(1) (Vernon 1980). See generally B. MANNING, *LEGAL CAPITAL* 84-90 (2d ed. 1981) (discussing statutory restrictions on the issuance of stock and the composition of corporate financial structure).

109. The fixed rate of interest on a bond or debenture is often called the coupon rate. See generally 1 A. DEWING, *supra* note 24, ch. 7 (discussing the benefits and complexities of bond issuance).

corporation promises to pay principal and interest to the purchasers and to abide by certain contractual conditions contained in the certificate issued to the holder or in an indenture.

The indenture constitutes a fundamental corporate document.¹¹⁰ The indenture is generally very complex and contractually binds not only the corporate borrower and lender, but also a trustee who oversees the administration of the indenture.¹¹¹ When the corporation issues debt securities to the public, the corporation ordinarily must register the indenture under the federal Trust Indenture Act.¹¹² Because of the complexity and expense involved in preparing an indenture, however, indentures are often avoided in close corporation situations.

Holders of bonds, debentures, or other forms of corporate notes do not share directly in the control of the corporation. The issuance of these securities, unless convertible into common stock, will not dilute the equity position of the existing common shareholders. In liquidation preference, however, bonds and debentures are superior to equity. Furthermore, provisions in the indenture can provide the bond and debenture holders with considerable influence over the corporation's affairs and operations. The indenture may require the corporation to establish a sinking fund¹¹³ or to make serial repayments prior to maturity.¹¹⁴ Often in a close corporation setting, neither a formal bond or debenture will be used to evidence the corporate indebtedness. Instead, the corporation will simply issue an unsecured or secured promissory note, although such notes may contain many sophisticated features such as redeemability, subordination, and convertibility.

C. Leverage

A fundamental business and legal consideration in planning the corporate capital structure is the proper ratio of debt to equity. A capital structure that includes only common stock offers the significant advantage of flexibility in raising money in the future. If the corporation issues various forms of equity, however, the flexibility of an equity capitalization may be restricted.

Debt financing also offers advantages.¹¹⁵ In addition to the advantage of nondilution of corporate control, debt financing may be a less expensive method of raising money if through debt financing common shareholders are able to leverage their investment. Leveraging is successful when the economic return on the debt exceeds the cost of maintaining the debt, provided that the corporation can continue to produce a sufficient income stream to

110. See AMERICAN BAR FOUNDATION, COMMENTARIES ON MODEL DEBENTURE INDENTURE PROVISIONS 1-10 (1971).

111. See AMERICAN BAR FOUNDATION, MODEL DEBENTURE INDENTURE PROVISIONS 14 (1967).

112. 15 U.S.C. § 77aa (1982) (current version).

113. A sinking fund is an arrangement in which a fixed amount of money, or an amount determined by formula, is set aside each year toward the ultimate redemption of the entire issue of bonds or debentures.

114. See 1 A. DEWING, *supra* note 24, ch. 8.

115. Debt financing is also known as leveraging or trading on equity.

meet the required debt repayments. Successful leveraging enables the common shareholders to derive economic benefits without contributing additional capital and without diluting their ownership interest in the corporation. In a period of high interest rates or volatile corporate earnings, however, leveraging is very risky.¹¹⁶

A tax issue related to the debt/equity question involves "thin capitalization," which occurs when a sole or majority shareholder or all shareholders proportionately loan excessive funds to an undercapitalized corporation. For tax purposes, the courts may treat the indebtedness as stock and recharacterize the distributions paid on the indebtedness as dividends, in which case the corporation cannot deduct interest on the loans.¹¹⁷ Moreover, bankruptcy courts and other courts considering insolvency matters possess the equitable power to recharacterize a controlling shareholder's loan to a troubled corporation as equity, thus subordinating the shareholder's claim to the claims of outside creditors.¹¹⁸

D. *Selective Legal Techniques for Maintaining Ownership Interests*

1. *Stock Classification.* The use of different classes of stock facilitates the allocation of both equity¹¹⁹ and voting¹²⁰ interests within a corporation. The TBCA permits stock to be divided into classes, which may consist of shares with or without par value.¹²¹ Creating more than one class of stock, however, may jeopardize a Subchapter S election. Generally, the Internal Revenue Service considers differences between shares with respect to voting rights, dividend rights, and liquidation preference to result in different classes of stock for Subchapter S purposes, thus preventing Subchapter S election. Recent tax code amendments, however, make clear that differentiation in the voting rights of common stock or the use of straight debt does not violate the one class restriction.¹²²

2. *Preemptive Rights.* Statutory preemptive rights can also facilitate the allocation of both equity and voting control within the corporation.¹²³ These statutory rights have arisen from the judicial doctrine of preemptive rights, which courts developed mainly from equitable considerations. The doctrine of preemptive rights provided a shareholder with the right to purchase in priority to others a new issuance of stock in proportion to his present percentage interest in the corporation.¹²⁴ The TBCA has codified

116. See H. GUTHMANN & H. DOUGALL, *CORPORATE FINANCIAL POLICY* 167 (4th ed. 1962).

117. See I.R.C. § 385 (1982).

118. See *Taylor v. Standard Gas & Elec. Co.*, 306 U.S. 307, 322-23 (1939).

119. 1 A. DEWING, *supra* note 24, at 123.

120. See Soldofsky, *Classified Common Stock*, 23 *BUS. LAW.* 899, 899-900 (1968).

121. TBCA art. 2.12, § A (Vernon 1980).

122. See I.R.C. § 1361(c)(4), (5) (West 1984).

123. See Drinker, *The Preemptive Right to Subscribe to New Shares*, 43 *HARV. L. REV.* 586 (1930); Morawetz, *The Preemptive Right of Shareholders*, 42 *HARV. L. REV.* 186 (1928).

124. See *Bonnet v. First Nat'l Bank*, 60 S.W. 325, 326 (Tex. Civ. App. 1900, writ dismissed); Frey, *Shareholders Pre-emptive Rights*, 38 *YALE L.J.* 563, 563 (1929).

and expanded this common law shareholders' right.¹²⁵ The TBCA characterizes the preemptive right as an opportunity to acquire stock or other securities under the terms and conditions set by the board of directors.¹²⁶ Presumably, the board must exercise its power subject to fiduciary standards and, in the case of a self-interested transaction, subject to the intrinsic fairness rule.¹²⁷

Preemptive rights may provide merely illusory protection to a shareholder. Legal concerns respecting preemptive rights exist with respect to funding, coverage, and proper purpose. First, a shareholder may not have sufficient funds or sufficient collateral to raise funds to exercise a preemptive right. Even if exercised, the preemptive right may be a costly way for a shareholder, particularly a minority shareholder, to maintain his proportionate interest in the corporation. Second, the statutory exception to preemptive rights concerning stock issued to employees may be used to circumvent the minority shareholders' preemptive rights.¹²⁸ Third, in several cases outside Texas, courts have ruled that a shareholder's preemptive right is the right not to have to purchase additional stock to avoid dilution of his equity interest if a valid business reason does not exist for issuing the additional stock.¹²⁹ Before recommending the use of preemptive rights, the attorney thus should carefully assess the problems that surround his client/shareholder's desire to maintain his proportionate interest. The attorney should also consider the effect such rights might have on future corporate financing plans.

3. *Stock Transfer Restrictions.* Under Texas law corporate stock is the personal property of the owner and is transferrable in accordance with chapter

125. TBCA art. 2.22-1 (Vernon 1980); accord DEL. CODE ANN. tit. 8, § 102(b)(3) (1983). The TBCA provides a shareholder with "a preemptive right to acquire additional, unissued, or treasury shares of the corporation, or securities of the corporation convertible into or carrying a right to subscribe or to acquire shares, except to the extent limited or denied by this Article or by the articles of incorporation." TBCA art. 2.22-1, § A (Vernon 1980). If preemptive rights are to be denied, therefore, they must usually be expressly denied in the articles of incorporation. The TBCA specifies, however, that unless otherwise provided in the articles of incorporation, no preemptive right exists in situations involving the issuance of stock: "(a) . . . to employees pursuant to approval by the affirmative vote of the holders of a majority of the shares entitled to vote thereon or when authorized by and consistent with a plan theretofore approved by such a vote of shareholders; or (b) . . . otherwise than for cash." TBCA art. 2.22-1, § B(1) (Vernon 1980). Moreover, the TBCA generally precludes, unless provided otherwise in the articles of incorporation, preemptive rights with respect to either stock of different classes or stock having preferential rights. TBCA art. 2.22-1, § B(2), (3), (4) (Vernon 1980). In comparison, Delaware law denies all preemptive rights unless expressly provided for in the articles of incorporation. DEL. CODE ANN. tit. 8, § 102(b)(3) (1983).

126. TBCA art. 2.22-1, § B(5) (Vernon 1980).

127. See *supra* text accompanying notes 47-51.

128. Elaborating in a provision of the articles of incorporation the exact nature and extent of the preemptive right given and combining this provision with additional charter provisions concerning the required vote to issue new shares and amend the articles of incorporation is one method for a minority shareholder to protect his preemptive rights. See *L.L. Minor Co. v. Perkins*, 246 Ga. 8, 268 S.E.2d 637, 643 n.15 (1980).

129. See, e.g., *Bennett v. Breuil Petroleum Corp.*, 34 Del. Ch. 6, 99 A.2d 236, 240-41 (1953); *Katzowitz v. Sidler*, 24 N.Y.2d 512, 518-19, 249 N.E.2d 359, 363-64, 301 N.Y.S.2d 470, 475-76 (1969); *Maguire v. Osborne*, 388 Pa. 121, 130 A.2d 157, 159 (1957).

