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# A ROUND PEG—A SQUARE HOLE: THE CLOSE CORPORATION AND THE LAW\*

by

J. B. Wolens\*\*

DELIMITING the close corporation is an exceedingly complex and difficult task.<sup>1</sup> Typically, the "close corporation" is composed of relatively few shareholders who are the active managers of the corporation. Conversely, in the public corporation equity ownership and management talent are almost completely separated. This basic difference explains in large measure why a statute basically designed for the public corporation is unsuited for the close corporation. Where business managers are the sole suppliers of risk capital, the organization and structure of that business are, and should be, distinct and different from that required where business managers are entrusted with the funds of others. Statutory provisions designed to protect outside investors and third party creditors from abuse and misapplication of capital and corporate powers by business managers are not equally applicable to insure fulfillment of the aspirations of the business's owner-managers themselves.

## I. CONCESSION OR RECOGNITION

In this country, the granting by the state of a certificate of incorporation was conceived as a "concession" to a group of natural persons to engage in business as a legally viable entity, *separate and distinct* from the individual members of the group. This legalistic act of conception required appropriate and mandatory procedures. The act was ritualized and prescribed for each jurisdiction in the form of a business corporation statute.<sup>2</sup> Apparently, the close corporate problems which we are now experiencing in such profusion stem from a "hang-up" on the ancient concessionistic

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<sup>1</sup> A complete listing of all articles of note on the needs of the close corporation is too extensive a task, and an unnecessary one, for the purposes of this paper. An idea as to the extent of such a list can be obtained from the following: Bradley, *Toward a More Perfect Close Corporation—The Need for More and Improved Legislation*, 54 GEO. L.J. 1145 (1966); Fuller, *The Incorporated Individual: A Study of the One-Man Company*, 51 HARV. L. REV. 1373 (1938); Herwitz, *Allocation of Stock Between Services and Capital in the Organization of a Close Corporation*, 75 HARV. L. REV. 1098 (1962); Hornstein, *Judicial Tolerance of the Incorporated Partnership*, 18 LAW & CONTEMP. PROB. 435 (1953); Isaacs, *The Close Corporation and the Law*, 33 CORNELL L.Q. 487 (1948); Kessler, *The Statutory Requirement of a Board of Directors: A Corporate Anachronism*, 27 U. CHI. L. REV. 696 (1960); O'Neal, *Developments in the Regulation of the Close Corporation*, 50 CORNELL L.Q. 641 (1965); Robinson, *"Shareholder Agreements" and the Statutory Norm*, 43 CORNELL L.Q. 68 (1957); Seward, *Special Problems of Closely Held Corporations*, 12 PRAC. LAW. 57 (Nov. 1966); Spoerri, *One Incorporator, One Director*, 19 BUS. LAW. 305 (1963); Symposium, *The Close Corporation*, 52 N.W.U.L. REV. 345 (1957); Weiner, *Legislative Recognition of the Close Corporation*, 27 MICH. L. REV. 273 (1929); Winer, *Proposing a New York "Close Corporation Law"*, 28 CORNELL L.Q. 313 (1943); Note, *Statutory Assistance for Closely Held Corporations*, 71 HARV. L. REV. 1498 (1948); and, of course, the two-volume treatise, F. O'NEAL, *CLOSE CORPORATIONS: LAW AND PRACTICE* (1958).

<sup>2</sup> N. LATTIN, ON CORPORATIONS 148-56 (1939); Kessler, *supra* note 1, at 702.

theory. Unless we are willing to change the conceptual base upon which the laws of the close corporation are formulated, we will continue to have problems with court refusal to recognize the validity of owner-management arrangements because of some supposed violation of the statutory norm established in the authorizing concession legislation. A completely satisfactory close corporate plan can be created only by legislation which recognizes the freedom of the individual participants to conduct their business, *inter se*, as they may determine, yet in a form which affords them all limited personal liability.

We are not without precedent for such a system. In England, while initial corporate development was based on a concession theory, business participants soon began to arrogate unto themselves the authority and power to create this new type of entity. Ultimately, validation of their acts was achieved in legislation, which under prescribed conditions, recognized such participant-created entities as legally viable. Under this concept of state "recognition," the participants were completely free to delineate the terms of their agreement within broad limits drawn by the state to protect third parties.

The participants in a close corporation require arrangements which will effectuate their agreement as to the conduct and management of the business and the sharing of profits and losses resulting therefrom. No such agreement should be allowed to tread upon provisions designed for the protection of business creditors and other third parties dealing with the business. However, there is no justification for imposing the rigors and formalities of concessionistic corporate statutes upon the close corporation, no matter how desirable and necessary such provisions may be for the publicly held business. What is required is a partnership-structured statute that provides full entity status and hence limited participant liability.

A simple example of the concession theory at work is in order. One provision basic to the bulk of modern corporate statutes is that "[t]he business and affairs of a corporation shall be managed by a board of directors."<sup>3</sup> Thus, any agreement between the shareholders *qua* shareholders which tends to predetermine the vote of such shareholders when acting as directors has been construed by the courts to be contrary to the prerequisite of independent business management by the directors *qua* directors.<sup>4</sup> No matter how laudatory such provision may be for the publicly held corporation, it is a preposterous imposition on the rational management of a close corporation. To require business men formalistically to wear different hats to accomplish what is, in reality, a unitary act—a business decision—foments disrespect for the law itself among the very class of society upon whom we must depend for the law's preservation.

In response to the needs of the business community, the ingenuity of counsel was called upon to devise techniques to circumvent the restrictive position taken by the courts. The techniques and devices so developed include: (1) classification of shares to provide for the election of a given

<sup>3</sup> E.g., TEX. BUS. CORP. ACT art. 2.31A (1955).

<sup>4</sup> See Kessler, *supra* note 1, and cases cited therein.

percentage of directors by the shares of each class,<sup>5</sup> (2) cumulative voting to insure representation in company management,<sup>6</sup> (3) the use of irrevocable proxies to implement the provision of shareholder agreements,<sup>7</sup> (4)

<sup>5</sup> Such a classification is generally permitted under most concession type corporate statutes. E.g., CAL. CORP. CODE § 1100 (West 1955); ILL. REV. STAT. ch. 32, § 157.14 (1933); TEX. BUS. CORP. ACT art. 2.2-13 (1955). Note, however, that courts have construed such classifications as an invalid indirect attempt to do what could not be done directly. E.g., *Renn v. U.S. Cement Co.*, 36 Ind. App. 149, 73 N.E. 269 (1905); and see Note, *A Plea for Separate Statutory Treatment of the Close Corporations*, 33 N.Y.U.L. REV. 700, 723-24 (1958). Classification of shares only assures initial representation on the board of directors and without other protective provisions either in a shareholder agreement or through a modern statute which prevents director removal except by the majority vote of each class of shares which such director represents, the effectiveness of classification is sorely limited. Without such protection, directors elected by class generally can be removed by a majority vote of all shareholders.

Tax problems also may be created for a corporation by such a classification of shares. To be eligible to elect the status of a "small business corporation," which permits the corporation to be taxed essentially as a partnership, the corporation may have only "one class of stock." INT. REV. CODE OF 1954, § 1371(a) (4). However, if the only distinction between the classes of the stock is the right to elect directors proportionate to the number of shares in each group, a disqualification for such election will not result. Treas. Regs. § 1.1137-1(g) (1959). However, a literal reading of the regulation would require that the shares representing each class of such stock be in proportion to the total number of shares issued. One of the reasons for the issuance of class stock could be to provide a greater voice in the management to a minority shareholder whose management experience is such so as to entitle him to a larger share of management prerogative.

Nevertheless, we may conclude that to date, classification of shares is the best method so far developed to assure at least initial representation of all interests on the board of directors. *Accord*, *Israels*, *supra* note 1, at 495; *Seward*, *supra* note 1, at 59-60.

<sup>6</sup> Depending upon the number of shares held by a particular shareholder and the number of directors to be elected, cumulative voting may provide an effective means for maintaining continuous representation of minority interests on the close corporate board of directors. An analysis of corporate statutes for all of the fifty states indicates that cumulative voting is either mandatory or permissive in each state except Massachusetts, Wisconsin, and Georgia. The new Georgia corporation law, GA. CODE ANN. §§ 22-801 to 22-808 (1968) may correct this deficiency insofar as the Georgia statute is concerned. Cumulative voting provisions range from the granting of an invariable right embodied in a state constitution, e.g., ARIZ. CONST. art. 14, § 10, ILL. CONST. art. XI, § 3, MISS. CONST. art. VIII, § 194, PA. CONST. art. XVI, § 4, to invariable authorization of such procedure in the basic corporate statute, e.g., CAL. CORP. CODE § 2235 (West 1951), KAN. GEN. STAT. ANN. § 17.3303 (1963), MICH. STAT. ANN. § 450.32 (1967), to that large group of corporate statutes where cumulative voting provisions are wholly permissive, e.g., DEL. CODE ANN. tit. 8, § 214 (Supp. 1967), N.Y. BUS. CORP. LAW ch. 4, § 618 (McKinney 1963), TEX. BUS. CORP. ACT art. 2.29D (1955).

Even though directors may be elected cumulatively, they may nevertheless be removed by simple majority vote of the shareholders under most corporate statutes. E.g., TEX. BUS. CORP. ACT art. 2.33 (1955).

Statutory protection of the cumulative voting device has been provided in many states. Although statutory protection of directors elected under cumulative voting procedures have not been enacted by even a majority of the jurisdictions, some states have afforded this protection. E.g., ARK. BUS. CORP. ACT § 64-304A (1965); N.Y. BUS. CORP. LAW § 706(c)(1) (McKinney 1963). In general, see the discussions contained in Folk, *Corporate Statutes: 1959-1966*, 1966 DUKE L.J. 875, 919; Rudolph, *Further Thoughts on the One- and Two-Director Statutes*, 20 BUS. LAW. 781, 782 (1965); *Seward*, *supra* note 1, at 59-60.

<sup>7</sup> Early corporate law development in the United States struck quickly and devastatingly at the attempted use of even a simple annual proxy. The early courts viewed the proxy as a denial to the individual shareholder of the advice and judgment of his fellow shareholders which was a part of the contract he made at the time of the purchase of his shares. *Phillips v. Wickham*, 1 Paige 590 (Ch. N.Y. 1829); *Commonwealth ex rel. Verree v. Bringham*, 103 Pa. 134 (1883). Proxies were also attacked on a basis of separating the voting rights from the ownership of the shares. *Cone's Ex'rs v. Russell*, 48 N.J. Eq. 208, 21 A. 847 (Ch. 1891); *William Randall & Sons, Inc. v. Lucke*, 123 Misc. 5, 205 N.Y.S. 121 (Sup. Ct. 1924).

