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The Close Corporation in California—Necessity of Separate Treatment

By ROBERT L. OPPENHEIM*

THE CLOSE CORPORATION is in essence a partnership with limited liability.1 The usual corporate separation of ownership from management does not exist. It would seem, therefore, that the doctrines created to service an organization where ownership is separated from management should have little or no application to close corporations.2

The purposes of this article are to examine some of the more well defined needs and practices of close corporations; to determine the extent to which these needs are recognized and allowed by present California law; to inquire into the desirability, and in some instances to suggest the adoption, of changes in present corporation law which would more adequately recognize these needs and practices. This article will attempt to justify a separate and independent treatment of the problems peculiar to close corporations; it being the author’s opinion that attempts to apply the same principles to both public issue and close corporations can lead only to confusion.3

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2 "It would seem that an intelligent approach to the general problem of incorporation would require at least three types of general incorporation laws in each state: One for the single incorporator, another for the small concern, and a third for the extensive business . . . ." Rutledge, Significant Trends in Modern Incorporation Statutes, 22 WASH. U.L.Q. 305, 339 (1937).

3 The need for separate statutory regulation of close corporations had been recognized in some jurisdictions. Of particular note is the new North Carolina Business Cor-
What Is a Close Corporation?

At present, California has no statutes specifically recognizing the close corporation as a distinct form of business association. But occasional judicial recognition of the basic differences between close and public issue corporations is not sufficient to cope with the problems presented by the nature of close corporations. It seems essential to the proper administration of all corporations that separate statutory treatment be given to some aspects of the close corporation. Separate treatment is necessary because it would be improper to allow a public issue corporation the same freedoms here recommended for a close corporation. If a separate treatment of close corporations is to be employed, a definition of the species must first be set forth.

Close corporations are usually characterized by: (1) substantial identity of ownership and management; (2) ownership by a small number of shareholders; (3) no general market for the stock, and (4) some limitation upon admission of shareholders. A statutory definition of a close corporation, which is necessary to any special treatment of the problems of such corporations, should encompass most of these characteristics. The North Carolina Business Corporations Act is the only statute which limits its application, in any extent, to close corporations. This Act defines a close corporation as one where it is not the case that “shares of the corporation are at the time or subsequently become generally traded in the markets maintained by securities dealers or brokers. . . .” This definition seems inadequate. It encompasses only one of the characteristics of close corporations. Furthermore, it is sufficiently vague that it would give rise to much litigation. A more definite, though perhaps more arbitrary, definition placing a

4 Several sections of the Corporations Code treat the problems of close corporations but such sections are also applicable to public issue corporations. See note 3 supra.


6 1 O'Neal 13; Schwarzer, CEB 403.


8 See note 3 supra.

9 N.C. GEN. STAT. ANN. § 55-73(b) (1960).
limit on the number of shareholders would seem more desirable. The following definition is suggested:

(A) A corporation shall be considered a close corporation for purposes of this statute when:
   (1) The number of shareholders does not exceed ten.\(^\text{10}\)
   (2) Its articles prohibit any invitation to the public to subscribe for any shares of stock, either common or preferred, in the corporation.

(B) A corporation shall not be considered a close corporation if one of its stockholders is itself a corporation which is not a close corporation.

(C) It is not necessary that the articles of incorporation of a close corporation place a restriction on the transfer of its shares, but if at any time such shares become generally traded in markets maintained by securities dealers and brokers, or the number of stockholders exceeds ten, the corporation shall cease to be considered a close corporation.

(D) A person shall not be considered a shareholder in the corporation solely because of his (or her) community property interest in the stock of his (or her) spouse.\(^\text{11}\)

The Close Corporation as a Separate Entity—
The Alter Ego Doctrine

It is important to recognize the partnership-type character of close corporations. The courts, however, tend to over-extend the concept and often look through the corporation to hold the shareholders liable for its acts. The resulting “alter ego” doctrine is one of the most perplexing aspects of close corporation law. The doctrine is particularly perplexing because of the various situations to which it is applied.