8 of the Texas Business and Commerce Code.¹³⁰ One of the fundamental rights of a property owner is the freedom to dispose of the property as the owner sees fit. Accordingly, the public policy of Texas and most other jurisdictions prohibits unreasonable restraints on alienation of personal property.¹³¹ Stock transfer restrictions, however, if properly structured and drafted within the statutory guidelines and case law standards, can be an important technique to control the distribution of and succession to power within a corporation.¹³²

a. Purposes. Stock transfer restrictions may serve a variety of purposes within the close corporation. First, stock transfer restrictions can enable the founding shareholders to control the substitution or addition of shareholders in the future. The shareholders may desire this control to prevent the intrusion of a disruptive or incompatible shareholder¹³³ or simply because they have relied upon the identity of other founding shareholders.¹³⁴ Second, stock transfer restrictions can prevent a shareholder from gaining control or otherwise altering the allocation of control among the founding shareholders. Third, federal and state securities laws may require stock transfer restrictions for the stock to qualify for a statutory exemption.¹³⁵ Fourth, stock transfer restrictions can prevent the transfer of stock to a nonqualifying or nonconsenting holder or the distribution otherwise of stock in a manner violative of the numerical limitations of Subchapter S of the Internal Revenue Code.¹³⁶ In this way, the restrictions can preserve the Subchapter S tax status of the close corporation. Fifth, a buy-sell arrangement can provide liquidity to a shareholder or his family in the event of disability, death, or divorce of the shareholder. Finally, a mandatory buy-out provision can provide a shareholder who works for the corporation with incentive to remain an employee of the corporation.

b. Types. Several types of stock transfer restrictions exist to accomplish these objectives. First, the shareholders may create a right of first refusal. This right provides the corporation or nonselling shareholders with an option to purchase shares from a selling shareholder at the best price offered by

130. TBCA art. 2.22, § A (Vernon 1980).

131. See Note, *Corporations—Stock Alienation Restrictions—Power of Directors to Restrict Issued Stock*, 14 Sw. L.J. 106, 106 (1960).

132. See Annot., 61 A.L.R.2d 1318, 1320 (1958).

133. An outsider who acquires a single share has the basic shareholder rights to inspect corporate books and records, to sue in a shareholder or derivative action, and to vote on fundamental corporate matters even if his stock is classified as nonvoting. Similarly, a new shareholder with different managerial ideas can disrupt a consensus among the founding shareholders.

134. This desire is related to the concept of *delictus personae* in partnership law. See J. CRANE & A. BROMBERG, *CRANE & BROMBERG ON PARTNERSHIP* 43 (1968).

135. Generally, a close corporation issues stock without registering the stock under applicable state and federal securities laws by relying on a statutory exemption. The issued shares constitute restricted securities and cannot be transferred or distributed except under certain circumstances.

136. See I.R.C. §§ 1361, 1362 (West 1984).

a bona fide third party.¹³⁷ Texas courts have generally upheld rights of first refusal.¹³⁸ Second, the shareholders may adopt a consent restraint, which provides that stock may not be transferred except with the consent of the corporation, its directors, or other shareholders. Although courts have traditionally questioned the validity of consent restraints,¹³⁹ the TBCA has permitted reasonable consent restraints since 1973.¹⁴⁰ A third stock transfer restriction involves a buy-sell or cross-purchase agreement. A buy-sell agreement obligates the corporation to purchase the stock of a shareholder on the occurrence of a specified event, such as retirement, disability, death, divorce, or termination of employment of the shareholder. A cross-purchase agreement obligates the nonselling shareholders to purchase stock under these circumstances.¹⁴¹ The TBCA expressly provides for both types of agreements.¹⁴² Finally, a stock transfer restriction may restrict transfers to specified persons. One can draft numerous variations and combinations of these basic types of stock transfer restrictions to meet a specific situation.¹⁴³

c. Legal Standards. Because stock transfer restrictions restrain the shareholder's right to alienate property, Texas courts will review the restrictions under a reasonableness standard.¹⁴⁴ Under this standard, a stock transfer restriction must have, as of the time that it is imposed, some prospective relationship to legitimate objectives of the corporation or its share-

137. See TBCA art. 2.22, § D(1) (Vernon Supp. 1985). Specific events other than a proposed sale to a third party, including a proposed sale to another shareholder, death, disability, or retirement of a shareholder, or a gift or pledge of stock, may precipitate first refusal rights. Furthermore, the shareholders may adopt a formula other than the price offered by a third party to set the option price. A. GUILD, D. DAVIS & D. HOXIES, *STOCK PURCHASE AGREEMENTS & THE CLOSE CORPORATION* 18 (3d ed. 1978).

138. See *Ling & Co. v. Trinity Sav. & Loan Ass'n*, 482 S.W.2d 841, 844 (Tex. 1972); *Coleman v. Kettering*, 289 S.W.2d 953, 957 (Tex. Civ. App.—Galveston 1956, no writ); *accord Lawson v. Household Fin. Corp.*, 17 Del. Ch. 343, 152 A. 723, 727 (1930).

139. See Annot., 69 A.L.R.3d 1327, 1327-29 (1976).

140. TBCA art. 2.22, § D(3) (Vernon Supp. 1985).

141. See A. GUILD, D. DAVIS & D. HOXIES, *supra* note 137, at 18; Bradley, *Stock Transfer Restrictions & Buy-Sell Agreements*, 1969 U. ILL. L.F. 139, 175.

142. See TBCA art. 2.22, § D(2) (Vernon Supp. 1985); *accord* DEL. CODE ANN. tit. 8, § 202(c)(2) (1983). A corporation's obligation to repurchase stock is, however, subject to the statutory requirements respecting stock redemptions and repurchases. *Id.* art. 2.03 (Vernon 1980 & Supp. 1984).

143. See O'Neal, *Restrictions on Transfers of Stock in Closely Held Corporations: Planning and Drafting*, 65 HARV. L. REV. 773, 777 (1952).

144. See TBCA art. 2.22, § C (Vernon 1980). The TCCL appears to permit restrictions on share transfers that TBCA article 2.22, § C does not. TCCL art. 12.32, § A(2) (Vernon Supp. 1985) specifically states:

All shareholders of a close corporation may make one or more shareholders' agreements. The business and affairs of a close corporation or the relations among the shareholders that may be regulated by a shareholders' agreement include with limitation:

-
- (2) buy-sell, first option, first refusal, or similar arrangements with respect to the close corporation's shares or other securities, and restrictions on their transfer, including restrictions beyond those permitted to be imposed by Article 2.22 of this Act.

I believe, however, that courts will also apply a reasonableness standard to stock restrictions created under the TCCL.

holders.¹⁴⁵ Accordingly, a court must analyze stock transfer restrictions on a case-by-case basis in light of the specific needs and expectations of the corporation and its shareholders. The TBCA provides that if a stock transfer restriction is reasonable and noted conspicuously on the security, the restriction is enforceable against the holder of the security or any successor or transferee of the holder.¹⁴⁶ If the restriction is not noted conspicuously, however, the restriction is ineffective except against a person with actual knowledge of the restriction.¹⁴⁷

d. Statutorily Permissible Restraints. The TBCA expressly approves of several types of stock transfer restraints. As noted above, however, courts will apply a reasonableness standard to all restraints.¹⁴⁸ Although the statutory laundry list of permissible restraints under the TBCA is not exhaustive, the prudent lawyer should structure a specific restriction within the context of a statutory provision. The TBCA provides that a stock transfer restriction is valid if: (1) the stock transfer restriction obligates holders of the restricted stock to offer that stock to the corporation or other shareholders; (2) the stock transfer restriction obligates the corporation or other shareholders to purchase the stock; (3) the stock transfer restriction requires the corporation or other shareholders to consent to any transfer of the restricted stock; (4) the stock transfer restriction prohibits the transfer of the restricted stock to designated persons, if such designation is not unreasonable; or (5) the stock transfer restriction maintains the corporation's status as a Subchapter S corporation under the Internal Revenue Code or as a close corporation under the TBCA.¹⁴⁹

e. Location of Restrictions. Stock transfer restrictions may be placed in the articles of incorporation, in the bylaws, or in a separate agreement. In the case of a new corporation, including stock transfer restrictions in the articles of incorporation may be the easiest means. This alternative offers two advantages. First, including restrictions in the articles ties the restrictions to the source of corporate existence and thus provides evidence against claims that the restrictions are unreasonable. Second, the articles constitute a public record and thus provide third parties with constructive notice of the restrictions even if the restrictions are not conspicuously noted on the stock certificates.

145. Panel Discussion, *The Problems of Closely-Held Corporations*, in PROCEEDINGS 1955 TEXAS BUSINESS CORPORATION ACT INSTITUTE 105, 142 (description of standard by Paul Carrington).

146. TBCA art. 2.22, § C (Vernon 1980).

147. TBCA art. 2.22, § C (Vernon 1980). The statute defines "conspicuous" as:

The location of such information or use of type of sufficient size, color, or character that a reasonable person against whom such information may operate should notice it. For example, a printed or typed statement in capitals, or bold-face or underlined type, or in type that is larger than or that contrasts in color with that used for other statements on the same certificate is "conspicuous."

TBCA art. 1.02, § A(19) (Vernon 1980).