The irrevocable proxy was met headlong by an intransigent court. Express irrevocable proxies nevertheless have been held to be: revocable because being a simple agency arrangement they must, like agency, be subject to revocation (e.g., *State ex rel. Breger v. Rusche*, 219 Ind. 559, 39 N.E.2d 433 (1942)); void as a device to prevent the purchaser of the shares from exercising the full right of ownership (*Sullivan v. Parkes*, 69 App. Div. 221, 74 N.Y.S. 787 (1902)); void as an attempt to establish a voting trust without following the mandatory statutory procedures (*Abercrombie v. Davis*, 35 Del. Ch. 599, 123 A.2d 893 (Ch.), *modified*, 36 Del. Ch. 102, 125 A.2d 588 (Ch. 1956)); void as a violation of the statute of limitations on the duration of the proxy and therefore

establishment of voting trusts to effect the terms of shareholders' agreements,<sup>8</sup> (5) preemptive rights to prevent dilution of a shareholder's interest in the company,<sup>9</sup> (6) jointly held shares to control and insure management positions,<sup>10</sup> and (7) higher than statutory quorum and/or voting requirements for shareholders' and/or directors' meetings in regard to specific or general matters.<sup>11</sup> These techniques have been employed because of

contrary to public policy (*People v. Burke*, 72 Colo. 486, 212 P. 837 (1923)); void as a device to purchase votes contrary to public policy (*Macht v. Merchants' Mortgage Co.*, 22 Del. Ch. 74, 194 A. 19 (1937); *Williams v. Fredericks*, 187 La. 987, 175 So. 642 (1937); *McQuade v. Stoneham*, 263 N.Y. 323, 189 N.E. 234 (1934)); or, void as a violation of the directors' discretion where such irrevocable proxy machinery is used to install certain persons as officers or employees (*Morel v. Hodge*, 133 Ga. 625, 61 S.E. 487 (1908); *Odman v. Oelson*, 319 Mass. 24, 64 N.E.2d 439 (1946)). In general, see the discussions in H. BALLANTINE, *ON CORPORATIONS* § 179 (rev. ed. 1946); F. O'NEAL, *supra* note 1, at 227-29, 316-42, 365; *Axe, Corporate Proxies*, 41 MICH. L. REV. 38 (1942); *Bradley, supra* note 1, at 1149, 1164-67; Note, *The Irrevocable Proxy and Voting Control of Small Business Corporations*, 98 U. PA. L. REV. 401 (1950).

<sup>8</sup> The voting trust was, of course, an outgrowth of the court's intransigent attitude toward the irrevocable proxy. There was no separation of ownership and voting rights where the proxy holder was in fact the legal holder of such shares. Ballantine, *Voting Trusts, Their Abuses and Regulations*, 21 TEXAS L. REV. 139, 146-47 (1942). The voting trust has now received express statutory authorization in almost every state. The terms upon which voting trusts are authorized vary with the jurisdiction. For example, the permissible term of such trusts varies from a maximum period of five years, as in New Mexico, to the Missouri provision which authorized voting trusts to be created for an unlimited time expressly waiving the rule against perpetuities in such instances. MO. REV. STAT. ch. 351, § 351.246 (1959).

<sup>9</sup> Preemptive rights may be asserted in the form of a suit: for damages to prevent dilution of voting power and corporate assets (e.g., *Stokes v. Continental Trust Co.*, 186 N.Y. 285, 78 N.E. 1009 (1906)); to enjoin the issuance of a new security (e.g., *Hammond v. Edison Illuminating Co.*, 131 Mich. 79, 90 N.W. 1040 (1902)).

Although the basic principles of preemptive rights of shareholders are still recognized where applicable (e.g., *Klopot v. Northrup*, 131 Conn. 14, 37 A.2d 700 (1944); *Steven v. Hale-Haas Corp.*, 249 Wisc. 205, 23 N.W.2d 620 (1946)), freeze-out and squeeze-out techniques are available to evade any existing preemptive rights. Such techniques include share issuance when minority interests are known to be financially "embarrassed" (*Bellows v. Porter*, 201 F.2d 429 (8th Cir. 1953); *Hyman v. Velsicof Corp.*, 342 Ill. App. 489, 97 N.E.2d 122 (1961)), or the issuance of stock for property or services.

<sup>10</sup> The possibility of issuing the stock of the corporation jointly in the name of all participants and then letting their agreement *inter se* determine how the votes so represented are to be cast, has not yet been fully developed. A now repealed Connecticut statute required unanimous action for a single jointly held share, yet if more than one share was jointly held, a majority of the joint owners could control the votes so represented. *Levine v. Randolph Corp.*, 150 Conn. 232, 188 A.2d 59 (1963); CONN. GEN. STAT. REV. § 33-311(d) (Supp. 1959). This anomalous result has been changed by recent amendment. CONN. GEN. STAT. REV. § 33-311(a) (1961).

<sup>11</sup> Interestingly enough five states, namely Alabama, Arizona, Nevada, Rhode Island, and Tennessee have no statutory provision regarding quorum requirements for shareholders' meetings, while twelve states, i.e., Alabama, Arizona, Idaho, Indiana, Kentucky, Minnesota, Nevada, New Jersey, New Mexico, Rhode Island, Washington, and West Virginia have no specific required percentage of votes for general shareholder action. The balance of the states have a general specification of a majority of the outstanding shares as the basic quorum requirement although some authorize the articles of incorporation or bylaws to vary such requirement, but not less than one-third of the outstanding shares. E.g., TEX. BUS. CORP. ACT art. 2.28A (1955).

Despite the dearth of authorization for greater than majority quorum requirements as regards shareholders' meetings, a majority of the states expressly permit greater than majority or statutory votes for general or specific shareholder action. E.g., TEX. BUS. CORP. ACT art. 2.28A (1955).

In regard to directors' meetings, apparently only two states, New Jersey and New Mexico, have no provision as to requisite quorum requirements, while four states set mandatory majority quorum standards, i.e., Idaho, Louisiana, Montana, and Pennsylvania.

Four states, New Jersey, New Mexico, Vermont, and West Virginia set no requirements in respect to the vote required to carry director resolutions, while nine states apparently establish an unvariable majority vote for resolution passage, i.e., Idaho, Kentucky, Louisiana, Michigan, Minnesota, Montana, Nevada, Pennsylvania, and Tennessee. Greater than majority voting requirements are authorized by a majority of the states, while a nevertheless substantial minority expressly authorize greater than majority quorum requirements. E.g., TEX. BUS. CORP. ACT art. 2.35A (1955).

High quorum or voting requirements have been invalidated on the grounds that: the statute prescribes a mandatory rather than permissive standard (e.g., *Clausen v. Leary*, 113 N.J. Eq. 324, 166 A. 623 (Ch. 1933)); such requirements are inconsistent with basic corporate mechanics (e.g.,

the uncertainty and the basic intransigence of the courts in construing shareholder agreements by which owner-managers have attempted to arrange contractually the management and affairs of their business.<sup>12</sup>

A critical examination of the effectiveness of such protective and control devices in the climate created by concessionistic corporate statutes clearly demonstrates that such devices are inadequate to accomplish contractual management arrangements among owner-participants in a close corporation. In general, such techniques are capable only of insuring various segments of the owner-participants an initial place on the board of directors and, hence, a temporary voice in the management. These devices are ineffective when statutory or contractual protection from removal of the directors so elected is not provided.

## II. THE PRESENT TRENDS

An analysis of modern cases indicates that courts are becoming more cognizant of the close corporation as a business form and more lenient in respecting the contractual desires of its shareholder-managers through a recognition of the validity and enforceability of shareholder agreements. Legislatures also are being made increasingly aware of the problems of the close corporation.<sup>13</sup>

While an examination of the corporation laws of the fifty states will disclose that most state legislatures have not been disposed to permit close corporate shareholders to invest their corporations with partnership-like contractual attributes, a growing mood of liberality is evidenced by recent amendments to several state corporate statutes. Some of these enactments expressly recognize the "partnership" character of the close corporation and prohibit shareholder arrangements from being invalidated on that ground.<sup>14</sup>

Two basic approaches have been taken by state legislatures in the at-

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Jackson v. Hooper, 76 N.J. Eq. 592, 75 A. 568 (Ct. Err. & App. 1910)); and such requirements give rise to deadlock and corporate paralysis and hence are contrary to public policy (e.g., Benintendi v. Kenton Hotel, 294 N.Y. 112, 60 N.E.2d 829 (1945)).

It must be recognized that even where expressly authorized, higher than normal quorum and/or voting requirements are essentially negative protection devices. They afford no affirmative remedy, but do allow a minority shareholder to block action which might be disadvantageous to his interests. However, it also permits an overly cautious or conservative shareholder to impede corporate progress and stagnate or even destroy the corporate business.

In general, see O'Neal, *Giving Shareholders Power To Veto Corporate Decisions: Use of Special Charter and By-Law Provisions*, 18 LAW & CONTEMP. PROB. 451 (1953).

<sup>12</sup> E.g., the New York experience as evidenced by Glazer v. Glazer, 374 F.2d 390 (5th Cir. 1967); Long Park, Inc. v. Trenton-New Brunswick Theaters Co., 297 N.Y. 174, 77 N.E.2d 633 (1948); Benintendi v. Kenton Hotel, Inc., 294 N.Y. 112, 60 N.E.2d 829 (1945); McQuade v. Stoneham, 263 N.Y. 323, 189 N.E. 234 (1934); Manson v. Curtis, 223 N.Y. 313, 119 N.E. 559 (1918).

<sup>13</sup> Nine states now expressly or impliedly recognize the validity of shareholder agreements. CAL. CORP. CODE ch. 1038, § 305 (West 1947); DEL. CODE ANN. tit. 8, §§ 350-354 (Supp. 1967); FLA. STAT. ANN. § 608.0105 (1963); GA. CODE ANN. §§ 22-611 (1968); MD. ANN. CODE art. 23, § 104 (Supp. 1967); N.C. GEN. STAT. § 55-73 (1955); N.Y. BUS. CORP. LAW § 620 (McKinney 1963); R.I. GEN. LAWS ANN. §§ 7-1-3, 7-4-5 (1956); S.C. BUS. CORP. ACT OF 1962, S.C. CODE ANN. § 12-16.22 (Supp. 1962).

<sup>14</sup> E.g., "No written agreement among stockholders of a close corporation . . . shall be invalid on the ground that it is an attempt . . . to treat the corporation as if it were a partnership or to arrange relations . . . in a manner that would be appropriate only among partners." DEL. CODE ANN. tit. 8, § 354 (Supp. 1967).

tempted accommodation of the close corporation. Some states have endeavored to provide for the more basic requirements of the close corporation within the framework of a general business corporation law, applicable to both public and closely held corporations. Such a combined statute proceeds on the assumption that provisions designed to relieve the close corporation from the formalism desirable only for the public corporation will be unworkable or untenable in the context of the publicly held company.<sup>15</sup> The other basic alternative is a special statute for the close corporation. To date, such a sharp break with time-encrusted concessionistic philosophy has been achieved by only three states,<sup>16</sup> and their achievement has been somewhat dulled by their inability to shift completely to a freely contractual and recognition-based statute.

Despite the fact that relatively few states have enacted special close corporation provisions, amelioration of concessionistic philosophy can be found in many corporate statutes. This legislative awareness of the close corporation has been manifested in a reduction of the formalism required as a prerequisite to close corporate existence. For example, it is not unusual now to find state corporate statutes which authorize such informalities as a single incorporator,<sup>17</sup> less than three directors,<sup>18</sup> higher than statutory quorum and/or voting requirements for shareholder and/or director action,<sup>19</sup> and informal directors' and/or shareholders' meetings.<sup>20</sup> A smattering of other

<sup>15</sup> This philosophy is evidenced by the New York, North Carolina, South Carolina, and Georgia legislation.

<sup>16</sup> DEL. CODE ANN. tit. 8, §§ 341-365 (1953); FLA. STAT. §§ 608.0100-.0107 (1963); MD. CODE ANN. art. 23, §§ 100-11 (Supp. 1967). But note that the Delaware provisions for close corporations are incorporated into the basic business corporation act which applies to publicly and closely held companies except insofar as made inapplicable by special provisions.

<sup>17</sup> E.g., ARK. BUS. CORP. ACT § 64-301 (1965); IND. ANN. STAT. § 25-213 (Burns Supp. 1968); IOWA CODE § 496A.48 (1959); MICH. COMP. LAWS § 450.3 (1948); MINN. STAT. § 301.03 (Supp. 1967); MO. REV. STAT. § 351.050 (1959); ORE. BUS. CORP. ACT § 57.306 (1953); WIS. BUS. CORP. ACT § 180.44 (1951); WYO. BUS. CORP. ACT § 17-36.45 (1961).