\(^{10}\) Though any limitation of this type is to some extent arbitrary, the limitation on the number of shareholders was set at ten for two reasons:
   (1) It is felt that the number of stockholders should be low;
   (2) Subchapter S (Int. Rev. Code of 1954 §§ 1371-77) gives shareholders of a corporation having less than ten shareholders an option to be taxed essentially as if they were in partnership. Section 1371(a)(1). It is thought that this ability to avoid the double taxation associated with the corporate form will increase the popularity of the close corporation to low income businesses. It was therefore felt to be advisable to integrate the close corporation regulatory statute with the taxing statute.

One type of problem is that which arises where a stockholder acts and the corporation either seeks to benefit, or a third party seeks to bind the corporation by this action. On occasion the courts have held that stockholder’s action cannot bind the corporation because the particular activity can only be transacted by the board of directors. This has been so held even though the particular shareholders were also the directors. In such situations the close association between ownership and management that is inherent in a close corporation demands that the shareholders be recognized as proper agents of the corporation. In a close corporation the formalistic organization of public issue corporations performs no useful function. Any reference to it as a binding pattern governing corporate activity leads only to confusion when discussing close corporations. The close corporation should be bound by or entitled to the benefits of shareholders acts regardless of whether at the time of the transaction the individuals were acting in their capacity as shareholders rather than as directors or officers.

There appears to be a growing tendency to recognize shareholders’ authority to bind the corporation. However, it is proposed that a statute of the type set forth below would assure judicial recognition of this business reality:

A holder of the voting stock of a close corporation shall be considered an agent of the corporation for the purpose of its business, and the acts of any such stockholder shall bind the

14 Gashwiler v. Willis, 33 Cal. 11 (1867); Chapman v. Sky L’Onda Mutual Water Co., supra note 13. In Gashwiler v. Willis, supra, a deed executed by three of five stockholders upon authority of a vote of the stockholders was void as to the corporation because the vote was by the stockholders in their capacity as stockholders rather than in their capacity as directors. This case has been cited and followed often. See, e.g., Hotaling v. Hotaling, 193 Cal. 368, 224 Pac. 455 (1924).
15 Id. A related problem is the binding effect on the corporation of a shareholder’s agreement. This will be discussed at another point in this article.
16 “[T]he separate entity concept should be viewed only as a shorthand formula for summarizing the attributes of a corporation for a fairly long list of legal issues in the solution of which the corporation is to be viewed as if it were a person distinct from the shareholders. (This list would include such important issues as liability for corporate debts.) It should not be used as the dogmatic premise from which, by sheer logic, one drives to the seemingly inescapable conclusion that whatever be the issue, the corporation is something completely separate and apart from the shareholders, let the chips fall where they may.” Latty, A Conceptualistic Tangle and the One- or Two-Man Corporation, 94 N.C.L. Rev. 471, 472 (1956). BALLANTINE & STERLING, CALIFORNIA CORPORATION LAWS 79 (1949).
corporation; unless by the articles, by-laws or vote of the board of directors, authority to bind the corporation has been withheld from such stockholders and the person with whom the stockholder is dealing knew of such lack of authority. An act of a stockholder which is not apparently for carrying on the business of the corporation in the usual way does not bind the corporation unless authorized by a vote of the shareholders.

The problem arising when third persons seek to bind the shareholders for debts of the corporation is different than that arising from attempts to bind the corporation for shareholder actions, and requires a different solution. In regard to the latter problem it was above said to be desirable to disregard the separate character of the corporation. In the problem of imposing liability on the shareholders, however, the corporations separateness should be preserved. Once the limited liability concept is justified it should not be disregarded because of the mere fact that the shareholders are few in number,\(^\text{17}\) or that they perform all the corporate functions without conforming to corporate formalities,\(^\text{18}\) or that they are in a "unity of interest" with the corporation.\(^\text{19}\) However, if a corporation is inadequately financed, or by means of their greater knowledge of corporate affairs and their opportunity for controlling corporate assets, the shareholders have used the corporation as a shield in defrauding creditors, liability should be imposed directly on such shareholders.\(^\text{20}\) "Alter ego" should play no part in such situations. It should be the character of the transaction rather than the character of the corporation upon which shareholder liability is based.