148. TBCA art. 2.22, § D (Vernon Supp. 1985).

149. TBCA art. 2.22, § D (Vernon Supp. 1985).

Including restrictions in the articles of incorporation also has disadvantages. The shareholders may not want the details of their contractual arrangements to be a matter of public record. Furthermore, unless the restrictions are in the articles, corporate expenditures pursuant to the restrictions are open to attack as *ultra vires*. Finally, less than all of the shareholders can amend the articles and thereby circumvent the restrictions, although a provision in the chapter requiring unanimity in order to amend the restrictions will remedy this problem.

One can also include the restrictions on stock transfer in the bylaws of the corporation. Since the bylaws contain the guidelines for the conduct of corporate activities, the bylaws provide a convenient document in which to repeat the restrictions. If the bylaws is the sole document in which the restrictions are contained, however, the attorney must be careful to ensure that the directors cannot amend the bylaws. This protection requires a suitable provision in the articles of incorporation.

Stock transfer restrictions are often set forth in a separate contractual agreement or incorporated in a buy-sell or stock purchase agreement. These ancillary contractual arrangements can more elaborately describe the technicalities involved in the implementation of the restrictions. These ancillary arrangements, however, should not be the sole source of the restrictions; rather, separate contractual arrangements should be combined with consistent provisions in the articles of incorporation or bylaws.¹⁵⁰

In the case of the adoption of bylaws or corporate consent to an agreement containing a stock transfer restriction, the corporation must file a counterpart of the adopted bylaw provision or the agreement at its principal place of business and its registered office.¹⁵¹ Shareholders have the same right to examine the bylaws provision or agreement as to examine the corporation's books and records.¹⁵² The TBCA permits a corporation to amend its articles of incorporation to include an agreement containing a stock transfer restriction without restating the agreement, provided a true and complete copy of the agreement is attached to the articles of amendment.¹⁵³

f. Parties. Transfer restrictions will, according to the terms of the relevant instrument, run to the corporation and to certain or all of the shareholders. As a practical matter, the corporation is often in a better position than the nonselling shareholders to repurchase the stock. When the corpo-

150. See *Irwin v. Prestressed Structures, Inc.*, 420 S.W.2d 491, 494 (Tex. Civ. App.—Amarillo 1967, writ ref'd n.r.e.).

151. TBCA art. 2.22, § B (Vernon 1980). The TBCA permits a corporation that has adopted a bylaw restriction or has agreed to a contractual transfer restriction to file such provision as a matter of public record with the secretary of state. TBCA art. 2.22, § E (Vernon Supp. 1985).

152. TBCA art. 2.22, § B (Vernon 1980).

153. TBCA art. 2.22, § F (Vernon 1980). The advantage of this procedure is unknown to me. Professor Bateman, one of the draftsmen of the 1975 TBCA revisions, concedes that the practical value of this latter provision "is not readily apparent." Bateman & Dawson, *The 1975 Amendments to the Texas Business Corporation Act and the Texas Securities Act*, 6 TEX. TECH L. REV. 951, 963 (1975).

ration assumes a mandatory buy-sell obligation, however, the shareholders should be additional parties in the event that the corporation is unable, either financially¹⁵⁴ or under TBCA repurchase restrictions,¹⁵⁵ to redeem the stock.¹⁵⁶ Successive options may be given in which the corporation has the first opportunity to purchase; if the corporation is unable or unwilling to purchase, then the option runs on a pro rata basis to the remaining shareholders. A mandatory buy-sell arrangement involving a shareholder purchase combined with a backup purchase by the corporation, however, generally should be avoided due to the possibility that the IRS will assert that the corporation's discharge of the shareholder's obligation is a dividend distribution.¹⁵⁷ If the corporation acquires the stock, the corporation must then consider whether to retire the stock, hold the stock as treasury stock, or reissue the stock. Moreover, as the number of shareholders increases, the successful implementation of the buy-sell becomes more difficult and complex.¹⁵⁸

g. Other Practical Considerations. Other practical considerations concerning stock transfer restrictions include drafting, price, duration, notation, funding, and tax consequences.¹⁵⁹ First, workable stock transfer restrictions must be drafted in charter documents or ancillary agreements, a process often arduous and filled with pitfalls. The documents should specify: (1) the person to whom the transfer restrictions run; (2) the number of shares to which the purchase option applies;¹⁶⁰ (3) the rights of other remaining shareholders if one remaining shareholder decides not to participate in the purchase; (4) the rights of parties to a divorce if stock constitutes community

154. See TBCA art. 2.03 (Vernon 1980 & Supp. 1985).

155. See TBCA art. 4.09 (Vernon 1980).

156. See *Hall v. Weller, Hall & Jeffery, Inc.*, 497 S.W.2d 374, 377 (Tex. Civ. App.—Houston [1st Dist.] 1973, writ ref'd n.r.e.).

157. For a discussion of the tax considerations of corporate and shareholder repurchase arrangements, see Lischer, *Buy-Sell Agreements for Closely-Held Business Interests*, 44 TEX. B.J. 283, 285-88 (1981).

158. A restriction created by agreement will only bind the contracting parties. Whether a restriction created by the articles of incorporation will bind all future shareholders or an original shareholder who objected to the restrictions is subject to question. See *B & H Warehouse v. Atlas Van Lines*, 490 F.2d 818, 821-22 (5th Cir. 1974) (applying Delaware law). The case may be different under the TCCL. TCCL art. 12.36, § A (Vernon Supp. 1985) states:

A shareholders' agreement, if executed in conformance with [the procedural requirements of] Article 12.33 of this Act, is considered to be an agreement among all the shareholders of the close corporation and is binding and enforceable in accordance with its terms on all shareholders of the close corporation regardless of whether a particular shareholder acquired shares in the close corporation by purchase, gift, bequest, or otherwise, or whether the shareholder had actual knowledge of the existence of the shareholders' agreement at the time of acquiring shares. A transferee or assignee of shares of a close corporation with respect to which there is a shareholders' agreement is bound by the shareholders' agreement for all purposes whether or not the transferee or assignee executed or was aware of the agreement.

159. Since stock transfer restrictions inherently contain the seeds of friction and dispute, adequate and workable dispute resolution techniques should also be included in the instrument creating such restrictions. See *infra* notes 253-79 and accompanying text.

160. See *Rainwater v. Milfeld*, 485 S.W.2d 831, 836 (Tex. Civ. App.—Corpus Christi 1972, no writ).

property;¹⁶¹ (5) the rights of an executor or administrator in voting and other corporate matters in the event of a shareholder's death; and (6) the events that trigger a purchase or buy-out.

Second, the parties must determine the purchase price or method for determining that price in the instrument creating the restriction.¹⁶² Book value, which can be ascertained by a quick review of the corporation's balance sheet, is the simplest (but often not the fairest) method of determining the purchase price.¹⁶³ If book value is used, however, the lawyer should give considerable thought to defining that term and should not simply rely upon the balance sheet of the corporation. Also, the integrity of the client's accountant and the accounting principles that the corporation uses will be most important in ensuring the integrity of any value derived.¹⁶⁴

Third, no express statutory restrictions exist concerning the duration of stock transfer restrictions.¹⁶⁵ Nevertheless, selecting a reasonable duration is important because a court will review the duration when considering the overall reasonableness of the restriction. Fourth, the TBCA requires a conspicuous notation of the restriction on the stock certificate.¹⁶⁶ Fifth, the parties must decide how to fund a purchase pursuant to a stock transfer restriction. Frequently used funding methods include: (1) a one-time cash payment; (2) a series of payments, in which case security for the debt becomes an important issue; (3) a corporate sinking fund; or (4) a key-person insurance policy. Finally, stock transfer restrictions, particularly with respect to buy-sell and cross-purchase arrangements and funding through insurance, can raise numerous income, estate, and gift tax problems. The

161. See *Earthman's, Inc. v. Earthman*, 526 S.W.2d 192, 202 (Tex. Civ. App.—Houston [1st Dist.] 1975, no writ).

162. One or more of the following methods of determining the purchase price is generally used: (1) book value; (2) capitalization of earnings; (3) fair market value as determined either by a disinterested appraiser or through arbitration; (4) fair market value as based on a bona fide third party offer; or (5) percentage of projected or actual net earnings from a specified number of future years. See Matsen, *Establishing the Price for Closely Held Business Buy-Sell Arrangements*, 5 J. CORP. TAX'N 134, 138-47 (1978).

163. Book value, however, may be wholly inadequate since questions arise: (1) whether goodwill should be included; (2) whether the book value corresponds to actual value, particularly in inflationary times; (3) whether assets are reflected on the books at costs that have significantly fallen or appreciated; (4) whether the true value of the business is in its book value or its ability to generate annual earnings; and (5) whether the corporation's methods of depreciation and inventory valuation are those that are commonly used in the industry.

164. For an example of the problems that can arise in the valuation process, even with a prearranged valuation mechanism, see *Sammons Enters. v. Manley*, 540 S.W.2d 751, 753-57 (Tex. Civ. App.—Texarkana 1976, writ ref'd n.r.e.).

165. Stock transfer restrictions generally terminate either according to the terms of the instrument creating them or through disuse. Professor Hamilton suggests that while these restrictions themselves are usually unrestricted as to duration, it "may be desirable to establish very precise time periods for the exercise of rights granted by such restrictions." 20 R. HAMILTON, *supra* note 53, at 151.