<sup>18</sup> E.g., ARK. BUS. CORP. ACT § 64-302 (1965); ILL. REV. STAT. ch. 32, § 157.46 (Smith-Hurd 1954); IOWA CODE § 496A.31 (1962); KY. REV. STAT. § 271.345 (1962); MINN. STAT. § 301.28(1) (1967); MO. STAT. ANN. § 351-315(1) (1959); NEB. BUS. CORP. ACT § 21-111 (1962); ORE. BUS. CORP. ACT § 57.185 (1953); W. VA. CODE ANN. ch. 31, art. 1, § 16(b) (1968); WYO. BUS. CORP. ACT § 17-36.34 (1957). Under the Wyoming statute, 222 of the 1,120 corporations formed between July 1, 1961, and July 1, 1964, provided for a one- or two-man board of directors; while from Jan. 1, 1962, to July 1, 1964, 61 of the corporations formed provided for one director, while 134 provided for two directors. See Rudolph, *supra* note 6, at 786.

<sup>19</sup> All states have some provision for higher quorum and/or voting requirements at shareholders' and/or directors' meetings except Idaho (IDAHO CODE ANN. § 30.139 (1967)). Louisiana (LA. REV. STAT. § 12.34 (1950)), New Jersey (N.J. STAT. ANN. § 14:10-9 (1937)), New Mexico (N.M. STAT. ANN. § 51-6-3 (1953)), and Michigan (MICH. COMP. LAWS §§ 450.38, 450.13(4)(c) (West 1967); *but see id.* § 450.32). Although in some instances, such provision takes the rather unsatisfactory form of simply permitting the articles or bylaws to vary the otherwise majority rule set by the statute (E.g., MINN. STAT. § 301.25(7) (1945)), a few statutes expressly authorize greater quorum requirements for shareholder and director meetings (e.g., N.Y. BUS. CORP. LAW §§ 616, 707, 709 (McKinney 1963); S.C. BUS. CORP. ACT §§ 12-16.8, 12-18.10 (Supp. 1967)), while an even greater number authorize greater than a majority vote at shareholder or director meetings for specified actions but never less than the percentage established at law. (E.g., ALASKA STAT. §§ 10.05.153, 10.05.801 (1962); COLO. CORP. ACT §§ 31-4-15, 31-5-6 (1958); D.C. BUS. CORP. ACT § 29-916d (1954); ILL. REV. STAT. ch. 32, §§ 157.37, 157.146 (1933); MISS. BUS. CORP. ACT §§ 5309-58, -76 (1962); TEX. BUS. CORP. ACT arts. 2.28(A), 2.35(a) (1953)).

<sup>20</sup> All states now expressly authorize: action by directors and/or shareholders without a meeting subject to unanimous written director or shareholder consent except Arizona, Kansas, Maine, Montana, New Hampshire, New Mexico, Tennessee, Vermont; stock transfer restrictions (e.g., TEX. BUS. CORP. ACT art. 2.22 (1955, as amended Supp. 1967)); or director authority to fix their own compensation as either directors or officers (e.g., WIS. BUS. CORP. ACT § 180.31(2) (1953)).

provisions which minimize the possibility of minority shareholder oppression have been enacted. Among the various state corporations statutes are provisions which require payment of dividends in specified situations,<sup>21</sup> permit shareholders to establish conditions precedent to judicial dissolution,<sup>22</sup> provide for dissolution on director and shareholder deadlock,<sup>23</sup> and permit the court to appoint a provisional director in order to break the deadlock of the directors and shareholders.<sup>24</sup> The broader and more extensive amendments to basic corporate statutes have at minimum clarified and to some extent simplified corporate administration for the closely held corporation.<sup>25</sup>

### III. THE UNIFIED STATUTES

*North Carolina.* North Carolina was the first state to enact a basic corporate revision which included specific accommodations for the close corporation.<sup>26</sup> While this accommodation of the close corporation ameliorates some formalities inherent in the corporate structure, many of the constraints of the old regimen remain unshaken. For instance, to overrule dicta of the North Carolina Supreme Court,<sup>27</sup> the statute declares that the existence of a corporation is not impaired by the acquisition of all the shares by one person,<sup>28</sup> nor is limited liability lost.<sup>29</sup> Informal shareholder action,<sup>30</sup> as well as informal director action,<sup>31</sup> is authorized upon the written consent of all persons entitled to participate in the meeting.

In spite of these advances, the North Carolina revision retains such anachronisms as the requirement of three incorporators,<sup>32</sup> a required organizational meeting of the initial board of directors,<sup>33</sup> and a minimum of three directors.<sup>34</sup> The latter requirement is even more unfortunate because of the far reaching provisions of the revision authorizing shareholders' vote pooling agreements<sup>35</sup> and other written shareholders' agreements relating to the affairs and management of the corporation even though such agreements limit the discretion of the board of directors.<sup>36</sup> The effect of such retained formalism is made even more unclear by the express provision that, "no written agreement . . . shall be invalid as between the parties thereto, on the ground that it is an attempt by the parties thereto to treat

<sup>21</sup> E.g., N.M. STAT. ANN. § 51-3-16 (1953).

<sup>22</sup> E.g., N.C. GEN. STAT. § 55-125(3) (1955).

<sup>23</sup> E.g., ILL. ANN. STAT. ch. 32, §§ 157.86-91 (1945).

<sup>24</sup> E.g., CAL. CORP. CODE § 819 (West 1955).

<sup>25</sup> In general, see Folk, *supra* note 6, at 946, 957-58; O'Neal, *supra* note 1.

<sup>26</sup> N.C. GEN. STAT. ch. 55 (1955).

<sup>27</sup> "Query: Since McLean has acquired all the stock of the plaintiff, is it now a corporation?" *Park Terrace, Inc. v. Phoenix Indem. Co.*, 241 N.C. 473, 478, 85 S.E.2d 677, 680 (1955). On rehearing, 243 N.C. 595, 91 S.E.2d 584 (1956), the court expanded the quoted dicta into a fullblown rationalization against the existence of a one-man corporation.

<sup>28</sup> N.C. GEN. STAT. § 55-3.1(a) (1957).

<sup>29</sup> *Id.* § 55-53(e).

<sup>30</sup> *Id.* § 55-63(c).

<sup>31</sup> *Id.* § 55-29(a).

<sup>32</sup> *Id.* § 55-6.

<sup>33</sup> *Id.* § 55-11.

<sup>34</sup> *Id.* § 55-25.

<sup>35</sup> *Id.* § 55-73(a).

<sup>36</sup> *Id.* § 55-73(c).

the corporation as if it were a partnership or to arrange their relationship in a manner that would be appropriate only between partners."<sup>37</sup> What is the status of a shareholders' agreement which purports to follow such authorization and gives the shareholders full management rights? Do the required three directors become do-nothing figureheads? Is an agreement invalid because it goes beyond control of director discretion and eliminates the board of directors as such? North Carolina declares the contractual freedom of the participants in a close corporation, yet apparently requires the useless appendage of a three-man board of directors without functions or duties.<sup>38</sup>

The North Carolina revisions omit any specific provisions to validate or regulate transfer restrictions.<sup>39</sup> Although it has been said that this omission was intentional because of the liberality of North Carolina courts in allowing such restrictions for any good business reason,<sup>40</sup> regulation of the right to restrict transferability should have been incorporated into the statute to prevent the "lock-in" of minority shareholders and to provide some system of notice to third parties.

The new provisions authorizing shareholder agreements have been enforced in one case by the North Carolina Supreme Court.<sup>41</sup> A shareholder's agreement requiring the election of one shareholder as president of the company for a period of five years was held valid on the basis of the revision of the corporate law, and the court awarded damages for breach of the agreement.<sup>42</sup> Although the president refused resignation and was ousted from office by shareholder vote, it is unclear whether he requested reinstatement in fulfillment of the shareholders' agreement or, if he had so requested, whether the shareholders' agreement would have been enforced by mandatory injunction. Such enforcement would be apparently warranted by the language of the statute,<sup>43</sup> yet might create substantial business problems. Arguably, the case may restrict the use of future shareholders' agreements, because the court apparently confined the use of such agreements to situations where the interests of other shareholders are not prejudiced and where a substantial benefit is not conferred on one of the parties. However, bestowing substantial benefits on a shareholder or group of shareholders may have been the purpose of the agreement. Furthermore, the determination of "prejudice" is a highly subjective matter, and it is questionable whether a *post hoc* determination by the court of "prejudice" should be allowed to neutralize the bargained positions of the participants in a close corporation.

<sup>37</sup> *Id.* § 55-73(b).

<sup>38</sup> *Id.* § 55-24(a) requires that the business of the corporation be managed by the board of directors subject to the provisions of the charter, bylaws, or agreement between shareholders.

<sup>39</sup> Except for a brief reference to the effect of a transfer of shares subject to a shareholders' agreement. *Id.* § 55-73(b).

<sup>40</sup> *E.g.*, *Wright v. Iredell Tel. Co.*, 182 N.C. 305, 108 S.E. 744 (1921). See also Latty, *The Close Corporation and the New North Carolina Business Corporation Act*, 34 N.C.L. REV. 432, 450 (1956). N.C. GEN. STAT. § 55-16(c) (1965) permits the bylaws to include any provisions for restricting transfer of shares.

<sup>41</sup> *Wilson v. McClenny*, 262 N.C. 121, 136 S.E.2d 569 (1964).

<sup>42</sup> *Id.* And see N.C. GEN. STAT. § 55-73(a) (1965).

<sup>43</sup> *Id.* But note that the court is given not only the right to determine voting rights but also such other relief as may be just and proper. *Id.* § 55-71.

The North Carolina revision permits superstatutory quorum requirements for directors<sup>44</sup> and shareholders' meetings,<sup>45</sup> and also greater than statutory voting requirements for both directors<sup>46</sup> and shareholders' meetings.<sup>47</sup> But the validity of charter or bylaw provisions requiring unanimous quorum or voting requirements is still in question. The revision leaves this area to negative implication rather than specifying the validity of such arrangements. Likewise, the greater than statutory requirements are not protected by provisions which prevent the removal of such requirements from charter or bylaws by a vote of less than the superstatutory percentage.<sup>48</sup> North Carolina also retains features authorizing cumulative voting<sup>49</sup> and voting trust agreements effective for periods not to exceed ten years.<sup>50</sup>

The status of irrevocable proxies in North Carolina may be somewhat questionable because the revision purports to make all proxies, whether or not coupled with an interest or otherwise irrevocable by law, valid for a period of no more than ten years.<sup>51</sup> This seems to indicate that irrevocable proxies may not exist in North Carolina unless they would otherwise be irrevocable by law. This conclusion appears to be reinforced by the language of the revision.<sup>52</sup> It is doubtful that the revisors of the corporate statutes intended to revive the problems inherent in the use of irrevocable proxies. Yet, such may be the result when a conservative court is faced with this problem.

Because superstatutory quorum and/or voting requirements create greater possibilities of corporate deadlock, scrupulous attention should be given deadlock provisions. The only remedy offered by the North Carolina revision is dissolution, which may be decreed in an action by a shareholder where deadlock exists, where the business cannot be conducted advantageously to all shareholders, or where events entitling a shareholder to dissolution as provided in the charter or other written agreement have occurred.<sup>53</sup> Dissolution may be too drastic a remedy, and in a given fact situation dissolution may well work to the disadvantage of a majority of the shareholders. To grant a minority interest this form of statutory blackmail goes too far. Amelioration of the provision to give the court broad equity powers has been suggested and should be incorporated in the statute.<sup>54</sup>

Although most of the changes intended to accommodate the close corporation are nevertheless available to any corporation incorporated in

<sup>44</sup> *Id.* § 55-28(d).

<sup>45</sup> *Id.* § 55-65(a).

<sup>46</sup> *Id.* § 55-28(d).

<sup>47</sup> *Id.* § 55-65(a).

<sup>48</sup> For example, see the provision in Connecticut: CONN. GEN. STAT. REV. § 33-329(c) (1961).

<sup>49</sup> N.C. GEN. STAT. § 55-67(c) (1965).

<sup>50</sup> *Id.* § 55-72.

<sup>51</sup> *Id.* § 55-68(b).