An example of a situation where the separate corporate entity should not be, but is, adhered to is found where a shareholder is

\(^{17}\) Minifie v. Rowley, supra note 13.


\(^{19}\) It is language such as the following quote that creates "alter ego" problems: "Before the acts and obligations of a corporation can be legally recognized as those of a particular person, and vice versa, the following combination of circumstances must be made to appear: First that the corporation is not only influenced and governed by that person, but there is such a unity of interest and ownership that the individuality, or separateness of the said person and corporation has ceased; second, that the facts are such that an adherence to the fiction of the separate existence of the corporation would, under the particular circumstances, sanction a fraud or promote injustice. . . . It is not necessary . . . that the complaint allege actual fraud; it is sufficient if the facts set forth disclose that the dealings were in form with a corporation but in reality with an individual and that a refusal to recognize this fact will bring about inequitable results." (Emphasis added.) Minifie v. Rowley, supra note 13, at 487-88, 202 Pac. at 676. See also Wenban Estate Inc. v. Hewlett, supra note 13; Judelson v. American Metal Bearing Co., 89 Cal. App. 2d 255, 200 P.2d 836 (1948).

allowed to become a secured creditor of the corporation. The case of *Middleton v. Astrastraville Mining Co.*\(^{21}\) illustrates the inequities of such a situation. Plaintiff, general manager of the corporation and holder of 40 per cent of its stock, sued to foreclose a mortgage on corporate property. Parties seeking to assert wage liens intervened as defendants. It was held that since plaintiff’s mortgage was recorded first he had a priority even though the labor giving rise to defendants’ wage liens was performed at plaintiff’s request.

This is a prime example of the inequity and capacity for fraud which is created by allowing a shareholder of a close corporation to become a secured creditor of the corporation. It is suggested that an approach similar to that taken by the Uniform Partnership Act\(^{22}\) would be proper in respect to close corporations. A stockholder should not be allowed to be a secured creditor except as to other stockholders, and any debts owed by the corporation to a stockholder should be postponed until the debts owed to non-stockholding creditors have been satisfied.

Legislation dealing with the problem of a shareholder asserting himself to be a preferred creditor seems easy to devise. The problems arising from other types of fraudulent use of the corporate shield are more difficult to cure. The decisions by the nature of the problem turn on delicate questions of fact. No legislation can provide an answer to just when the corporation becomes a shield for fraud. It is proposed, however, that a general recognition of the independent character of a close corporation and the organization’s inherent and desirable flexibility will indicate the legislature’s desire that the courts refrain from assessing personal liability because of factors that are primarily matters of form.

**Intra-Corporate Relationships**

**A. Introduction**

The preceding discussion was concerned with the relationship of the close corporation with non-stockholders. The remainder of this article will be concerned with the relationship of the shareholders with each other and with the corporation. It is in connection with this aspect of the close corporation that the greatest reform is needed. The formalities imposed on public issue corporations are justified by the wide distribution and the correspondingly strong public interest. There is, however, little or no public interest involved in regulating

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\(^{22}\) CAL. CORP. CODE §§ 15001-45.
the internal structure of close corporations. "When there is substantial identity between the shareholders and the directors . . . the elaborate statutory machinery of corporate government tends to be an obstacle to the making of internal arrangements which the partners want and which do not harm anyone else."28

Stockholders in a close corporation often seek to circumvent the formalities imposed on public issue corporations and achieve a partnership type relationship by use of appropriate provisions in the articles24 and by-laws25 of the corporation and by contracts among themselves known as shareholders' agreements. The validity of the provision often depends on where it is found26 (articles, by-laws, or shareholders' agreement) and its purpose.27 Generally, articles and by-laws are subject to more rigid control28 than are shareholders' agreements.29 This is indicated by the dictum in Oakland Scavenger Co. v. Gandhi,30 where the validity of a by-law restriction on transferability of stock was in issue. There the court said: "A by-law adopted by a majority vote binds stockholders who do not assent. Even a by-