166. TBCA art. 2.19, § G (Vernon 1980) provides that stock certificates subject to a transfer restriction shall contain either: (1) a statement of the restriction conspicuously set forth on the certificate's face; (2) a conspicuous reference on the certificate's face to such restrictive statement, with a summary statement on the back of the certificate; or (3) a conspicuous statement on the certificate's face or back that a restriction exists and that the corporation will furnish the shareholder a copy of the document containing the restriction or that such document is on file with the secretary of state.

corporate attorney, unless personally familiar with such tax implications, should seek tax counsel with respect to these matters.¹⁶⁷

V. ALLOCATING AND MAINTAINING "MANAGERIAL" CONTROL

A. *The Problems*

A fundamental concern in organizing a corporation is the allocation and maintenance of "managerial" control. The most significant practical difficulties encountered in allocating and maintaining this control within the newly formed corporation are: (1) ensuring that each owner can elect at least one, and possibly more than one, director; (2) providing that the owners may vote their shares together to elect several directors and control the board of directors; (3) providing shareholder controls over various director actions; and (4) providing continuity of competent and acceptable managers on a day-to-day basis.¹⁶⁸

B. *Selective Legal Techniques*

This section discusses seven legal techniques that practitioners can use to address issues of control within the corporation. In addition to these seven techniques, the use of stock transfer restrictions, including buy-sell arrangements¹⁶⁹ and preemptive rights,¹⁷⁰ may impact the allocation of managerial control.¹⁷¹

1. Stock Classification. Under the common law, members of a corporation had equal rights, and each member was entitled to one vote and no more. The TBCA provides that each validly issued outstanding share is entitled to one vote unless the articles of incorporation or TBCA provides otherwise.¹⁷² The TBCA presumes all stock to have voting rights unless the articles specifically provide otherwise. The TBCA expressly provides that the articles of incorporation may limit or deny voting rights to any class of stock to the extent that such limitation or denial is not inconsistent with the TBCA.¹⁷³ Voting rights as to certain fundamental matters, such as charter amendments,¹⁷⁴ voluntary dissolution,¹⁷⁵ merger or consolidation,¹⁷⁶ and disposition of substantially all assets,¹⁷⁷ cannot be denied to a class of shares.

The TBCA permits the articles of incorporation to provide for more or

167. See Z. CAVITCH, *TAX PLANNING FOR CORPORATIONS & SHAREHOLDERS* ch. 7 (1980); Lischer, *supra* note 157, at 285-88; Turley, *Changing Capital Structures and Shareholders in a Closely-Held Texas Corporation*, 11 HOUS. L. REV. 351, 351-408 (1974).

168. See Hetherington, *Special Characteristics, Problems, and Needs of the Close Corporation*, 1969 U. ILL. L.F. 1, 4, 5.

169. See *supra* notes 130-67 and accompanying text.

170. See *supra* notes 123-29 and accompanying text.

171. See O'Neal, *Control Distribution Devices*, 1969 U. ILL. L.F. 48, 59-60.

172. TBCA art. 2.29 (Vernon 1980).

173. TBCA art. 2.12, § A (Vernon 1980).

174. TBCA art. 4.03, § B (Vernon Supp. 1985).

175. TBCA art. 6.03 (Vernon 1980).

176. TBCA art. 5.03 (Vernon 1980).

177. TBCA art. 5.10 (Vernon 1980).

less than one vote per share.¹⁷⁸ Consequently, variations in the voting rights of classes of stock are possible. Assume, for example, that Ms. Jones and Mr. Smith desire to form a corporation. They agree that each will have equal voting control, even though Ms. Jones will contribute twice as much capital as Mr. Smith. If the corporation has only one class of common stock, the corporation will not have the desired voting control. The corporation, however, can issue two classes of common stock, Class A and Class B, each class having equal voting power and each share having equal ownership rights. If the corporation issues two thousand shares of Class A to Ms. Jones and one thousand shares of Class B to Mr. Smith, then each class of stock will have the power to elect half the board of directors. Thus, this structure enables the participants to share voting control equally despite their different equity contributions.¹⁷⁹

Different classes of stock can similarly be used to deny voting rights in certain matters and give voting rights in other matters, or to create a class of nonvoting stock with contingent voting rights.¹⁸⁰

2. *Irrevocable Proxies.* A proxy is a special form of agency in which one person is authorized to vote the stock of another. The irrevocable proxy is a control technique often used in conjunction with a shareholder pooling arrangement.¹⁸¹ Because the law surrounding the use of irrevocable proxies is cloaked in terms of basic agency principles, the argument is often made that a proxy, unless coupled with an interest, is revocable notwithstanding the proxy's express terms to the contrary.¹⁸²

Under the TBCA a proxy is irrevocable if either the proxy instrument's express terms make the proxy irrevocable or the proxy is made irrevocable by law.¹⁸³ Few Texas cases have defined when a proxy is made irrevocable by law. *Roberts v. Whitson*,¹⁸⁴ a 1945 case that has been criticized, indicates in dictum that an irrevocable proxy, unless coupled with an interest, is con-

178. TBCA art. 2.29, § A (Vernon 1980).

179. The same result could be achieved by having Class A voting stock and Class B non-voting stock with Ms. Jones and Mr. Smith each receiving 1,000 shares of Class A stock and with Ms. Jones also receiving 1,000 shares of Class B stock. Under another variation Ms. Jones is issued 2,000 shares of Class A stock and Mr. Smith is issued 1,000 shares of Class B stock, but with Class B stock having two votes per share. See Annot., 3 A.L.R.4th 1204, 1206-07 (1981).

180. Case law exists outside Texas suggesting that a class of stock may be created that has only voting rights and none of the conventional rights to dividends or liquidation. *Lehrman v. Cohen*, 43 Del. Ch. 222, 222 A.2d 800, 806 (Sup. Ct. 1966); *Stroh v. Blackhawk Holding Corp.*, 48 Ill. 471, 272 N.E.2d 1, 4-7 (1971).

181. See Comment, *Voting Trusts and Irrevocable Proxies*, 41 TEMP. L.Q. 480, 484 (1968). TBCA art. 2.29, § C (Vernon 1980).

182. See Comment, *Irrevocable Proxies*, 43 TEX. L. REV. 733, 736-37 (1965).

183. TBCA art. 2.29, § C (Vernon 1980). This article provides:

A shareholder may vote either in person or by proxy executed in writing by the shareholder or by his duly authorized attorney in fact. No proxy shall be valid after eleven (11) months from the date of its execution unless otherwise provided in the proxy. A proxy shall be revocable unless expressly provided therein to be irrevocable and unless otherwise made irrevocable by law.

Id.

184. 188 S.W.2d 875 (Tex. Civ. App.—Dallas 1945, writ ref'd w.o.m.).

trary to public policy.¹⁸⁵ Although a strong argument can be made that use of the "coupled with an interest" rationale is inappropriate in the context of shareholders' arrangements, the prudent course is nevertheless to ascertain whether the irrevocable proxy is in fact coupled with an interest.¹⁸⁶

The difficult problem concerns what "coupled with an interest" means. Delaware law states that the coupled with an interest requirement is satisfied by either a particular interest in the stock or general interest in the corporation.¹⁸⁷ Unfortunately the matter remains unclear under Texas law. If an irrevocable proxy is used in conjunction with a shareholders' agreement pursuant to the TBCA,¹⁸⁸ one could argue that the irrevocable proxy is enforceable to the same extent as the shareholders' agreement.¹⁸⁹ From a practical viewpoint no justification exists for distinguishing between an irrevocable proxy and a shareholder pooling arrangement or a voting trust. I recommend, however, because of the uncertainties surrounding the irrevocable proxy, that the irrevocable proxy not be used unless required for structuring the desired control arrangement.

3. *Cumulative Voting Rights.* Cumulative voting rights are used to assure minority shareholders a voice on the board of directors of a corporation.¹⁹⁰ The cumulative voting right is a statutory device for increasing the possibility that shareholders will be represented on the board of directors. Essentially, cumulative voting allows a shareholder to multiply the number of shares held by the number of directors to be elected and to cast that total number of votes as he chooses. For example, assume that seven directors are to be elected and that the shareholder owns one thousand shares, each of which entitles him to one vote. Under cumulative voting, the shareholder would have seven thousand votes to spread among one or more of the various candidates.¹⁹¹ The TBCA provides that cumulative voting exists unless expressly prohibited by the articles of incorporation.¹⁹² The shareholder who intends to vote cumulatively is required to give written notice of that intent to the secretary of the corporation on or before the day preceding the election.¹⁹³ Moreover, all shareholders may vote cumulatively if any shareholder gives the required notice.

Cumulative voting can become quite tricky and dangerous. A graphic example is contained in the 1883 Pennsylvania case of *Pierce v. Common-*

185. *Id.* at 878.

186. See W. PAINTER, *supra* note 4, at 151-53.

187. DEL. CODE ANN. tit. 8, § 212(c) (1983).

188. TBCA art. 2.30, § B (Vernon 1980).

189. TBCA art. 2.30, § B (Vernon 1980). For a sample form of a Joint Irrevocable Proxy, see Lewis, *A Joint Irrevocable Proxy*, 4 ALI-ABA COURSE MAT'LS J., June 1980, at 105.

190. Campbell, *The Origin and Growth of Cumulative Voting for Directors*, BUS. LAW., May 1955, at 3, 5-6.

191. See generally C. WILLIAMS, CUMULATIVE VOTING FOR DIRECTORS 47-156 (1950) (detailing the use and mechanics of cumulative voting).

192. TBCA art. 2.29, § D(1) (Vernon 1980). Conversely, Delaware law presumes that cumulative voting rights are denied. DEL. CODE ANN. tit. 8, § 214 (1983).