<sup>52</sup> *Id.* § 55-68(c) provides that the proxy is suspended by the appearance at the meeting of the person executing the proxy, "except in the case of valid proxy which is by law irrevocable and which states on its face that it is irrevocable . . ." (Emphasis added.)

<sup>53</sup> *Id.* § 55-125(a).

<sup>54</sup> Folk, *Revisiting the North Carolina Corporate Law: The Robinson Treatise Reviewed and the Statute Reconsidered*, 43 N.C.L. REV. 768, 867-71 (1965).

North Carolina, the shareholders' agreement relating to management of the corporation in a partnership manner is restricted to corporations whose shares are not at the time or subsequently "generally traded in the markets maintained by securities dealers or brokers."<sup>55</sup> The problems with this attempted definition are basic ambiguity of terminology and failure to capture the essential characteristic of the close corporation, namely the participation in management by the business owners.<sup>56</sup> Nevertheless, the North Carolina statute was novel for its time and provided the basic framework for the subsequent changes in New York and South Carolina.

*New York.* The New York Business Corporation Law of 1961 represents the culmination of five years of extensive law revision effort, and the expenditure of more than one third of a million dollars.<sup>57</sup> It is interesting that in such a complete revision New York chose a unified corporate statute basically applicable to public and close corporations alike.<sup>58</sup> This decision was apparently made because of the New York Law Revision Commission's articulated inability to arrive at a precise definition of the close corporation which would clearly separate it from the publicly held enterprise.<sup>59</sup> Yet the Revision Commission was required to define the close corporation for the purposes of voting agreements, and for this purpose in effect defined the closely held corporation as one whose shares are not "listed on a national securities exchange or regularly quoted in an over-the-counter market by one or more members of a national or affiliated securities association."<sup>60</sup>

The problem of defining the close corporation cannot be minimized, but the attempt to equate close corporateness with lack of share trading catches only a single result of close corporateness and none of its essence. Lack of share trading may be a manifestation of the personal involvement of the close corporate shareholders in their business; but it may also result from factors arising in the life of a corporation with independent management. Moreover, this definition suffers from the same vagueness and uncertainties as the North Carolina provision.<sup>61</sup> What is "an over-the-counter market?" When is stock "regularly quoted?" The Revision Commission saw fit to leave these questions open, presumably for ad hoc court determination.

<sup>55</sup> N.C. GEN. STAT. § 55-73(b) (1965).

<sup>56</sup> For a general discussion of the North Carolina revision, see Bradley, *Toward a More Perfect Close Corporation—The Need for More and Improved Legislation*, 54 GEO. L. REV. 1145, 1150, 1179-84 (1966); Kessler, *The Statutory Requirement of a Board of Directors: A Corporate Anachronism*, 27 U. CHI. L. REV. 696, 725-28 (1960); Latty, *The Close Corporation and the New North Carolina Business Corporation Act*, 34 N.C.L. REV. 432 (1956); Note, *Dissolution of the Close Corporation*, 41 ST. JOHN'S L. REV. 239, 246-48 (1966).

<sup>57</sup> Henn, *The Philosophies of the New York Business Corporation Law of 1961*, 11 BUFFALO L. REV. 439 (1962).

<sup>58</sup> For detailed discussion of the New York Business Corporation Law of 1961 in general, see Folk, *supra* note 6; Henn, *supra* note 57; Hoffman, *New Horizons for the Close Corporation in New York Under Its New Business Corporation Law*, 28 BROOKLYN L. REV. 1 (1961); Hornstein, *Analysis of the Business Corporation Law*, 6 MCKINNEY'S CONSOLIDATED LAWS OF NEW YORK, ANNOTATED, app. 1, at 441 (West 1963); Israels, *supra* note 1; Stevens, *Close Corporations and the New York Business Corporation Law of 1961*, 11 BUFFALO L. REV. 481 (1962). And see 6 MCKINNEY'S CONSOLIDATED LAWS OF NEW YORK, ANNOTATED 39 (Supp. 1967).

<sup>59</sup> Hoffman, *supra* note 58, at 2.

<sup>60</sup> N.Y. BUS. CORP. LAW § 620(c) (McKinney 1963).

<sup>61</sup> See text accompanying note 56 *supra*.

This is not the clarity or certainty which the practicing attorney desires or deserves. When the attorney has labored to establish a viable business entity, he is entitled to the security of knowing that his brain-child will survive.

New York's new formal requirements for organization of the close corporation conform more realistically with corporate practice. For example, the New York law requires only one incorporator; yet surprisingly enough this incorporator must be a "natural" person.<sup>63</sup> Organizational meetings are no longer required, and instead, a written instrument signed by the incorporators may be filed in lieu of the organizational meeting.<sup>64</sup>

The statute also provides for shareholder action without a meeting upon the unanimous consent of all shareholders and with the further provision that the certificate of incorporation may provide for such informal action upon the concurrence of less than unanimous consent, but still presumably more than a majority.<sup>65</sup> Regrettably, no similar provision is made for informal meetings of the board of directors. This may have resulted from the Revision Commission's belief that close corporate shareholders would utilize the provision of the new Act authorizing them to exercise the management discretion of the board of directors.<sup>66</sup>

Although the shareholders may transfer all management authority of the board of directors to one or more shareholders, there is no provision for complete elimination of the board of directors, which apparently must remain as a totally ineffective appendage.<sup>67</sup> Because the Act is without provisions for informal meetings of the board of directors, this powerless group apparently must hold formal meetings to decide nothing. It is almost inconceivable that a court would impose such useless formality in the face of the permissiveness of the Act, yet a look at the decisions under the new law convinces one that anything is possible.<sup>68</sup>

Insofar as planning of the close corporation is concerned, the New York Business Corporation Law retains and amplifies such basic features of the model act as classification of shares,<sup>69</sup> cumulative voting provisions,<sup>69</sup> pro-

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<sup>63</sup> N.Y. BUS. CORP. LAW § 401 (McKinney 1963).

<sup>64</sup> *Id.* § 404(b).

<sup>65</sup> *Id.* § 615.

<sup>66</sup> Hoffman, *supra* note 58, at 9; N.Y. BUS. CORP. LAW § 620(b) (McKinney Supp. 1967).

<sup>67</sup> *Id.* § 620(b) places no express limits on the extent to which the management powers of the board of directors can be invaded by shareholder agreements incorporated within the certificate of incorporation. However, *id.* § 701 places management of the company in the board of directors except as limited by such agreements. While this provision may be interpreted to authorize the elimination of the board of directors, yet it would seem that *id.* § 702 would require that there be a board of directors, albeit with no authority to manage. Such section requires that in no event shall the number of directors be "less than the number of shareholders." Such provision could conceivably be interpreted by a conservative court as requiring a board of directors even though shares are held by only one person.

<sup>68</sup> A federal district court has held that greater than statutory voting requirements void when made as against public policy were still void even in light of the new statute since the shareholders had not expressly readopted such provisions after the effective date of the new act. It was not noted by the court that the shareholders had not acted to repeal the provisions after the act purported to make them effective. *Globe Slicing Machine Co. v. Hasner*, 223 F. Supp. 589 (S.D.N.Y. 1963), *aff'd*, 333 F.2d 413 (2d Cir. 1964), *cert. denied*, 379 U.S. 969 (1965) (affirmed without discussion on this point).

<sup>69</sup> N.Y. BUS. CORP. LAW § 501 (McKinney Supp. 1967).

<sup>69</sup> *Id.* § 618 (McKinney 1963).

visions for voting trust agreements,<sup>70</sup> elaborate provisions relating to preemptive rights,<sup>71</sup> and shareholder appraisal rights and procedure for enforcement.<sup>72</sup>

The New York revision also expressly validates all forms of shareholder voting agreements. In particular, shareholder voting agreements, pooling agreements and voting trusts are expressly authorized.<sup>73</sup> Unhappily, the voting agreement provision relates only to "voting rights," and it is possible that this section will be interpreted to mean only those voting rights which are now validly exercisable under the provisions of the statute or by prior case law.<sup>74</sup> A shareholders' agreement to elect named persons as directors was recently upheld even though the agreement specified no termination date.<sup>75</sup>

Greater than majority requirements for quorum and voting of shareholders and directors are expressly permitted<sup>76</sup> if such provisions are placed in the certificate of incorporation. Because the Revision Commission did not see fit expressly to authorize unanimous voting agreements, the status of such provisions will remain unclear until a court decision resolves the matter.

The narrow construction which may be placed on the permissively intended Business Corporation Law is well illustrated by a New York appellate decision.<sup>77</sup> The bylaws of the corporation purported to require a two-thirds shareholder vote to amend the provision of the bylaws establishing the number of directors. The New York law provides that the shareholders may change the number of directors by an amendment to the bylaws embodying such change or by simple resolution if such procedure is authorized in the bylaws.<sup>78</sup> The Act further provides that a majority vote of the shareholders is all that is required to amend the bylaws unless the *certificate of incorporation* provides otherwise.<sup>79</sup> In this case, the shareholders attempted by resolution adopted on simple majority vote to increase the number of directors from four to five. Although the majority of the court correctly found that the superstatutory bylaws provision was invalid, the shareholder action by simple resolution without a supporting bylaw permitting such action was found to be equally invalid.<sup>80</sup> In dissent, Judge Fuld, with his usual perception, decried the literalness of the majority, pointing out that the shareholder action was sufficient under the statute to amend the bylaws to provide for the increase in the number of

<sup>70</sup> *Id.* § 621.

<sup>71</sup> *Id.* § 622.

<sup>72</sup> *Id.* § 623 (McKinney Supp. 1967).

<sup>73</sup> *Id.* §§ 620(a), 621 (McKinney 1963).

<sup>74</sup> Hoffman, *supra* note 58, at 8.

<sup>75</sup> 721 Corp. v. Morgan Guar. Trust Co., 40 Misc. 2d 395, 243 N.Y.S.2d 198 (Sup. Ct. Spec. T. 1963). The court sustained a motion to restrain a special shareholders' meeting of Tiffany & Co., called to remove two directors elected pursuant to a shareholders' agreement. The court found the agreements unlimited as to term, nevertheless within the authority granted under N.Y. Bus. Corp. Law § 620(a) (McKinney 1963).

<sup>76</sup> N.Y. Bus. Corp. Law §§ 616, 709 (McKinney 1963).

<sup>77</sup> Model, Roland & Co. v. Industrial Acoustics Co., 16 N.Y.2d 703, 209 N.E.2d 553 (1965).

<sup>78</sup> N.Y. Bus. Corp. Law § 702(b) (McKinney Supp. 1967).

<sup>79</sup> *Id.* §§ 601, 614(b), 616(a)(2).

<sup>80</sup> Model, Roland & Co. v. Industrial Acoustics Co., 16 N.Y.2d 703, 209 N.E.2d 553 (1965).

directors. Thus, the shareholder resolution should have been treated as the requisite action which, in fact, it was intended to be.<sup>81</sup> The hyper-technical adherence to formalism insisted on by the majority serves to defeat the efforts and labors of the Revision Commission.