23 A Plea for Separate Statutory Treatment of the Close Corporation, 33 N.Y.U.L. Rev. 700, 744 (1958). It is further stated in that article at 745 that "as a matter of policy, there is no justification for a formalistic—perhaps one might even say sadistic—insistence upon unnecessary and inevitable internal structure or operational organization as a condition of limited liability in the close corporation."

24 "The articles may include any desired provisions: . . . (c) Imposing any limitations and requirements authorized by this division, and otherwise regulating the business and affairs of the corporation and the powers of the directors and shareholders in a manner not in conflict with the law." CAL. CORP. CODE § 501.

25 CAL. CORP. CODE § 501 which specifies several subjects of permissible by-law provisions, states: "The by-laws of a corporation may make provisions not in conflict with law of its articles for: . . . (k) any other proper and lawful regulations."


27 1 O'Neal 243; e.g., Dulin v. Pacific Wood & Coal Co., 103 Cal. 357, 35 Pac. 1045, 37 Pac. 207 (1894). (Purpose of contract was to maintain A as officer. Invalidated accompanying agreement to elect him a director.)

28 The case for rigid control is set forth in BALLANTINE & STERLING, CALIFORNIA CORPORATION LAWS 53 (1949): "Articles of incorporation are not merely a contract between the incorporators or organizers as to their own enterprise. They are much more, viz., the constitution of a continuing business association to consist of a shifting of group associates who are expected to invest their money in the enterprise, or take by transfer the places of those who have invested. Future shareholders who contribute the capital have no voice in drafting the articles and most of them invest without reading the articles to ascertain provisions which may deprive shareholders of their customary rights and protection. Special and unusual provisions may thus prove traps for unwary investors and give opportunity for abuse and oppression by the management."

29 "Articles, but not shareholders' agreements or by-laws, are subject to the jurisdiction of the Secretary of State; articles, by-laws, and those shareholders' agreements which pertain to the issue of securities or to which the corporation is a party are subject to examination by the Commissioner of Corporations." SCHWARZER, CEB 410.

30 51 Cal. App. 2d 69, 124 P.2d 143 (1942).
law, if invalid, may operate as a binding agreement on those who assent to it, if not opposed to public policy as a contract." \(^{31}\) (Emphasis added.)

However, it must be noted that there may be limitations on the extent to which a corporation will be bound by contracts to which it is not explicitly made a party, or where it has not expressly adopted the contract. \(^{32}\) This should be kept in mind when examining the extent to which various intra-corporate policies desired by the shareholders may be implemented by provisions in the articles, by-laws, shareholders' agreements or by any combination thereof. A careful choice of the method to be used to accomplish the desired result is necessary.

As previously stated, shareholders in a close corporation are desirous of escaping the corporate norms applicable to public issue corporations. They seek, and it is felt should be allowed, to formulate their own intra-corporate policies.

The subject of these intra-corporate policies are listed by O'Neal as follows: \(^{33}\)

1. how the shares of the parties to the agreement are to be voted in elections of directors;
2. who are to be the officers of the corporation;
3. long-term employment arrangements for some or all of the participants;
4. the salaries to be paid shareholder-officers;
5. the power one or more of the participants is to have to veto corporate decisions;
6. the circumstances in which dividends are to be declared; and
7. a method of resolving corporate disputes, e.g., an arbitration provision or some method for dissolving the corporation in the event of dissension or deadlock among the shareholders or directors.