193. TBCA art. 2.29, § D(2) (Vernon 1980).

wealth,¹⁹⁴ which involved the election of six directors. The majority held 3,400 shares and the minority held 3,000 shares. The majority spread its 20,400 cumulative votes evenly among six candidates. The opposing minority, which had 18,000 cumulative votes, ran two dummy nominees and spread their votes over only four candidates and thus captured four seats and control of the board.

Generally, the smaller the board of directors the less effective cumulative voting is in ensuring minority representation. Moreover, controlling shareholders can emasculate the cumulative voting right through such devices as the classification of the board of directors through staggered terms,¹⁹⁵ the reduction of the number of board members, the use of an executive committee with broad powers, or the amendment of the articles of incorporation or bylaws. If cumulative voting is used, adequate protection should be included in the articles of incorporation and bylaws to prevent a subsequent amendment or termination of this right without the consent of the minority shareholders.

4. *Higher Quorum and Voting Requirements.* Higher quorum and voting requirements may effectively provide a minority shareholder with a veto power at either the shareholder or board of directors level. The TBCA permits the percentage required for shareholder or director approval to be increased to the point of requiring unanimity.¹⁹⁶ The TBCA also empowers a corporation to increase the quorum requirement to 100% for either the shareholders' or the board of directors' meeting.¹⁹⁷

Generally, increased voting requirements are sufficient to provide an effective veto. This veto power, however, increases the likelihood of deadlock and thus makes even more important the need for suitable dispute resolution procedures.¹⁹⁸ Consequently, a blanket increase of quorum or voting requirements should be made with extreme caution. The wiser approach is to use this technique selectively with respect to specific matters.¹⁹⁹

The minimum voting and quorum requirements for acts requiring a per-

194. 104 Pa. 150, 150-52 (1883).

195. Compare TBCA art. 2.33, § A (Vernon 1980) (permitting staggered terms to be provided for by the bylaws only if the board consists of nine or more directors) with DEL. CODE ANN. tit. 8, § 141(d) (permitting staggering without any minimum number of directors).

196. See TBCA arts. 2.35 (Vernon 1980), 9.08 (Vernon 1980 & Supp. 1985).

197. TBCA arts. 2.28, 2.35 (Vernon 1980).

198. See *Keating v. K-C-K Corp.*, 383 S.W.2d 69, 70-71 (Tex. Civ. App.—Houston 1964, no writ).

199. Professor Painter suggests the following checklist as areas in which to increase quorum or voting requirements: (1) the corporation's making of major organic changes; (2) the corporation's issuance of additional stock or sale of treasury stock; (3) the corporation's repurchase of outstanding stock; (4) the corporation's creation of new indebtedness; (5) the corporation's reduction of common stock dividends; (6) the corporation's reduction of salaries of officers and major employees; (7) the corporation's firing of officers and major employees; (8) the corporation's reduction in the number of directors; (9) the corporation's classification of directors or staggering of directors' terms; (10) the corporation's articles of incorporation or bylaws being amended; (11) the corporation's execution of contracts with corporations, partnerships, or other entities in which any shareholder has a substantial interest; and (12) the corporation's consent to a petition in bankruptcy. W. PAINTER, *supra* note 4, § 3.6, at 66-67.

centage vote of shareholders under the TBCA may be increased only by provisions in the articles of incorporation.²⁰⁰ With respect to other actions, the minimum voting and quorum requirements for shareholders and the quorum and voting requirements for the board of directors may be increased by either the articles of incorporation or the bylaws.²⁰¹ If the bylaws is the sole document that contains a provision regarding quorum and voting, one must ensure that the bylaws can not be amended to defeat the purposes of the higher voting or quorum requirements. The safest course is to include such matters in the articles of incorporation and to repeat them in the bylaws.

5. *Voting Trusts.* A voting trust generally ensures that voting control will remain in the hands of certain shareholders. Consequently, shareholders frequently use a voting trust as an alternative to a shareholder pooling arrangement.²⁰² The distinguishing characteristic of a voting trust is that it creates a legal trust. A shareholder must irrevocably surrender legal title to the shares to a trustee for the term of the trust. The shareholder, however, remains the beneficial owner unless the trust agreement provides differently.²⁰³ Generally, the shareholders receive from the trustee certificates of beneficial interest, which are freely transferable.

In Texas the voting trust is essentially a creature of statute.²⁰⁴ The TBCA provides that any number of shareholders may create a voting trust for the purpose of conferring upon a trustee the right to vote their shares. The voting trust, however, must meet the following statutory requirements: (1) the term of the trust does not exceed ten years; (2) the trust agreement is in writing; (3) the corporation has on file a counterpart of the trust agreement at the corporation's registered office; and (4) the stock subject to the trust is transferred to the trustee.²⁰⁵ Moreover, case law suggests an additional non-statutory requirement that the trust exist for a proper purpose.²⁰⁶

The trust instrument may restrict the voting powers of the trustee and

200. TBCA art. 2.28 (Vernon 1980).

201. TBCA arts. 2.28, 2.29 (Vernon 1980).

202. See *infra* notes 214-28 and accompanying text. 5 W. FLETCHER, *supra* note 62, § 2075 states:

A voting trust has been defined as a trust created by an agreement between a group of the stockholders of a corporation and the trustee, or by a group of identical agreements between individual stockholders and the common trustee, whereby it is provided that for a term of years, or for a period contingent upon a certain event, or until the agreement is terminated, control over the stock owned by such stockholders, either for certain purposes or for all, shall be lodged in the trustee, either with or without a reservation to the owners or persons designated by them of the powers to direct how such control shall be used.

203. See Baldwin, *Voting Trusts*, 1 YALE L.J. 1, 2-4 (1891); Ballantine, *Voting Trusts, Their Abuses and Regulation*, 21 TEX. L. REV. 139, 142 (1942); Wormser, *The Legality of Corporate Voting Trusts and Pooling Agreements*, 18 COLUM. L. REV. 123, 123-24 (1918).

204. TBCA art. 2.30, § A (Vernon 1980).

205. TBCA art. 2.30, § A (Vernon 1980).

206. See *Grynberg v. Burke*, 378 A.2d 139, 144 (Del. Ch. 1977) (summary judgment denied: fact issue existed concerning shareholders' agreement with stock purchase option), *cross motion for summary judgment granted*, 410 A.2d 169 (Del. Ch. 1979), *rev'd sub nom.* *Oceanic Exploration Co. v. Grynberg*, 428 A.2d 1 (Del. 1981); *Grogan v. Grogan*, 315 S.W.2d 34, 39 (Tex. Civ. App.—Beaumont 1958, writ ref'd n.r.e.).

delineate the extent of the shareholder's beneficial interest. For example, the trust instrument may prohibit the trustee from voting on fundamental corporate matters without the consent of a specified percentage of the beneficial owners. The trust agreement frequently specifies that dividends, which the trustee collects, shall be distributed to the beneficial owners.²⁰⁷ The TBCA provides that the holder of a beneficial interest in a voting trust shall be regarded as a holder of record of the shares and thus must inspect the record of shareholders of the corporation.²⁰⁸ Moreover, under the TBCA a beneficial owner in a voting trust has standing to sue as plaintiff in a derivative suit.²⁰⁹

In the absence of statutory clarification to the contrary, the voting trust agreement will most probably be subject to trust law in addition to the TBCA.²¹⁰ Consequently, the drafting attorney should carefully specify the powers, duties, and bases for indemnification of the trustee in the trust agreement.²¹¹ Unless the voting trust agreement expressly provides otherwise, the trustee does not have to be a shareholder. The trustee may be a bank or other institution, a neutral party, or one or more of the shareholders. If the trustee is a shareholder or participates in the corporation as a director, officer, or employee, conflict of interest situations may arise.

The primary advantage of a voting trust over a shareholder pooling agreement is that the voting trust avoids procedural problems related to voting shares during a dispute between the shareholders. Except as limited by the trust instrument, the voting rights vest in the trustee, who is under a fiduciary duty to vote the stock in the manner set forth in the trust agreement. Accordingly, the voting trust agreement should specify in detail how the trustee must vote.

The primary disadvantages of the voting trust are the trust's formality, the need to comply with statutory requirements, and the divestiture of the stock's legal title. Moreover, shares of beneficial interest in a voting trust may constitute securities, the transfer of which is subject to state and federal securities laws.²¹² Traditional problems under Subchapter S with respect to voting trusts have been eliminated, however, and a voting trust is now considered to be a qualified shareholder.²¹³

6. *Shareholder Pooling Agreement.* A shareholder may not legally sell (separately from a sale of the actual shares) his vote or agree to vote the shares in return for some personal benefit.²¹⁴ Shareholders may, however, contract to vote their shares together for specified purposes in order to main-

207. See Note, *The Voting Trust: Drafting Suggestions*, 42 N.Y.U. L. REV. 349, 356 (1967).

208. TBCA art. 2.44, § F (Vernon 1980).

209. TBCA art. 5.14, § B(1) (Vernon 1980).

210. See A. SCOTT, *THE LAW OF TRUSTS* § 193 (3d ed. 1967 & Supp.).

211. Comment, *Voting Trusts in Texas*, 12 Sw. L.J. 85, 92-99 (1958).

212. See Securities Act of 1933, § 2(1), 15 U.S.C. § 77b(1) (1982) (current version); Securities Exchange Act of 1934, § 3(10), 15 U.S.C. § 78c(10) (1982) (current version).