An innovation of the New York Act is the provision which authorizes ten per cent of the shareholders to file a suit for the removal of a director for cause,<sup>82</sup> thus overruling prior case law.<sup>83</sup> Also, if provided in the certificate of incorporation, all officers or specified officers may be elected directly by the shareholders instead of the board of directors,<sup>84</sup> and officers so elected may be removed only by the shareholders.<sup>85</sup> However, the officers so elected may be "suspended" for cause by the board of directors.<sup>86</sup> Minority interests are further protected by giving shareholders of ten per cent of the outstanding shares the right to petition the court for removal for cause of officers elected by the shareholders.<sup>87</sup>

In the area of stock transfer, the new Act validates estate planning techniques by expressly recognizing the right of the company to repurchase its shares if at the time specified for performance it has legally available surplus for such purpose.<sup>88</sup> This effectively should end the conflict in case law development.<sup>89</sup>

Although deadlock is an ever increasing possibility as minority shareholder protective devices are expressly authorized and used in close corporate formation, the New York revision provides only the harsh solution of dissolution for such problems. As a positive note, however, creditor protection is provided by authorizing creditors to petition the court to restrain voluntary dissolutions by shareholders which would not be in the best interest of the corporation or the creditors.<sup>90</sup>

In four of the five statutory modes, the New York Act keys shareholder petitions for dissolution in deadlock to inaction of the board of directors or the shareholders in electing directors.<sup>91</sup> The remaining statutory mode requires proof that the shareholders are so divided that dissolution is beneficial to the shareholders as a group.<sup>92</sup> If the shareholders by agreement<sup>93</sup> can eliminate the board of directors, four of these statutory methods of dissolution evaporate. In addition, if a board of directors is required (regardless of whether it functions due to such shareholder agreements), a period of at least one year must elapse before a minority shareholder can petition

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<sup>81</sup> *Id.*

<sup>82</sup> N.Y. BUS. CORP. LAW § 706(d) (McKinney 1963).

<sup>83</sup> *In re Burkin*, 1 N.Y.2d 570, 136 N.E.2d 862 (1956).

<sup>84</sup> N.Y. BUS. CORP. LAW § 715(b) (McKinney 1963).

<sup>85</sup> *Id.* § 716(a).

<sup>86</sup> *Id.*

<sup>87</sup> *Id.* § 716(c).

<sup>88</sup> *Id.* §§ 513-14.

<sup>89</sup> *I.e.*, *City Bank of Columbus v. Bruce*, 17 N.Y. 507 (1958), which upheld the right of the corporation to repurchase its shares as contrasted with the more recent line of cases following *Topken, Loring & Schwartz v. Schwartz*, 249 N.Y. 206, 163 N.E. 735 (1928) which held unenforceable an agreement to repurchase shares upon termination of the employment of an employee.

<sup>90</sup> N.Y. BUS. CORP. LAW § 1008(a) (McKinney 1963).

<sup>91</sup> *Id.* §§ 1104(a)(1), 1104(a)(2), 1104(b), 1104(c).

<sup>92</sup> *Id.* § 1104(a)(3).

<sup>93</sup> *Id.* § 620(b) (McKinney Supp. 1967).

for dissolution.<sup>94</sup> Drastic economic consequences can occur within a stagnated business in less time. If a minority shareholder can block corporate action through superstatutory voting requirements but must wait for one year to petition for dissolution, neither he nor the majority shareholders have been benefitted.<sup>95</sup>

Although space and the scope of this paper preclude a more detailed analysis of the New York provisions, it is submitted that the ambiguities and conflicts created by even a well-drafted unified statute for close and public corporations make this type of approach undesirable. The need for a definition of the close corporation is not eliminated, and the attempt to make provisions applicable to two dissimilar entities cannot be wholly successful.

*South Carolina.* In 1962 South Carolina joined the bandwagon of states including in a unified statute major provisions for the close corporation. The principal goal of the South Carolina Business Corporation Act of 1962 was flexibility—to allow close corporate shareholders to act as freely as if in partnership.<sup>96</sup> This is purportedly recognized in the Act.<sup>97</sup>

Though one-man corporations are judicially recognized in South Carolina,<sup>98</sup> the new South Carolina Act does not expressly provide for ownership of all shares by one person. However, the Act does provide that one "person" may act as an incorporator,<sup>99</sup> and by the definition of "person,"<sup>100</sup> a partnership or corporation may act as the incorporator of a corporation.<sup>101</sup>

In regard to formality, the South Carolina Code still requires an organizational meeting;<sup>102</sup> yet informal meetings of shareholders<sup>103</sup> and directors<sup>104</sup> are expressly authorized where there is unanimous written consent. The Act does not authorize the elimination of the board of directors,<sup>105</sup> and

<sup>94</sup> *Id.* § 1104(c) (McKinney 1963).

<sup>95</sup> *Id.* § 1104(a)(2) authorizes the holders of one-half of the shares to petition for dissolution if the votes required for director election cannot be obtained. In a case such as posed in the text, at least one-half of the shares should be able to agree on dissolution to prevent complete destruction of their interests. However, as the practitioner well knows, it is difficult to predict what shareholder action can be taken given the animosities developed in such contexts. § 1104(b) authorizes dissolution upon petition of holders of more than one-third of the shares, if superstatutory voting requirements for election of directors, or director action are in effect. Again, such provision is ineffective if there are no changes in director election requirements and management of the company is transferred to the shareholders under *id.* § 620(b) (McKinney Supp. 1967).

In general, see references cited in Note, *supra* note 58.

<sup>96</sup> Meyers, *The Close Corporation Under the New South Carolina Corporation Law*, 16 S.C.L. REV. 577 (1964).

<sup>97</sup> S.C. CODE ANN. § 12-16.22(a) (1962) provides that "No agreement among shareholders . . . shall be invalid because the agreement purports to treat the affairs of the corporation as if it were a partnership and the shareholders as if they were partners."

<sup>98</sup> *Gordon v. Hollywood-Beaufort Package Corp.*, 213 S.C. 438, 49 S.E.2d 718 (1948).

<sup>99</sup> S.C. CODE ANN. § 12-14.2 (1962).

<sup>100</sup> *Id.* § 12-11.2(a).

<sup>101</sup> Folk, *The Model Act and the South Carolina Corporate Law Revision*, 18 BUS. LAW. 351, 353 (1963), modified slightly and reprinted in 15 S.C.L. REV. 275 (1964).

<sup>102</sup> S.C. CODE ANN. § 12-14.7 (1962).

<sup>103</sup> *Id.* § 12-16.18.

<sup>104</sup> *Id.* § 12-18.12(b).

<sup>105</sup> *Id.* § 12-18.1, 12-18.3.

it is unclear to what extent shareholders may take over full management.<sup>106</sup> However, shareholder management apparently was intended.<sup>107</sup> It has been stated that a provision specifically authorizing shareholder management was omitted in order to prevent confusion and the possibility of foreclosing a line of development of the close corporation.<sup>108</sup> It is difficult to understand how the uncertainty created by the omission can do anything but create confusion. South Carolina limits the validity of shareholder agreements to ten years.<sup>109</sup> This provision allows shareholders to reevaluate their positions but forces minority shareholders to renegotiate protective devices built into the agreement. Under this system, an attorney is well advised to build as much minority shareholder protection as possible into the articles of incorporation where such protection apparently will not be subject to renewal every decade. Seemingly, shareholder agreements among less than all shareholders are not valid. This conclusion is derived by negative implication from the Act.<sup>110</sup>

South Carolina defines the close corporation in virtually identical language and for the same purposes as New York.<sup>111</sup> This definition suffers from the same uncertainties and ambiguities as that of New York and is subject to the same criticisms.<sup>112</sup> Overruling prior case law,<sup>113</sup> the South Carolina Act expressly authorizes vote pooling agreements when in writing and signed by all of the parties thereto.<sup>114</sup> Likewise, irrevocable proxies are authorized to enforce pooling agreements.<sup>115</sup> In contrast to shareholder agreements, vote pooling agreements need not be consented to by all shareholders;<sup>116</sup> however, vote pooling agreements are, like shareholder agreements, restricted to a term of ten years.<sup>117</sup> The imposition of a ten-year limitation appears to conflict with South Carolina's wholehearted acceptance of the freedom and flexibility inherent in a statute authorizing partnership-like shareholder agreements.<sup>118</sup> Requiring the shareholders in a close corporation to review their basic formulation at a specified time interval seems undesirable.<sup>119</sup> If the corporation is proceeding normally, with no dissension among the shareholders, the provisions will be routinely renewed as authorized by the Act.<sup>120</sup> If, on the other hand, some disagreement has

<sup>106</sup> I.e., compare *id.* § 12-16.22(a)-(b) with N.Y. BUS. CORP. LAW § 620(b) (McKinney Supp. 1967), which latter provision expressly authorizes transfer of all or part of the directors' management powers to the shareholders.

<sup>107</sup> S.C. CODE ANN. § 12-16.22(e) (1962) imposes director liability on the shareholders to the extent that the shareholders exercise director discretion.

<sup>108</sup> See discussion in Folk, *supra* note 101, 18 BUS. LAW. 351, 363 (1963).

<sup>109</sup> S.C. CODE ANN. § 12-16.22(b)(3) (1962).

<sup>110</sup> *Id.* § 12-16.22(b)(1)-(3) establishes conditions of validity for such agreements, one of which is unanimous shareholder consent.

<sup>111</sup> Shareholders' agreements shall be valid only so long as shares "are not traded on any national security exchange or regularly traded in any over-the-counter market . . ." *Id.* § 12-16.22(c). Such definition also applies to dissolution agreements. *Id.* § 12-22.14(b).

<sup>112</sup> See text and footnote comments at notes 56 and 61 *supra*.

<sup>113</sup> Cf. *Johnson v. Spartanburg County Fair Ass'n*, 210 S.C. 56, 41 S.E.2d 599 (1947).

<sup>114</sup> S.C. CODE ANN. § 12-16.15 (1962).

<sup>115</sup> *Id.* § 12-16.14(f)(5).

<sup>116</sup> *Id.* § 12-16.15 provides for such agreements "between two or more shareholders."

<sup>117</sup> *Id.* § 12-16.15.

<sup>118</sup> Bradley, *supra* note 56, at 1173.

<sup>119</sup> E.g., as in South Carolina every ten years. S.C. CODE ANN. § 12-16.15 (1962).

<sup>120</sup> E.g., S.C. CODE ANN. § 12-16.22(b) (1962).

arisen, the minority shareholders, who may have bargained for and received substantial concessions through the shareholder agreement, may be relegated to a position which subjects them to all of the freeze-out and squeeze-out techniques available under the old procedures.

While most of the other South Carolina close corporate provisions follow the lead of North Carolina and New York,<sup>121</sup> some are unique. For example, the Act provides an apparently invariable majority rule as to holders of jointly owned shares.<sup>122</sup> This may come as quite a blow to practitioners who envisaged the jointly held share as a means of effective close corporate planning.

South Carolina's provisions for dissolution upon deadlock are similar to the New York provisions previously discussed;<sup>123</sup> however, the South Carolina Act expressly authorizes discretionary court relief similar to that granted under the English Private Company Act.<sup>124</sup> Thus, in any shareholder-filed dissolution action, the court within its discretion may take action other than dissolution, such as: (1) cancelling or altering provisions of the articles or bylaws; (2) altering a resolution or other act of the corporation; (3) directing or prohibiting the act of the corporation, the shareholders, directors, officers, or other parties to the action; or (4) providing for the purchase of the shares of any shareholder by either the corporation or the other shareholders.<sup>125</sup> In addition, the Act lists seven specific conditions where a shareholder may petition the court for dissolution. As these conditions are listed conjunctively and not made expressly disjunctive, the outcome of a shareholder's petition under only one of them is uncertain.<sup>126</sup>

A more detailed analysis of the South Carolina close corporate provisions is unnecessary for the purposes of this paper. It suffices to say that, with its own idiosyncrasies, the South Carolina Act suffers from the contradictions and ambiguities inherent in any attempt to devise a single framework for such dissimilar entities as the public and close corporation. To some extent the close corporate form in South Carolina may have been disadvantaged by the Act because of the uncertainties which it injects into their formation and operation.<sup>127</sup> However, the judicial alternatives to dissolution upon deadlock are a much needed innovation.

*Georgia.* On April 3, 1968, Georgia joined the list of states which have enacted close corporate provisions within the framework of a general cor-

<sup>121</sup> Such as superstatutory quorum and voting requirements for shareholders' meetings (*id.* §§ 12-16.8, 12-16.10), and for directors' meetings (*id.* § 12-18.10).

<sup>122</sup> *Id.* § 12-16.13.