It should be noted that the above list pertains only to the management or actual everyday operations of the corporation. There are also some non-management problems that require special treatment in a close corporation. Representative of these are buy out arrangements, non-competition clauses and stock transfer restrictions. \(^{34}\)

**B. Stock Transfer Restrictions**

Shareholders in a close corporation often consider themselves partners. There are few stockholders and generally they take an active part

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\(^{31}\) *Id.* at 81, 124 P.2d at 150. See also Vannucci v. Pedrini, 217 Cal. 138, 17 P.2d 706 (1932); Fawkes v. Farm Lands Inv. Co., 112 Cal. App. 374, 297 Pac. 47 (1931).

\(^{32}\) *Peek v. Steinberg*, 163 Cal. 127, 124 Pac. 834 (1912).

\(^{33}\) *O'Neal* 224.

\(^{34}\) The related problems of buy out arrangements and non-competition clauses are not discussed in this article.
in the management and operation of the business. Also the corporation is often the "family business." For these reasons the stockholders are very interested in who their fellow stockholders may be. To protect themselves from the contingency that shares will come into the possession of objectionable persons, the shareholders place restrictions on the transferability of shares. It has been stated:35

Restrictions upon the transferability of shares most commonly fall under one of the following types:

1. a preemptive or optional right in favor of the corporation to purchase in preference to outsiders;
2. the reservation of a similar right in favor of other shareholders;
3. the requirement of approval or consent of the directors or shareholders to a transfer;
4. a limitation on the classes of persons to whom a transfer may be made;
5. a reservation of a lien upon shares to secure debts due to the corporation.

All of these restrictions to varying degrees violate the policy of maintaining freedom of alienability. Their validity, therefore, is said to rest on their reasonableness.36 The test has been said to be "whether the restraint is sufficiently needed by the particular enterprise to justify overriding the general policy against restraints on alienation."37 Generally, absolute prohibitions on transfer are invalid.38 However, the recent amendment to the California Civil Code,39 abolishing the statutory rule against the suspension of alienation arguably could indicate a tendency toward more liberal treatment of absolute prohibitions.

A restriction giving existing shareholders a right to veto the seller's choice of a purchaser is known as a consent provision. No cases were found in California dealing directly with consent provisions although the provision in *Oakland Scavenger Co. v. Gandi*40 was very similar

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35 **BALLANTINE & STERLING, CALIFORNIA CORPORATION LAWS 71 (1949).** See also 2 O'NEAL 6.

36 **CAL. CORP. CODE § 501 states:** "The by-laws of a corporation may make provisions not in conflict with law or its articles for: . . . (g) Special qualifications of persons who may be shareholders, and reasonable restrictions upon the right to transfer or hypothecate shares." Note that under a strict construction of this statute qualifications for shareholders may be unreasonable. It is doubtful, however, that any unreasonable restriction or qualification would be upheld.

37 2 O'NEAL 10.

38 **But see Smith v. S.F. & N.P. Ry. Co., 115 Cal. 584, 47 Pac. 582 (1897),** where a voting trust which included an absolute reservation of voting rights on any shares transferred was upheld.


40 51 Cal. App. 2d 69, 124 F.2d 143 (1942).
to a consent provision. There a restriction making the corporation a trustee of the deceased stockholder for purposes of selling his stock was upheld. The status of consent provisions in other jurisdictions is unsettled. California Corporations Code section 501 (g) allows a by-law provision setting forth "... special qualifications of persons who may be shareholders. ..." A broad construction of this section would seem to provide a basis for the validity of consent provisions.

The use of first option provisions, which are also known as a right of first refusal, seems to be the generally recommended form of stock transfer restriction. These provisions give the continuing stockholders a right to purchase, at their option, before the seller may offer stock to outsiders. Such provisions however, are not without problems in California.

These restrictions may properly be placed in the articles, by-laws, or in a shareholders’ agreement. The choice of which of these instruments is to be used is an important one and should be carefully made.