213. I.R.C. § 1361(c)(2)(A)(iv) (1982).

214. *Schreiber v. Carnery*, 447 A.2d 17, 24-25 (Del. Ch. 1982); Clark, *Vote Buying and*

tain control of a corporation. These voting agreements, though cannot seek to govern how the directors actually vote or otherwise to impair the directors' discretion.²¹⁵ Unlike a voting trust, in which voting powers are divorced from ownership, shareholders that agree to vote together retain all incidents of ownership, except when the power to vote is contractually pooled.²¹⁶

A question existed under Texas common law whether pooling agreements were valid. Pooling agreements probably were valid if supported by proper consideration.²¹⁷ Any doubt dissipated, however, with the enactment of an express provision in the TBCA.²¹⁸ The TBCA provides that shareholders may enter into a voting agreement on any matter submitted to a vote at a meeting of shareholders.²¹⁹

A shareholder pooling agreement must meet the following requirements: (1) the agreement's term cannot exceed ten years; (2) the agreement is in writing; (3) the corporation has on file a counterpart of the agreement at the corporation's principal office and that agreement is subject to shareholder examination; and (4) the stock certificates subject to a voting agreement contain a statement that the stock is subject to such agreement.²²⁰ Moreover, a shareholder pooling agreement, like a voting trust, must have a proper purpose.²²¹ Arguably, the TBCA shareholder pooling agreement requirements are not exclusive and an agreement that does not meet the TBCA's strict requirements may nevertheless be valid.²²² The most prudent course, however, is to draft all shareholder pooling agreements to meet the TBCA statutory requirements.

Certain major problems may exist with a shareholder pooling agreement. First, because shareholders maintain legal title to and physical control over stock subject to a pooling agreement, disagreements among the various contracting parties are possible. Ideally, a pooling agreement will specify the exact method of voting and the particular individual or the particular course of action for which the shareholder is to vote. If a disagreement occurs, however, a suitable mechanism for dispute resolution is important.²²³

Second, the TBCA provides that a shareholder pooling agreement is spe-

Corporate Law, 29 CASE W. RES. L. REV. 776, 778 (1979); Manne, *Some Theoretical Aspects of Share Voting*, 64 COLUM. L. REV. 1427, 1429 (1964).

215. *Burnett v. Word, Inc.*, 412 S.W.2d 792, 795 (Tex. Civ. App.—Waco 1967, no writ).

216. See Hornstein, *Stockholders' Agreements in the Closely-Held Corporation*, 59 YALE L.J. 1040, 1040-41 (1950).

217. See *Roberts v. Whitson*, 188 S.W.2d 875, 877-78 (Tex. Civ. App.—Dallas 1945, writ ref'd w.o.m.).

218. TBCA art. 2.30, § B (Vernon 1980).

219. TBCA art. 2.30, § B (Vernon 1980).

220. TBCA art. 2.30, § B (Vernon 1980).

221. See *Grogan v. Grogan*, 315 S.W.2d 34, 39 (Tex. Civ. App.—Beaumont 1958, writ ref'd n.r.e.).

222. See *Irwin v. Prestressed Structures, Inc.*, 420 S.W.2d 491, 494 (Tex. Civ. App.—Amarillo 1967, writ ref'd n.r.e.); see also *Oceanic Exploration Co. v. Grynberg*, 428 A.2d 1, 5 (Del. 1981) (upholding validity of agreement not in compliance with statutory provisions).

223. For example, ancillary provisions may be inserted into the agreement concerning arbitration, voting for liquidation of the corporation, or granting an irrevocable proxy. See *infra* text accompanying notes 253-79.

cifically enforceable when a counterpart of the agreement is deposited with the corporation and the prescribed statutory statement is endorsed upon the stock certificates.²²⁴ Delaware law, however, contains no provision permitting specific performance.²²⁵ Accordingly, if a Delaware corporation is involved, a specific contractual provision should be contained in the agreement granting the remedy of specific performance.²²⁶

Third, when the subject of the pooling arrangement goes beyond the election of directors, the question arises whether the additional subject matter is the proper subject of a shareholder agreement. For example, the validity of an agreement to pool votes with respect to employment of corporate officers, authorization or approval of management contracts, or control over dividend policies is questionable. Those subjects are within the authority of the board of directors and any infringement upon the board's discretion is improper and invalid. This argument's force diminishes, however, when the agreement is between all the corporation's shareholders.²²⁷

Fourth, although mutual promises should be sufficient consideration in a shareholders' agreement, prudence mandates the recitation of additional consideration whenever possible. Finally, since the shareholder's agreement should contain a provision restricting the parties' transfer of stock, the stock certificates are subject to the TBCA conspicuous notice requirement.²²⁸

7. *Shareholder Arrangements and the TCCL.* Shareholders in a close corporation can use any or all of the control devices noted above since none of the devices are inconsistent with the TCCL.²²⁹ There are four additional alternatives that may benefit the allocation of control within a close corporation.²³⁰ First, the shareholder's agreement may name the persons who will serve as directors for the duration of the agreement and thereby avoid the need for annual elections.²³¹ Second, the shareholders' agreement may authorize pooling and voting trust arrangements that are not limited by the

224. TBCA art. 2.30, § B (Vernon 1980).

225. See DEL. CODE ANN. tit. 8, § 218 (1983).

226. For an example illustrating the difficulties that can arise in the enforcement of a shareholder pooling agreement under Delaware law, see *Ringling v. Ringling Bros.—Barnum & Bailey Combined Shows, Inc.*, 29 Del. Ch. 318, 49 A.2d 603, 611 (1946), *modified*, 29 Del. Ch. 610, 53 A.2d 441 (Sup. Ct. 1947).

227. To prevent the subject matter of the shareholder agreement from being outside the realm of shareholder competence, all the shareholders should sign the agreement and the articles of incorporation should include specific veto provisions. Incorporating an express severability clause in the pooling agreement is also advisable. See *Zion v. Kurtz*, 50 N.Y.2d 92, 98-105, 405 N.E.2d 681, 684-86, 428 N.Y.S.2d 199, 202-05 (1980) (upholding a unanimous shareholders' agreement that required consent of minority shareholders before certain business activities could be transacted by the corporation, even though agreement did not strictly comply with Delaware law); Annot., 15 A.L.R.4th 1078, 1078-1100 (1982). Moreover, if the subject matter of the agreement goes beyond the election of directors, having the corporation sign the agreement is prudent. In all cases the agreement should clearly state that the agreement is binding on the shareholders' heirs, representatives, successors, and assigns.

228. See *supra* notes 146-47 and accompanying text.

229. TCCL art. 12.03, § B (Vernon Supp. 1985).

230. See Lebowitz, *supra* note 15, at F-11.

231. *Id.*

TBCA.²³² Third, the agreement may require super majorities or unanimity and bind the parties even if not mentioned in the articles of incorporation.²³³ Finally, the shareholders' agreement may provide that each shareholder shall have only one vote rather than one vote for every share of stock.²³⁴

8. *Management Contracts.* Shareholders in a closely-held corporation often participate actively in the corporation's day-to-day operations. These working shareholders may rely on salary distributions to reap their economic benefits from the corporation. The use of management contracts can ensure a predictable income stream for the minority shareholder/employee. In addition, for the more mature close corporation, members of management may not be significant shareholders. Such persons, however, have expectations to preserve that benefit for both such managers and the corporate owners.

a. *Statutory Provisions.* For many years Texas courts viewed long-term employment contracts with disfavor, especially when the contracts provided employment for corporate officers. The courts considered employment contracts to be against public policy and unenforceable as infringements upon the prerogatives of future boards of directors.²³⁵ The TBCA currently provides, however, that a corporation can enter into management contracts with the corporation's officers and agents.²³⁶

b. *Authority to Employ.* The TBCA provides that the board of directors shall elect the corporation's president, vice-president, secretary, and treasurer.²³⁷ The TBCA appears to provide a statutory basis for the board of directors to delegate this power to an executive or other committee if the articles of incorporation or bylaws so provide.²³⁸ Only the board of directors, however, has the power to employ the president, vice-president, secretary, and treasurer.²³⁹ Thus, the board apparently cannot subsequently ratify the exercise of this authority by someone other than the full board of directors.²⁴⁰ The ministerial acts of negotiating and executing the employment contract may, however, be delegated to an officer of the corporation.

c. *Bylaw Limitations.* A problem can arise if the corporation's bylaws provide that officers are to be elected to one-year terms. Such a bylaw provi-

232. *Id.* Voting commitments or delegations of voting power can therefore exist for a term longer than ten years and need not be filed with the corporation.

233. *Id.* The agreement can also specify how voting power will be exercised or divided either in general or specific matters.

234. *Id.* at F-15.

235. *See Denton Milling Co. v. Blewett*, 254 S.W. 236, 238-39 (Tex. Civ. App.—Texas-kana), *writ ref'd per curiam*, 114 Tex. 581, 278 S.W. 1114 (1923).

236. TBCA art. 2.02, § A(12) (Vernon Supp. 1985).

237. TBCA art. 2.42, § A (Vernon Supp. 1985).

238. *See* TBCA art. 2.36 (Vernon Supp. 1985).

239. *See* TBCA art. 2.42, § A (Vernon Supp. 1985).