<sup>123</sup> Compare *id.* §§ 12-22.4, 12-22.15 with N.Y. BUS. CORP. LAW § 1104 (McKinney 1963).

<sup>124</sup> S.C. CODE ANN. § 12-22.23 (1962); English Company's Act, 1948, § 210, 11 & 12 Geo. 6, c. 38, § 28.

<sup>125</sup> S.C. CODE ANN. §§ 12-22.23(a)(1)-(4) (1962).

<sup>126</sup> *Id.* § 12-22.15(a). This may be an oversight on the part of the drafters of the Code; however, the section in effect reads that the court may award dissolution upon the petition of a shareholder when he establishes that the seven conditions all exist. As the conditions are not made expressly disjunctive it is certainly open for a court to read the conditions conjunctively.

<sup>127</sup> Accord, Bradley, *supra* note 56, at 1173.

porate code revision.<sup>128</sup> Although the Georgia Act eliminates many of the useless formalities of the older model codes,<sup>129</sup> it suffers the vice of all the unified statutes. Specific close corporate provisions (such as express validity of shareholder agreements) apply only to those corporations whose shares are "not generally" traded in an over-the-counter market.<sup>130</sup> This definition, like those previously discussed, does not capture the essence of the close corporation, settling instead on only one outward manifestation of close corporateness. Such a definition is not adequate, for the stock of a company may be in the hands of many investors who for various reasons do not trade it. These investors may need the protection of a general corporate code, yet definitions based on share-trading could be used to authorize and validate undue informalities in the operations of a small "public" corporation.

The Georgia Act authorizes such basic close corporation control devices as superstatutory quorum and voting requirements for directors' and shareholders' meetings,<sup>131</sup> shareholder pooling agreements,<sup>132</sup> irrevocable proxies,<sup>133</sup> voting trusts,<sup>134</sup> and basic dissolution upon deadlock provisions.<sup>135</sup> The Act also authorizes the appointment by the court of a provisional director in case of director deadlock which the shareholders are unable to resolve. Such appointment may be made on application of not less than one-half of the directors or one-third of the shareholders. Once appointed, the provisional director serves until removed by the court or by a majority of the shareholders.<sup>136</sup> This provision appears to be quite similar to the California statute.<sup>137</sup>

Unfortunately Georgia, like South Carolina, saw fit to limit the term of shareholders' agreements.<sup>138</sup> Georgia provides for reducing the number of directors, but apparently prohibits the elimination of the board of directors,<sup>139</sup> even though management may be vested in the shareholders pursuant to provisions placed in the articles of incorporation, bylaws, or written shareholder agreement.<sup>140</sup>

Judging from the little information available to the author, it appears that the new Georgia enactment fits into the basic pattern set by those

<sup>128</sup> Bowman, *An Introduction to the New Georgia Corporation Law*, 4 GA. ST. B.J. 419 (1968). A copy of the new enactment was not available to the author in time for this Article, so reliance is placed on Mr. Bowman's reporting of the new Georgia statute.

<sup>129</sup> Such innovations are added as: only one incorporator is required (GA. CODE ANN. § 22-801 (1968)); a corporation may be an incorporator (*id.*); no incorporation meeting is required (*id.* § 22-802(a)(11)); shareholders and directors may act without a meeting upon unanimous consent (*id.* §§ 22-603(d), 22-710); and if less than three shareholders, then a minimum number of required directors not less than the number of shareholders (*id.* § 22-702(a)).

<sup>130</sup> *Id.* § 22-611(b).

<sup>131</sup> *Id.* §§ 22-607(a), 22-609(a), 22-707.

<sup>132</sup> *Id.* § 22-611(a).

<sup>133</sup> *Id.* § 22-610(g).

<sup>134</sup> *Id.* § 22-612.

<sup>135</sup> *Id.* §§ 22-1317(a)(1), 22-1322.

<sup>136</sup> *Id.* § 22-703 (1968).

<sup>137</sup> CAL. CORP. CODE § 819 (West 1955).

<sup>138</sup> Term may not exceed twenty years in Georgia. GA. CODE ANN. § 22-611(c) (1968). For criticism of such provisions, see text accompanying notes 109-10 *supra*.

<sup>139</sup> *Id.* § 22-702(d) requires an annual election of directors.

<sup>140</sup> *Id.* § 22-701(a); but note that such provisions are not effective as to third parties without notice. *Id.* § 22-701(b).

states which have tried to work out a single statute to provide for formation and operation of both publicly and closely held corporations.

#### IV. THE CLOSE CORPORATION STATUTE

*Florida.* To date, Florida is the only state which has enacted a separate statute to accommodate the close corporation.<sup>141</sup> The Florida Act, like the unified statutes, is permissive in that it applies only to those close corporations which desire its specific application.<sup>142</sup> Unlike its counterparts, however, the Act provides that close corporate status can be acquired upon the vote of a simple majority of the shares.<sup>143</sup> How this election proceeds or how it is terminated is left to counsel's ingenuity, for the statute is silent on these matters. Apparently, there is no need to reject close corporate status if it is not desired, but this conclusion can be reached only by negative inference from the election provisions. There is no provision for official documentation of the election, and this may invite *post hoc* determination when such serves the convenience of the parties. Unfortunately, Florida used the form of definition supplied by the North Carolina revision, tying close corporateness to stock trading.<sup>144</sup> Enough has previously been said about the inadequacies of such a definition. But the Florida definition creates even more uncertainties because it contains no provision in the event of loss of close corporation status.

As in the North Carolina statute,<sup>145</sup> the Florida Act expressly declares that no shareholders' agreement shall be invalid because it attempts to treat the corporation as if it were a partnership or to arrange shareholder relations in a manner appropriate only between partners.<sup>146</sup> The Act validates the one-man corporation by expressly stating that the acquisition of the stock by one or two persons violates no public policy of Florida.<sup>147</sup> Because such validation is not limited to corporations electing close corporate status, it is assumed that validation applies to all corporations in Florida.<sup>148</sup> Corporations with only one or two shareholders may possess all managerial boards, bodies, and capacities which are held or authorized for corporations with three or more shareholders.<sup>149</sup>

For a close corporation, if there are not less than three stockholders, the articles of incorporation may provide that the business be managed by

<sup>141</sup> Fla. Session Laws 1963, ch. 379, §§ 1-8. For a comparison of North Carolina and New York revisions with the Florida Act, see Bradley, *supra* note 56, at 1174-86; O'Neal, *supra* note 1, at 659-62; Rudolph, *supra* note 6, at 787-88; Note, *supra* note 56, at 246; *Recent Statutes: Corporations—In General—Florida Legislature Enacts Close Corporation Law—Florida Laws 1963, ch. 63-379*, 77 HARV. L. REV. 1551 (1964). For a criticism of the Florida legislation, see Dickson, *The Florida Close Corporation Act: An Experiment That Failed*, 21 U. MIAMI L. REV. 842 (1967).

<sup>142</sup> FLA. STAT. ANN. § 608.0100(1) (1963).

<sup>143</sup> *Id.*

<sup>144</sup> The close corporation is a corporation for profit whose shares of stock are not generally traded in the markets maintained by securities dealers or brokers. *Id.* § 608.0100(2). Compare with N.C. GEN. STAT. § 55-73(b) (1955).

<sup>145</sup> N.C. GEN. STAT. § 55-73 (1955).

<sup>146</sup> FLA. STAT. ANN. § 608.0105(2) (1963).

<sup>147</sup> *Id.* § 608.0101(2).

<sup>148</sup> The language of the section makes it applicable to a "corporation, hereafter or heretofore formed under the laws of this state." *Id.* § 608.0101(1).

<sup>149</sup> *Id.*

the stockholders. In such a situation, the stockholders are deemed the directors for all purposes required under the basic corporation statute.<sup>150</sup> The mystic number of three again arises to plague corporate revision. What logic can support a provision which permits twenty shareholders to manage their company directly, but requires that the sole shareholder manage his close corporation through the medium of a formalistic board of directors? Such illogical provisions support the suggestion that the statute was adopted without due and adequate consideration.<sup>151</sup> A curious provision of the Act permits close corporate shareholders to retain the board of directors, yet strip them of all management and discretionary powers through a shareholders' agreement.<sup>152</sup> Apparently, this provision could be used by the one- or two-shareholder close corporation, which under the provisions of the Act must retain a board of directors.

Informal meetings of the shareholders<sup>153</sup> and directors, where the business of a close corporation is managed by a board of directors,<sup>154</sup> are authorized upon unanimous written consent of all persons entitled to participate or vote at such meeting.

A novel provision in the Florida Act is the delineation of seven areas to which a shareholders' agreement may relate. Although not limiting shareholder agreements to these specific areas, the Florida Act calls attention to the usual areas covered by such agreements, namely management of the business, declaration and payment of dividends or division of profits, identity of officers and/or directors, restrictions on stock transfers, voting requirements for shareholder and/or director action, employment contracts, and arbitration of shareholder or director deadlock.<sup>155</sup>

Removal of an uncooperative director is assured under the provision which permits removal of a director with or without cause by the shareholders entitled to elect such director.<sup>156</sup> Although this presumably was the intent of the section, the language used makes it unclear whether a group of shareholders entitled to elect a director may remove *any* director with or without cause. Such a construction could be ruinous to the bargained position of minority interests.

In the matter of deadlock, Florida again follows somewhat blindly the lead of earlier close corporate provisions in specifying dissolution as the only remedy for director and shareholder deadlock.<sup>157</sup> Although any one shareholder may petition the court for dissolution, he must prove that (1) the directors are deadlocked and the shareholders are unable to break the deadlock, or the shareholders are deadlocked, and (2) arbitration or other remedy provided in the shareholders' agreement has failed.<sup>158</sup> It is unfortunate that the Florida Revision Committee did not take the additional

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<sup>150</sup> *Id.* § 608.0102.

<sup>151</sup> Dickson, *supra* note 141, at 842.

<sup>152</sup> FLA. STAT. ANN. § 608.0105(3) (1963).

<sup>153</sup> *Id.* § 608.0103.

<sup>154</sup> *Id.* § 608.0104.

<sup>155</sup> *Id.* §§ 608.0105(1)(a)-(g).

<sup>156</sup> *Id.* § 608.0106.

<sup>157</sup> *Id.* § 608.0107.

<sup>158</sup> *Id.* §§ 608.0107(1)-(3).

step provided in South Carolina, Delaware, and Maryland, authorizing the court to take action short of dissolution in appropriate circumstances.<sup>159</sup>

Florida's Close Corporation Act has been severely criticized as a self-conflicting, haphazard borrowing from other state corporation statutes.<sup>160</sup> While even a cursory examination of the statute supports this conclusion, the Florida revision must at least be praised for its recognition of the fact that the close corporation is so different from the publicly held corporation that a separate and distinct statute is required for its regulation.

### V. THE COMPROMISE STATUTE

*Delaware.* The 1967 Delaware solution to the problems of the close corporation represents a blending of the unified statute and separate statute treatments. Instead of rewriting basic code provisions into a new statute to accommodate the close corporation, the Delaware revision adds special close corporation provisions in a separate subchapter of the general corporation act.<sup>161</sup> The Delaware close corporate law applies only to corporations which meet a definitional test and elect to become a close corporation in the manner prescribed in the law.<sup>162</sup> A non-electing corporation is subject to all of the provisions of the basic corporation act, while the electing close company is subject to only the provisions of the basic act which are not otherwise changed by the special close corporate subchapter.<sup>163</sup>

Delaware is the first state to attempt a comprehensive definition of the close corporation based upon multiple criteria. Delaware defines a close corporation as one whose certificate of incorporation, in addition to the basic requirements of the law, provides that: (1) all of the company's issued stock of all classes shall be held of record by not more than thirty persons; (2) all of the issued stock of all classes shall be subject to at least one restriction which either: (a) obligates the shareholder to give the corporation, the other shareholders, or other specified person a first refusal before selling such stock; (b) obligates the corporation, the other shareholders, or other specified party to purchase the securities of a shareholder offered for sale; (c) requires shareholder or director consent to any proposed transfer of the stock; or (d) reasonably prohibits the transfer of the stock to designated persons or classes of persons; and (3) none of the corporation's stock is offered in a manner which would constitute a "public offering" within the meaning of the Securities Act of 1933.<sup>164</sup>

Such a definition comes substantially closer to catching the essence of the close corporation than a definition based upon the single criteria of the trading of stock in a securities market. The close corporation is essentially

<sup>159</sup> DEL. GEN. CORP. LAW §§ 352, 353 (1967); MD. CODE ANN. art. 23, § 109(c) (1967); S.C. BUS. CORP. ACT § 12-23 (1962).