Such significant issues as the amendability of the restriction may depend on where it is found. A restriction placed in the articles may require a two-thirds vote for amendment, whereas a by-law provision or a shareholders’ agreement can probably provide for any reasonable amendatory procedure involving at least a majority vote. There also may be some problem as to the binding effect of a share-

41 This agreement was really more in the nature of a limitation on the type of person who could be a successor than a consent provision.
43 2 O’NEAL 13; SCHWARZER, CEB 431; Hornstein, Judicial Tolerance of the Incorporated Partnership, 18 LAW & CONTEMPO. PROB. 435, 446 (1953).
45 CAL. CORP. CODE § 501 (g).
47 In Thomsen v. Yankee Mariner Corp., supra note 44, an article giving shareholders a first option could not be amended with the two-thirds vote provided for in CAL. CORP. CODE § 3634 (h). Section 3634 (h) requires a two-thirds vote “to diminish or alter adversely any options or rights theretofore granted to the holders thereof to purchase other shares of the corporation.”
48 However, the by-laws themselves could provide for a greater than majority vote for amendment. CAL. CORP. CODE § 500.
49 It has been suggested that a shareholders’ agreement would require unanimous consent for amendment unless otherwise specified in the agreement. SCHWARZER, CEB 411.
holders' agreement on the non-assenting shareholders,\textsuperscript{50} whereas an article or by-law passed by a majority would bind all shareholders whether or not they assented. Wherever the restrictive provision is placed, the fact of the restriction must be noted on the face of the stock certificate.\textsuperscript{51}

Restrictive provisions are subject to review by either the Secretary of State\textsuperscript{62} or the Commissioner of Corporations\textsuperscript{56} or both, and may be disapproved if the consideration is found to be inadequate\textsuperscript{54} or if in any other way the agreement is found to be improper. There is a possibility, however, that even though either of those officials disapproves of a provision it still may be enforced by the courts as a valid shareholders agreement.\textsuperscript{55} Note, however, that the Commissioner will probably examine even non-by-law shareholder agreements connected with the issuance of stock and a disapproval by him would render stock issued in violation of his order void.\textsuperscript{56} It would seem that public policy would demand that contracts concerning the transfer of such stock, or the interest represented thereby, would also be void.

A recent opinion of the Attorney General casts some doubt on the extent to which the Commissioner may require his approval of stock transfer restrictions.\textsuperscript{57} It was held that the Corporate Securities Act\textsuperscript{58} did not require submission of a shareholders' agreement restricting the transfer of the previously issued stock of a three man corporation, and that the agreement, so far as it gave an option to the shareholders, was not within the terms of the Act.\textsuperscript{59} The sale to the corporation would not require a permit either. Therefore it was not necessary to require a permit before entering into the shareholders' agreement. It should be noted, however, that the shares were already issued and

\textsuperscript{50}Oakland Scavenger v. Gandi, 51 Cal. App. 2d 69, 124 P.2d 143 (1942).
\textsuperscript{51}CAL. CORP. CODE § 2404; Vannucci v. Pedrini, 217 Cal. 138, 17 P.2d 706 (1932); Mancini v. Patrizi, 110 Cal. App. 42, 293 Pac. 828 (1930). This requirement is also found in the UNIFORM STOCK TRANSFER ACT § 15, 6 U.L.A. § 15. There is a problem whether the agreement itself or merely notice thereof must appear on the certificate.
\textsuperscript{52}See note 29 supra.
\textsuperscript{53}Id.
\textsuperscript{54}Vannucci v. Pedrini, supra note 51, allowed an agreement where purchase price was set at book value. It has been suggested that the Secretary of State and Commissioner of Corporations would be more likely to approve a valuation set by formula.
\textsuperscript{58}CAL. CORP. CODE §§ 25000-26104.
the opinion is based on the finding that a sale to either the shareholders or the corporation was not within the Act. An agreement connected with the initial issuance of the securities may present a different problem. The Commissioner could probably refuse to permit such issuance on condition of examining and approving any shareholders' agreements affecting the transferability of the stock. It would seem that the exemption from the Commissioner's perusal afforded by this option will be limited to agreements entered into subsequent to the initial issuance of stock.

There are two basic types of options, those running to the shareholders and those that give the corporation a right to purchase the stock directly.