240. *See Continental Assurance Co. v. Supreme Constr. Corp.*, 375 F.2d 378, 383 (5th Cir. 1967).

sion is generally considered to restrict the board of directors' power to enter into an employment contract with an officer for a term in excess of one year.²⁴¹ The TBCA, however, vests power to amend or repeal corporate by-laws in the board of directors unless the articles of incorporation specifically reserve this power to the shareholders.²⁴² The board of directors thus may amend a restrictive bylaw provision that limits the term of office to one year. If the articles of incorporation reserve the power to amend the bylaws to the shareholders, however, the board of directors remains restricted by the by-law provision. If the closely-held corporation desires to use management contracts, the best course is to make adequate provisions in the bylaws at the time of incorporation.

d. Specific Term. Under Texas law an employee generally may terminate an employment contract at any time, though he still might be subject to noncompetition or trade secret disclosure covenants. If the corporation prematurely terminates the contract, the discharged employee retains any contract rights he has under the agreement.²⁴³ Thus, drafting the agreement to specify clearly the grounds on which the corporation may discharge an employee is important.

e. Restrictive Covenants. Often management will attempt to protect the corporation from vindictive action by a shareholder/employee by including restrictive covenants, such as noncompetition and confidentiality clauses in the employment contract. Texas courts have generally upheld covenants not to compete. In *Weatherford Oil Tool Co. v. Campbell*²⁴⁴ the Texas Supreme Court held that covenants not to compete are enforceable if the terms are reasonable even though the covenants are in restraint of trade.²⁴⁵ Thus, if the noncompetition agreement is ancillary to and in support of the employment contract and is not an unreasonable restraint of trade, courts will enforce the noncompetition agreement.²⁴⁶

The two primary factors that courts consider to determine whether a restrictive covenant is reasonable are: (1) the duration of the restriction; and (2) the territory that the restriction encompasses.²⁴⁷ The courts will, however, consider other factors, such as hardship on the employee, the em-

241. See *Pioneer Specialties, Inc. v. Nelson*, 339 S.W.2d 199, 200-01 (Tex. 1960); *Dixie Glass Co. v. Pollak*, 341 S.W.2d 530, 535-36 (Tex. Civ. App.—Houston 1960), *writ ref'd n.r.e.*, 347 S.W.2d 596 (Tex. 1961).

242. TBCA art. 2.23 (Vernon 1980).

243. TBCA art. 2.43 (Vernon 1980) provides:

Any officer or agent or member of a committee elected or appointed by the board of directors may be removed by the board of directors whenever in its judgment the best interests of the corporation will be served thereby, but such removal shall be without prejudice to the contract rights, if any, of the person so removed.

244. 161 Tex. 310, 340 S.W.2d 950 (1960).

245. *Id.* at 312, 340 S.W.2d at 951.

246. *Frankiewicz v. National Comp Assocs.*, 633 S.W.2d 505, 507-08 (Tex. 1982); *Justin Belt Co. v. Yost*, 502 S.W.2d 681, 682 (Tex. 1973).

247. *Weatherford Oil Tool*, 161 Tex. at 311-13, 340 S.W.2d at 951.

ployee's skill, and the employee's dealings with the employer's customers. The court determines the reasonableness of a restriction since the question is one of law.²⁴⁸ Rather than void an agreement that is unenforceable upon its terms, however, a court will enforce the agreement in a manner that is reasonable under the circumstances.²⁴⁹

Under well-settled Texas law, the unauthorized use of confidential information and trade secrets may be enjoined on the basis of either contract or tort law.²⁵⁰ When drafting a provision prohibiting the use of trade secrets or other confidential information, the draftsman should specify what information is considered confidential and that the employee has a fiduciary relationship with the employer. Restrictions may not be imposed, however, with respect to matters of general knowledge or matters that do not directly relate to the competitive position of the corporation.²⁵¹

f. Protection of the Employee. The management contract is frequently used to protect a minority shareholder/employee from majority oppression. In such instances the draftsman must consider contractual provisions relating to the basis for discharge, the basis and payment of compensation, the term of employment, and the means of enforcing the contract. A cautious counsel will often incorporate a management contract into a shareholder agreement so that the management contract binds both the corporation and all the shareholders. Counsel should also consider articles of incorporation or bylaw provisions that create a veto power for the shareholder/employee in matters involving a material change in employment terms, conditions of discharge, or amendments to the articles and bylaws concerning such matters.²⁵²

VI. EFFECTIVE DISPUTE RESOLUTION

Effective dispute resolution procedures are of great concern in the closely-held corporation. In the closely-held corporation personal and business relationships often exist among the owners, and a close identification exists between the owners and managers. The closely-held corporation is analogous, in many respects, to an extended family. When harmony prevails, the unit is a most productive and supportive structure. When dissension develops, however, the analogy shifts to that of a bitter divorce.²⁵³ From the use of

248. *Chenault v. Otis Eng'g Corp.*, 423 S.W.2d 377, 384 (Tex. Civ. App.—Corpus Christi 1967, writ ref'd n.r.e.).

249. *Lewis v. Krueger, Hutchinson & Overton Clinic*, 153 Tex. 363, 364, 269 S.W.2d 798, 799 (1954). For further discussion, see 8 W. DORSANEO, TEXAS LITIGATION GUIDE ch. 201 (1985).

250. *Hyde Corp. v. Huffines*, 158 Tex. 566, 577-79, 591-92, 314 S.W.2d 763, 770-71, 780-81 (1958).

251. *Furr's, Inc. v. United Specialty Advertising Co.*, 338 S.W.2d 762, 765 (Tex. Civ. App.—El Paso 1960, writ ref'd n.r.e.).

252. See STATE BAR OF TEXAS, *Long-Term Employment Contracts*, in INCORPORATION PLANNING IN TEXAS 47 (1973); Kessler, *Employment Arrangements in Close Corporations*, 11 SETON HALL L. REV. 187, 189-90 (1980).

253. See Howe, *Corporate Divorce: Deadlocks in the Close Corporation*, 22 BUS. LAW. 469,

the various control devices discussed above, one can readily see that the seeds of dissension exist in the closely-held corporation. Unlike a partnership, which the partners can readily dissolve at any time, a corporation may not be so easily terminated. Moreover, even if the shareholders can dissolve the corporation, dissolution may not be in the best interest of all parties concerned.²⁵⁴

A. Bases of Dispute

Disputes within the closely-held corporation may arise for a variety of reasons, including: (1) the active involvement of shareholders in corporate management; (2) the breakdown of personal relationships between shareholders; (3) family difficulties; (4) deadlock among the shareholders, particularly when veto powers have been given through the articles of incorporation, bylaws, or ancillary agreements; (5) deadlock on the board of directors; (6) problems concerning buy-out arrangements; and (8) problems concerning whether to dissolve. The disputes themselves break down to either irreconcilable matters heading to litigation, appraisal/valuation matters, or arguments over managerial policies.

B. Contractual and Charter Solutions

1. *Standby Trust or Irrevocable Proxy.* A standby trust is essentially a voting trust, operative only in the event of deadlock, in which the trustee votes for dissolution or in another manner designed to resolve the dispute. This trust is subject to the same restrictions concerning voting trusts as previously discussed.²⁵⁵ As a substitute for a standby trust, shareholders may agree in a shareholders' agreement to grant an irrevocable proxy in the event of a deadlock.²⁵⁶

2. *Buy-Sell Arrangements.* Buy-sell arrangements often favor shareholders with readily available cash, and the mechanics of such an agreement can often be unwieldy.²⁵⁷ Moreover, buy-sell arrangements can give rise to fur-

469 (1967); Pachman, *Divorce Corporate Style: Possession, Oppression and Commercial Morality*, 10 SETON HALL L. REV. 315, 318 (1979). One commentator mused:

As a rough generalization, a closed corporation is one in which all the stockholders know each other by sight and, more often than not, are related by blood or marriage. It is notorious that no feuds are so venomous as those within families, and a closed corporation is often a Petri dish for the cultivation of every known strain of human vindictiveness, greed and chicanery. It has been said that God made the country, man made the city and the Devil made the small town. God has little to do with the creation of corporations, public or closed, but the Devil certainly seems to take an interest in the workings of family corporations.

Bishop, Book Review, 1976 DUKE L.J. 155, 158.

254. See Field, *Resolving Shareholder Disputes and Breaking Deadlocks in the Closed Corporation*, 58 MINN. L. REV. 985, 993 (1974).

255. See *supra* text accompanying notes 202-13.

256. See *supra* text accompanying notes 181-89.

257. See *supra* notes 141-42 and accompanying text.

ther disputes. Thus, providing for arbitration, dissolution, or another dispute settlement mechanism in these agreements is important.

3. *Contractual Appraisal Provisions.* If a dispute concerns the valuation of the corporation, an independent appraisal procedure may be desirable.

4. *Special Class of Stock.* If the corporation is a party to the shareholder agreement, the draftsman can provide for the corporation to issue a special class of stock in the event of a deadlock. The corporation issues this stock to a specified neutral party. The stock contains voting rights and the right to call a special shareholders' meeting, but only for so long as the deadlock continues. The corporation then redeems the stock following resolution of the deadlock. This special class of stock only has the privilege of voting in a deadlock situation, although the stock upon redemption has a liquidation preference.²⁵⁸

5. *Special Dissolution Provisions.* The drafter can write contractual provisions that set forth the right and conditions for dissolution of the corporation. These provisions can be included in either the articles of incorporation or a shareholders' agreement executed by all shareholders and preferably also by the corporation. If desired, a closely-held corporation can contract to have dissolution procedures similar to the procedures of a partnership.²⁵⁹

6. *Limited Corporate Life.* Although most corporations today specify a perpetual existence, the drafter can provide in the articles of incorporation for a limited duration, which can be subsequently amended if desired. If the limited duration is used, a provision in the articles of incorporation concerning veto power over the amendment of the articles on this matter may be desirable.