<sup>160</sup> Bradley, *supra* note 56, at 1186; Dickson, *supra* note 141, at 842.

<sup>161</sup> DEL. CODE ANN. tit. 8, ch. 1, subch. XIV (1967), being §§ 341-56 of the General Corporation Law of the State of Delaware (1967).

<sup>162</sup> DEL. CODE ANN. tit. 8, ch. 1, § 341(a) (1967).

<sup>163</sup> *Id.* § 341(b).

<sup>164</sup> *Id.* §§ 202(c)(1)-(4), 342(a)(1)-(3). For a definition of "public offering" see Securities and Exchange Commission Release No. 4552 (Nov. 6, 1962); SEC v. Ralston Purina Co., 346 U.S. 119, 124-25 (1953).

a business with few owners, substantially all of whom participate directly in management. In practice, a close corporation is a sole proprietorship or partnership with limited owner liability. Until legislatures and courts accept this simple fact of business life, statutes and decisions will continue to fail to serve effectively the purposes for which they are intended.

Ostensibly, close corporate provisions are intended to do away with formalities and other investor protective devices built into general corporation acts which are not required when the investors themselves are directly involved in the day-to-day management and affairs of the business. Although the multiple criteria used in the Delaware Act better isolate the close corporation than prior definitions based on stock trading, the Act still fails to prevent abuse of the investor through management adoption of close corporate informalities in the small "public company." A corporation with thirty or twenty or even ten investor/shareholders, none of whom are involved in management, should be provided with the protection afforded by the general corporation statutes. However, the Delaware limitation on the aggregate number of shareholders, coupled with restrictions on transferability of interests in the company, does partake of some aspects of partnership arrangements.<sup>165</sup>

Obviously, the corporation is no longer a close corporation once it has made a "public offering" of its stock. Although the term "public offering" is a word of art as used in the securities acts, when a company's stock is held in a manner which makes such a term applicable, the company in all probability has moved into the realm of the management-shareholder/investor dichotomy which typifies the public corporation. Such a provision is therefore useful in proscribing the outside limit of close corporateness.

To elect close corporation status under the new Delaware provisions, a corporation amends its certificate of incorporation (by a two-thirds shareholder vote) to include the statement that it elects to become a "close corporation" and includes a similar statement in the heading and name of the corporation.<sup>166</sup> The election continues until terminated by (1) an amendment to the company's certificate of incorporation passed by a two-thirds vote of the shareholders or such greater voting requirement as may be specified in the certificate of incorporation, deleting such provisions from the certificate; or (2) a breach of one or more of the definitional criteria, and neither the corporation nor any of the shareholders taking action to correct the defect within thirty days after it is discovered.<sup>167</sup> Unless the event causing termination is the voluntary act of the shareholders in accordance with provisions of the certificate of incorporation or law, the courts are given jurisdiction upon petition of the corporation or any shareholder to issue orders necessary to prevent the termination of the close corporate status.<sup>168</sup>

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<sup>165</sup> E.g., TEX. REV. CIV. STAT. ANN. art. 6132(b), § 27(1) (1962) prevents the admission of a transferee of a partner's interest into management without the consent of all then existing partners.

<sup>166</sup> DEL. CODE ANN. tit. 8, ch. 1, §§ 343(a), 344 (1967).

<sup>167</sup> *Id.* §§ 345, 346, 348(a).

<sup>168</sup> *Id.* § 348(b).

Constructive notice of stock restrictions to any purchaser is expressly provided by the Delaware Act which requires the stock certificate to be conspicuously marked with appropriate language. If so marked, any person to whom such stock is transferred in violation of the qualifications or restrictions is conclusively presumed to have notice of his ineligibility to be a shareholder, and the corporation may refuse to transfer the stock into the purchaser's name.<sup>169</sup> Alternatively, the appropriate court upon the petition of the corporation or any other shareholder presumably may rescind the transfer.<sup>170</sup> Transfer restrictions and other limitations on share ownership appear to be adequate to guarantee validity of any reasonable restriction and insure recognition and enforcement of such provision through appropriate court action.<sup>171</sup>

The Delaware Act specifically provides for direct management of the close corporation by the shareholders. In this event the shareholders are deemed to be the directors of the company for the purposes of the applicable provisions of the general corporation law. If the board of directors is eliminated, a statement to this effect must be placed in the certificate of incorporation and on the face of each stock certificate.<sup>172</sup>

If the shareholders do not eliminate the board of directors, a majority of the shareholders of a close corporation may enter into a written agreement among themselves restricting the discretion or powers of the board of directors in regard to the conduct of any phase of the business of the corporation. In so doing, the shareholders who are parties to the agreement assume liability for managerial acts or omissions to the extent that corporate management is controlled by the agreement.<sup>173</sup> The Delaware Act expressly validates partnership-like arrangements contained in any such shareholders' agreement.<sup>174</sup>

The balance of the special close corporation subchapter of the Delaware Act deals with the problems of close corporate disharmony. Like other close corporation acts, the Delaware Act permits the shareholders to specify in the certificate of incorporation events which will automatically dissolve the company or give rise to an option in any of the shareholders to petition a court to dissolve the corporation. Any such provision must be noted on each stock certificate.<sup>175</sup> In addition, any shareholder is given the right in specified instances to petition the court for the appointment of a custodian whose duties are to continue the corporate business, rather than to liquidate the affairs of the corporation and distribute its assets.<sup>176</sup>

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<sup>169</sup> *Id.* § 347(d).

<sup>170</sup> *Id.* § 348(b).

<sup>171</sup> If a restriction is held invalid in any proceeding, the corporation is given the option for a thirty-day period after such determination becomes final in which to purchase the stock which was the subject of such court proceedings. If the parties cannot agree on a purchase price, the appraisal proceedings established under the general corporation act are used. *Id.* §§ 349, 262.

<sup>172</sup> *Id.* § 351.

<sup>173</sup> *Id.* § 350.

<sup>174</sup> *Id.* § 354.

<sup>175</sup> *Id.* §§ 352(a)(2), 355. Compare with S.C. CODE ANN. § 12-22.15(a)(6) (1962) and the basic right of a partner to dissolution, *e.g.*, TEX. REV. CIV. STAT. ANN. art. 6132b, §§ 31(1)(2), 32(1)(d) (1961).

<sup>176</sup> Such right arises if the "affairs of the corporation are managed by the stockholders and they are so divided that the business of the corporation is suffering or is threatened with irreparable

Upon such petition the court has the power to appoint a custodian or an impartial provisional director if the latter will better serve the interests of the corporation.<sup>177</sup> In addition, owners of one-third of all the stock or one-half of the directors then in office may petition the court for the appointment of a provisional director.<sup>178</sup>

Apparently, a shareholder has no right to petition for dissolution as such except under circumstances prescribed in the certificate of incorporation or when the corporation has abandoned its business and failed to dissolve.<sup>179</sup> Conceivably, the general corporate law provision for the appointment of a custodian could be construed to authorize the court to order liquidation of the corporation by the custodian. However, this action is not clearly authorized, and in view of the courts' usual hesitancy to order dissolution, it is uncertain whether dissolution is an available remedy for deadlock under the Delaware Act.<sup>180</sup> If dissolution is not such a remedy, shareholders will have to accept stagnation of the business or management by a third party.<sup>181</sup>

Regrettably, Delaware does not provide shareholders with the further and more practical alternative of a forced buy or sell agreement under court supervision.<sup>182</sup> Dissolution or third party management would then become an alternative to effective and equitable shareholder control without continuing court involvement. This remedy puts additional pressure upon the various factions within the close corporation to reach an agreement, and also provides an alternative in situations in which the court determines that hostilities have reached the point that future reconciliation is impossible.

*Maryland.* Maryland, like Delaware, provides for the close corporation by a series of special provisions within the framework of a general corporate law.<sup>183</sup> For the purposes of the Maryland Act, a "close corporation" is any corporation whose charter contains the statement that it is a close corporation.<sup>184</sup> Unless such a statement is contained in the original articles of incorporation, an amendment to add such a statement can be made only by the unanimous vote of the shareholders.<sup>185</sup>

Similarly, an amendment to the charter of a close corporation to re-

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injury and any remedy with respect to such deadlock provided in the certificate of incorporation or by-laws or any written agreement of the stockholders has failed." DEL. CODE ANN. tit. 8, ch. 1, §§ 352(a)(1), 262(b) (1967).

<sup>177</sup> *Id.* § 352(b).

<sup>178</sup> *Id.* § 353(b).

<sup>179</sup> *Id.* §§ 226, 275, 352, 353, 355.

<sup>180</sup> *Id.* § 226(b) provides that it is the duty of the custodian to "continue the business of the corporation and not to liquidate its affairs and distribute its assets, *except when the Court shall order otherwise* and except in cases" where the business has been abandoned or the certificate of incorporation authorizes dissolution. (Emphasis added.) See also *id.* § 226(a)(2) and the implications of §§ 355(a)-(b).

<sup>181</sup> *I.e.*, either a provisional director or a custodian under *id.* §§ 226, 352, 353.

<sup>182</sup> *E.g.*, such as the Maryland provision but with judicial discretion as to which group of shareholders is entitled on equitable grounds to the first option to buy. MD. CODE ANN. art. 23, § 109(c) (Supp. 1967).

<sup>183</sup> *Id.* §§ 100-11. For a general discussion of the close corporate provisions, see Hall, *The New Maryland Close Corporation Law*, 27 MD. L. REV. 341 (1967).

<sup>184</sup> MD. CODE ANN. art. 23, § 100(a) (Supp. 1967).

<sup>185</sup> *Id.* § 100(a)(iii).

scind an election can be effected only by the unanimous vote of all shareholders.<sup>186</sup> Such a provision seems rather strange—it could permit conservative minority shareholders in effect to blackmail an expanding, thinly capitalized company into a forced purchase of the minority's shares in order to secure additional financing through the issuance of new shares. However, the provision arguably may be desirable in such cases and also in light of the Maryland requirement that no stock of a close corporation can be transferred without unanimous shareholder consent or such transfer restrictions in a shareholders' agreement which either grant an option of first refusal or require the purchase of shares offered for transfer.<sup>187</sup>

Although the devolution of stock by operation of law (e.g., from a deceased shareholder to the shareholder's executor or administrator) is not a "transfer" within the meaning of the Maryland Act, any subsequent transfer by the executor or administrator to a devisee of the stock under the terms of the deceased shareholder's will is a "transfer" and requires unanimous approval of the surviving shareholders.<sup>188</sup> Such restrictions, of course, are desirable insofar as they prevent the "lock-in" of minority interests and should not be an undue burden if a properly drafted provision is included in the shareholders' agreement. The unanimous consent provision is similar to the partnership requirement for admission of a new partner,<sup>189</sup> and the flexibility of change through shareholder agreement provisions also resembles that available in general partnership law.<sup>190</sup> However, the Maryland provision seems more restrictive and could create substantive law problems for the legal representative, who may be required by the terms under which he holds the shares to transfer them to a testamentary trustee. It is unclear whether the Maryland Act would permit this second "transfer." Presumably, a refusal to consent to such a transfer by even one surviving shareholder would require the legal representative to petition for involuntary dissolution which again could be in violation of the conditions under which the representative holds the shares.<sup>191</sup> The only possible solution is appropriately drafted provisions in the shareholders' agreement coupled with due consideration of these provisions in drafting testamentary instruments for each of the shareholders. The Maryland Act supplements the transfer restrictions by requiring unanimous shareholder consent to the issuance of any security by the close corporation which is or would give the holder a right to acquire its common stock.<sup>192</sup>

As does the Florida statute,<sup>193</sup> the Maryland Act specifies seven areas which may be covered by a shareholders' agreement in addition to other provisions relating to any aspect of the affairs of the corporation or the re-

<sup>186</sup> *Id.* § 100(b); Hall, *supra* note 183, at 353.

<sup>187</sup> MD. CODE ANN. art. 23, § 101(a) (Supp. 1967); in general, see Hall, *supra* note 183, at 348, 351-52.

<sup>188</sup> MD. CODE ANN. art. 23, § 101(c) (Supp. 1967), last sentence.

<sup>189</sup> E.g., TEX. REV. CIV. STAT. ANN. art. 6132b, §§ 27(1), 25(2)(c)-(d), 28(B)(1)(B), 41(1), 41(3) (1961).

<sup>190</sup> Compare the usual partnership agreement provision, such as *id.* § 18, with the new shareholder's agreement provisions such as MD. CODE ANN. art. 23, § 104 (Supp. 1967).

<sup>191</sup> MD. CODE ANN. art. 23, § 101(b) (Supp. 1967).

<sup>192</sup> *Id.* § 102; Hall, *supra* note 183, at 352-53.

<sup>193</sup> FLA. STAT. ANN. §§ 608.0105(1)(a)-(g) (1963).

lations of the stockholders *inter se*.<sup>194</sup> Unlike the Delaware Code, the Maryland provision requires unanimous shareholder approval of the initial shareholders' agreement or any amendment regardless of whether the agreement is included in the charter, the bylaws or other written instrument.<sup>195</sup> The court is given specific power to enforce shareholder agreements by injunction or by other appropriate means.<sup>196</sup> Caution is well advised, because a shareholders' petition to enforce such agreements can lead to dissolution proceedings or trigger the buy out provisions contained in the Maryland Act.<sup>197</sup>

The deadlock and dissension remedies of the Maryland Act provide substantially more relief for the close corporation shareholder than does the usual close corporation statute. In addition to the common corporate statutory provision for dissolution upon deadlock,<sup>198</sup> a shareholder may petition for dissolution upon either a refusal of the other shareholders to consent to a proposed bona fide transfer or internal dissension which prevents conducting business for the benefit of all shareholders.<sup>199</sup>

A shareholder who wants out of the corporation gets his wish under the Maryland Act, but possibly not in the manner he expected or desired. A petition for dissolution automatically gives the non-petitioning shareholders an option to purchase the petitioning shareholders' stock at an agreed price or one determined by the court in accordance with general corporate appraisal procedure.<sup>200</sup> It is unclear from a reading of the statute whether a petition for dissolution based upon an event or contingency specified in a valid shareholders' agreement activates the option provisions.<sup>201</sup> If not presently available, such an addition would seem desirable. Also desirable would be a provision authorizing the court in its discretion to award the purchase option to those shareholders equitably entitled thereto. As the statute now stands, the petitioning shareholder gets no option to purchase the stock of the other shareholders, even though it may be their oppressive actions which create the conditions forcing such a drastic alternative. Such a pro-

<sup>194</sup> MD. CODE ANN. art. 23, §§ 104(a)(1)-(7) (Supp. 1967); in general, see the discussion in Hall, *supra* note 183, at 354-57.

<sup>195</sup> Compare MD. CODE ANN. art. 23, §§ 104(a)-(b) (Supp. 1967) with DEL. CODE ANN. tit. 8, ch. 1, § 350 (1967).

<sup>196</sup> MD. CODE ANN. art. 23, § 104(d) (Supp. 1967).

<sup>197</sup> *Id.*

<sup>198</sup> *Id.* § 79A.

<sup>199</sup> *Id.* §§ 101(b), 109(a); and for general discussion, see Hall, *supra* note 183, at 343, 361.

<sup>200</sup> *Id.* §§ 109(c) (Supp. 1967), 73(f) (1966). Compare with similar provisions in CONN. GEN. STAT. CORP. CODE § 4658 (1955), and W. VA. CODE ANN. § 31-1-80 (1966). And see the discussion in Hall, *supra* note 183, at 349, 361.

<sup>201</sup> The language of the Code is relatively ambiguous. "Any one or more stockholders desiring to continue the business of a close corporation may avoid the dissolution of the corporation or the appointment of a receiver *under this section or under § 79A of this article* by electing to purchase the shares of stock owned by the petitioner at a price equal to their fair value." MD. CODE ANN. art. 23, § 109(c) (Supp. 1967) (emphasis added). Section 79A contains relatively standard dissolution for deadlock provisions and requires not less than twenty-five per cent of the shares to join in the petition unless dissolution is sought for oppressive or fraudulent acts of directors, or the failure of the shareholders to elect directors for two consecutive annual meetings. Section 109 applies only to dissolution for internal dissension. Dissolutions required by the terms of a shareholders' agreement are apparently not covered by such option provision and it is conceivable that a court would so construe § 109(c). A viable corporate business could thus be dissolved by a dissatisfied shareholder without utilizing the desirable alternative of permitting the other shareholders the right to continue the business if they so desire.

vision could simply provide a subsequent option for the other shareholders if the members of the first group do not exercise their right to purchase.

A superstatutory vote may be authorized for any purpose in the charter of any corporation.<sup>302</sup> Hence, it is conceivable that such provisions, when used in the framework of a close corporation, could give a minority interest tremendous leverage with regard to the business and affairs of the corporation. The majority of the shareholders may be hamstrung by the provisions of their agreement, and if they petition for dissolution, they risk purchase of their shares by the minority interests. The Maryland Act, it is suggested, goes too far in its protection of minority interests, preferring them to possibly valid and legitimate desires of the majority. Unanimous consent provisions are wonderful protection devices for oppressed minority interests, but the majority must be protected from a statutorily created minority tyrant.

Other provisions of the Maryland Act provide for minimizing the number of directors to one or more if a board of directors is used,<sup>303</sup> dispensing with annual meetings of shareholders unless a written request for such meeting is timely delivered to an appropriate official,<sup>304</sup> requesting a statement of corporate affairs once annually,<sup>305</sup> and eliminating the board of directors with direct shareholder management through appropriate provisions in the close corporation's charter.<sup>306</sup> In the event the shareholders manage the company directly, they are liable for any corporate disbursement contrary to the provisions of the Act or loans made to any officer, director, or shareholder.<sup>307</sup>

## VI. CONCLUSION

The close corporation statutes have come a long way since the North Carolina enactment of 1955. Hopefully, their development will continue. It is suggested that the ideal accommodation of the close corporation is a separate statute, based upon a philosophy of "recognition" of the participants' freedom to contract, limited only as necessary to protect creditors and the shareholders from their own poor planning.

Such a statute is envisaged as modeled on the Uniform Partnership Act, which was evolved to regulate the business form which most nearly resembles the close corporation. The Partnership Act would, of course, require modification to provide, at minimum: (1) a definition of the close corporation couched in terms of the degree of shareholder participation in

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<sup>302</sup> MD. CODE ANN. art. 23, § 42(b) (1966).

<sup>303</sup> *Id.* § 106 (Supp. 1967).

<sup>304</sup> *Id.* § 104; Hall, *supra* note 183, at 360.

<sup>305</sup> MD. CODE ANN. art. 23, § 108(a) (Supp. 1967).

<sup>306</sup> *Id.* § 105(a); Hall, *supra* note 183, at 358-59.

<sup>307</sup> MD. CODE ANN. art. 23, § 105(c) (Supp. 1967).

management whether directly or as directors and/or officers;<sup>208</sup> (2) exclusivity of the prescribed form for limited liability businesses falling within the definition;<sup>209</sup> (3) registration and filing of the shareholders' agreement and amendments which, among other provisions, would specify the minimum amount of capital contributed to the business by each shareholder and all additional contributions whether by loan or otherwise;<sup>210</sup> (4) limitation of shareholder's personal liability to the extent of his specified capital contribution and additional sums contributed to the business;<sup>211</sup> (5) proceedings for the termination or acquisition of close corporate status by corporations ceasing or commencing to meet the definitional test;<sup>212</sup> (6) full partnership treatment for failure to comply with the provisions of the Act regarding requisite filings or transfer from close corporation to regular corporation status or vice versa;<sup>213</sup> and, provisions for discretionary court action in the event of substantial shareholder dissension or deadlock. Of course for tax purposes we would need to denominate such a statute a "corporation" statute of some variety so as not to upset the delicately balanced equities and inequities currently built into the federal income tax structure.<sup>214</sup>

This concept is not new.<sup>215</sup> It has been resisted on many grounds, the most formidable of which is probably the practitioner's own stubborn, tenacious clinging to the traditional, the "tried and true." Although the practitioner's magnificently devised plan may be of uncertain validity, it has "gotten by" in the past, and, at least as important, he knows the amount of income which can be generated by the simple incorporation

<sup>208</sup> The close corporation must be defined in such a way as to catch the essence of its heterogeneous nature while at the same time furnishing the practitioner and the businessman an objective test. A proposed cut-off point is suggested at thirty-five per cent ownership by non-participating shareholders, i.e., true investors. United Kingdom Finance Act of 1965, Statutes Supp. 150, sched. 18, pt. I, §§ 1-6, utilizes such a definition in conjunction with rules attributing ownership to close relatives.

<sup>209</sup> It is desirable to insure that the regular corporate statute is not used in such a way as to oppress minority interest. With a separate statute for the close corporation, the regular corporation statute should be stripped of its ad hoc provisions desirable only for the close corporation. With such provisions removed, the regular corporate statute could become an instrument of abuse if permitted to be used for the close corporate business.

<sup>210</sup> Notice of the arrangement *inter se* and the minimum amount of capital would be given creditors and other intended parties by such filing. It is assumed that a minimum amount of capitalization would be established in the statute. Additional contributions to capital would require filings to so advise creditors, if any were in fact depending upon such filing for notice. In any event, filing provides a central source for obtaining such information when desired.

<sup>211</sup> The idea of requiring a businessman to risk his entire capital and family fortunes in his business venture should have disappeared with the dark ages. Most creditors have become adequately sophisticated to provide for their own protection. Further, the institution of insurance has become commonplace, and in most states is required to provide funds for the more frequent and usual tort claimants.

<sup>212</sup> Obviously required are the mechanical methods by which a corporation initially outside the close corporation definition proceeds when it falls within such definition through stock purchase or otherwise. Similar procedures are required when the definition ceases to apply to a corporation previously filed as a close corporation.

<sup>213</sup> Teeth are put into the filing requirements by providing for partnership treatment in the event of non-compliance. Such provision can, of course, be tempered as desired.

<sup>214</sup> The taxation of the close corporation and the current delicate balance of equities and inequities which exist in the present federal income tax structure have been developed in J. Wolens, *Taxation and the Paper Tiger*, 1968 (unpublished thesis, Harvard Law School Library).

<sup>215</sup> E.g., Kessler, *With Limited Liability for All: Why Not a Partnership Corporation?*, 36 *FORDHAM L. REV.* 235 (1967); and partnership-like treatment was suggested in 1943, Winer, *supra* note 1.

procedures. It is suggested that the practitioner's income would not be adversely affected by the proposed change, and once the basic format for the "close corporation agreement" has been worked out (which can be printed as a suggested form in the statutory material),<sup>216</sup> the practitioner would have little trouble adapting it to fit the specific desires of his clients.

The new close corporation statutes have taken the corners off the square hole; why not make it a perfect circle and hence, a perfect fit for our round peg—the close corporation.

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<sup>216</sup> E.g., TEX. BUS. CORP. ACT art. 3.02 (1955).

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