C. Arbitration

The Texas General Arbitration Act²⁶⁰ permits parties to enter into an agreement to arbitrate future controversies. Arbitration agreements, inserted into shareholders' agreements, buy-sell agreements, or bylaws, are often proposed as an efficient, informal, and less expensive way of resolving corporate disputes. Arbitration, however, is not always the most efficient and expeditious means to resolve conflicts. Although litigation is expensive, the courtroom consistently provides an effective forum for clarifying issues and bringing a final resolution to the disputed matter. Depending upon the quality and intelligence of the arbitrator and the efficiency and effectiveness

258. See *Capital Nat'l Bank v. S.E. Realty Corp.*, 515 S.W.2d 330, 331 (Tex. Civ. App.—Houston [14th Dist.] 1974, no writ).

259. See Texas Uniform Partnership Act § 30, TEX. REV. CIV. STAT. ANN. art. 61326 (Vernon Supp. 1985).

260. TEX. REV. CIV. STAT. ANN. arts. 224-49 (Vernon 1973 & Supp. 1985); see Carrington, *The 1965 General Arbitration Statute of Texas*, 20 SW. L.J. 21 (1966); Comment, *1979 Amendment to the General Arbitration Act: Will It Allow Arbitration to Become a Viable Tool for Settling Disputes?*, 32 BAYLOR L. REV. 314, 315 (1980).

of the contracted settlement mechanism, arbitration may in fact be less desirable than straightforward litigation.

A practitioner should consider the following guidelines in drafting an arbitration agreement. First, the agreement should comply with the Texas Arbitration Act.²⁶¹ Second, the agreement should delineate the types of controversies that the agreement covers. Third, the agreement should specify the requisite qualifications of arbitrators and how an arbitrator will be selected. Fourth, both judicial and nonjudicial standards to be employed by the arbitrators should be indicated within the agreement. Fifth, the agreement should specify the procedures that the arbitrators will use when conducting the arbitration. Sixth, the agreement should clarify whether any preconditions to arbitration exist and whether arbitration is the exclusive remedy available to the parties. Seventh, the agreement should provide for the finality and enforcement of the arbitral decision. Finally, the agreement should specify how the cost of the arbitration proceeding is to be allocated.

Arbitration has several limitations. First, arbitration is an intrusion into the traditional management decision-making processes and may substitute for decisions that the board of directors should make. Arbitration also may bypass the fiduciary duties that should exist between the various actors in the closely-held corporation. Moreover, court suits can evade the arbitration mechanism if the arbitration provision is not properly structured or if the matter is deemed not to be subject to arbitration.²⁶²

D. Statutory Receivership and Dissolution

Dissolution is the most drastic and often the least desirable method of resolving disputes within the closely-held corporation.²⁶³ TBCA article 7.05 is the primary statutory provision concerning a deadlocked corporation.²⁶⁴ The article provides that a shareholder may bring an action for the appointment of a rehabilitative receiver if he can show either that: (1) the corporation may suffer irreparable damage because of a deadlock among the directors that the shareholders are unable to break,²⁶⁵ or (2) the shareholders are deadlocked and have consequently failed for the past two years to elect successors to those directors whose terms have expired.²⁶⁶

If the court-appointed receiver's rehabilitative efforts are not successful, the court may direct liquidation of the corporation if no feasible plan for remedying the corporation's condition is presented within twelve months after the receiver's appointment.²⁶⁷ Thus, dissolution may ultimately occur,

261. TEX. REV. CIV. STAT. ANN. art. 224 (Vernon Supp. 1985).

262. See Note, *Mandatory Arbitration as a Remedy for Intra-Close Corporate Disputes*, 56 VA. L. REV. 271, 279-86 (1980).

263. See Heatherington & Dooley, *Illiquidity and Exploitation: A Proposed Statutory Solution to the Remaining Close Corporation Problem*, 63 VA. L. REV. 1, 1-6 (1977); Hillman, *The Dissatisfied Participant in the Solvent Business Venture: A Consideration of the Relative Permanence of Partnerships and Close Corporations*, 67 MINN. L. REV. 1, 3 (1982).

264. TBCA art. 7.05 (Vernon 1980).

265. TBCA art. 7.05, § A(1)(b) (Vernon 1980).

266. TBCA art. 7.05, § A(1)(e) (Vernon 1980).

267. TBCA art. 7.06, § A(3) (Vernon 1980).

although the procedure may be rather lengthy. Even if rehabilitation, but not dissolution, is desired, the appointment of a receiver introduces an independent third party as the controller of the corporation's affairs. Much depends upon whom the judge appoints as receiver. The appointed receiver may or may not be astute in business and financial affairs. As a practical observation, I would be extremely hesitant to invoke the rehabilitative provisions of the TBCA unless ultimate dissolution is inevitable or desired.

If a minority shareholder wants the court to appoint a receiver for rehabilitative purposes, the minority shareholder must show either that: (1) the corporation is in danger of insolvency;²⁶⁸ (2) the directors or officers have acted illegally, oppressively, or fraudulently;²⁶⁹ or (3) the directors or officers are wasting the corporation's assets.²⁷⁰ Additionally, the minority shareholder must show that all other available remedies, including appointment of a receiver for specific corporate assets, are inadequate.²⁷¹ Such a showing may be extremely difficult to make. Neither mere shareholder dissatisfaction with corporate management²⁷² nor a need to conserve specific corporate assets²⁷³ is a sufficient ground for statutory receivership.

E. Approach Under the TCCL

The TCCL contains express provisions dealing with dispute resolution.²⁷⁴ The TCCL authorizes either the close corporation or a shareholder to seek judicial resolution of shareholder disputes.²⁷⁵ TCCL article 12.51 reflects the Texas legislature's recognition of the need for greater flexibility in resolving disputes within a close corporation. Article 12.51 provides that the party seeking judicial resolution of a corporate dispute may, in addition to filing suit for judicial resolution according to the provisions available to an ordinary corporation under the TBCA, initiate a proceeding to enforce a close corporation provision, appoint a provisional director, or appoint a custodian.²⁷⁶ Article 12.51 further provides that the TCCL dispute resolution mechanisms are not exclusive, but supplement any other shareholder remedies that the TBCA or law allows.²⁷⁷ The shareholder who seeks to initiate a judicial proceeding to resolve a corporate dispute, however, may not invoke the TCCL dispute resolution provisions until all nonjudicial remedies provided for in the shareholder agreement have been exhausted unless he can prove that the corporation, the shareholders as a whole, or the share-

268. TBCA art. 7.05, § A(1)(a) (Vernon 1980).

269. TBCA art. 7.05, § A(1)(c) (Vernon 1980).

270. TBCA art. 7.05, § A(1)(d) (Vernon 1980). The statutory provisions must be strictly followed. See *Aubin v. Territorial Mortgage Co. of Am., Inc.*, 640 S.W.2d 737, 741-42 (Tex. Civ. App.—Houston [14th Dist.] 1982, no writ).

271. TBCA art. 7.05, § A (Vernon 1980).

272. *Texarkana College Bowl, Inc. v. Phillips*, 408 S.W.2d 537, 539 (Tex. Civ. App.—Texarkana 1966, no writ).

273. *Humble Exploration Co. v. Fairway Land Co.*, 641 S.W.2d 934, 939 (Tex. Civ. App.—Dallas 1982, writ ref'd n.r.e.).

274. TCCL arts. 12.51-.54 (Vernon Supp. 1985).

275. TCCL art. 12.51, § B (Vernon Supp. 1985).

276. TCCL art. 12.51, § B (Vernon Supp. 1985).

277. TCCL art. 12.51, § D (Vernon Supp. 1985).

holder himself will suffer irreparable injury before the nonjudicial remedies are exhausted.²⁷⁸ Thus, if the shareholder agreement provides for any nonjudicial remedies, such as arbitration, the complaining shareholder must either pursue the remedies prescribed in the agreement or prove that judicial intervention is justified under the circumstances. This additional hurdle of exhaustion of extrajudicial remedies is yet another reason that counsel responsible for drafting the incorporation documents and shareholder agreement should ensure that the shareholders prefer nonjudicial remedies as a first alternative to the judicial remedies granted close corporations by the TCCL.²⁷⁹ Counsel, of course, bears the burden of informing the incorporating shareholders during the planning stages of their alternatives with respect to dispute resolution and should outline for the shareholders the practical effects of each alternative.

VII. CONCLUSION

Properly structuring the governance of the closely-held corporation is a most challenging and rewarding experience for the corporate lawyer. Unlike the large, publicly-held corporation, the close corporation has the dynamic elements of human personality and relations, replete with all the idiosyncrasies that these attend, infused within every phase of the corporation's existence and operation. The TCCL provides additional flexibility over the broad framework of the TBCA and accommodates the informal and personal characteristics of the close corporation. Thus, the corporate lawyer is well-equipped under the Texas corporation statutes both to meet the legal needs of the individual business and to structure the corporation in accordance with the business arrangements of the owners and managers.

I have attempted to provide a guide to understanding how the closely-held corporation operates within the peaceful coexistence of the TBCA and the TCCL. More importantly, I have endeavored to create a guide to planning and creating the close corporation and to anticipate the legal and personal pitfalls inherent in the beast. In all events, counsel responsible for planning and incorporating the close corporation should first resort to the basic charter documents to accommodate the specific needs of the business within the structure and protections afforded by the TBCA and TCCL. By paying close attention to these statutes and balancing anticipation with simplicity, the corporate lawyer can often meet the desires of the incorporators without resorting to more complicated, more expensive, and more legally treacherous ancillary contractual arrangements.

278. TCCL art. 12.51, § E (Vernon Supp. 1985).

279. See *supra* notes 260-62 and accompanying text for a discussion of the positive and negative aspects of arbitration.