Even though an option going to the shareholders will probably be valid it may not be advisable. An important aspect of the management of a close corporation is the balance of control between its shareholders. An offer to the remaining shareholders may find one shareholder unable to meet the purchase price. This could bring about a drastic change in the balance of power. Also, it is often the case that the stockholders have most of their funds invested in the corporation. Withdrawal of such funds to buy this stock may be possible only by means of costly dividends and may drain the corporation of needed working capital.

Another problem connected with a purchase by the shareholders is based on the fact that several shareholders will also be directors and officers of the corporation. A sale to them may give rise to problems concerning their fiduciary duty to the seller.

If the option is made to run to the corporation many of these problems are avoided. The problem of draining corporate working capital would still exist. However, payment will probably be more easily achieved because there is little problem that a tax on dividends will be imposed. Further, though either method will cause a difference in each stockholder's proportion of the whole, there is no chance

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61 This will not be a problem if the corporation elects Subchapter S treatment. Int. Rev. Code of 1954, §§ 1371-77.


63 When the corporation pays for the stock out of its earnings and profits, the Internal Revenue Service may assert this is a dividend to the continuing shareholders. This argument succeeded in Louis Zipp, 28 T.C. 314 (1957), aff'd Zipp v. Commissioner, 259 F.2d 119 (6th Cir. 1958). However, the case of Holsey v. Commissioner, 258 F.2d 865 (3rd Cir. 1958), found this not to be a dividend. The Commissioner has acquiesced, Rev. Rul. 58-614, 1958-2 Cum. Bull. 920. See Rice, Family Tax Planning 521-522 (State Bar of Cal., Comm. on Continuing Education of the Bar, 1959).
of a drastic shift in the balance of power due to the lack of liquidity of one stockholder. Further, ownership of the stock by the corporation may facilitate the admission of a new shareholder\textsuperscript{64} since a sale by the shareholders would be subject to taxation on any gain therefrom, whereas a sale by the corporation of its treasury stock would be tax free.\textsuperscript{65}

However, the validity of first options to the corporation has not always been certain in California.\textsuperscript{66} The present limitations on the corporation's ability to purchase its own stock are found in sections 1705 to 1708 of the Corporations Code. Most important of these sections for present purposes is section 1707 which states:

A corporation may also purchase shares issued by it, or by a corporation of which it is a subsidiary, in any of the following cases:

\begin{itemize}
\item[(b)] From surplus resulting from a reduction of stated capital, subject to provisions of section 5 of this part.
\item[(c)] Subject to any limitations contained in its articles, out of earned surplus . . . .
\end{itemize}

It would seem then that any restriction giving an option to the corporation should state that the corporation can purchase only out of earned surplus or reduction surplus in order for the option to be valid. Perhaps an agreement could validly bind the shareholders to reduce stated capital to create sufficient surplus to purchase the stock. It should be noted that paid in surplus is not available for the purchase of the corporations' own securities. No justification for this is apparent, especially in light of the 1957 amendment releasing paid in surplus for payment of dividends.\textsuperscript{67}

The validity of stock transfer restrictions is generally recognized in California today. However, in order to clarify and, in some ways, alter the present law on this subject, it is recommended that something in the nature of the following statute be adopted:

The articles or by-laws of a close corporation may set reasonable qualifications for shareholders, provide for transfer by a shareholder of stock only with consent of the other shareholders, or create other reasonable restrictions upon the right to transfer or hypothecate shares.

It is also suggested that an amendment to California Corporations

\textsuperscript{64} However, it should be noted that a subsequent sale by the corporation would probably require a permit, but a subsequent sale by the shareholders might be exempt under \textit{Cal. Corp. Code} § 25152.
\textsuperscript{65} \textit{Int. Rev. Code} of 1954, § 1032.
Code section 1707 be made authorizing the purchase by a corporation of its stock out of paid in surplus.

C. Management of Corporate Affairs—Control Devices

1. Introduction

Stockholders in a close corporation often want to be treated as partners among themselves. The minority shareholders want to have an active voice in the business, and perhaps an ability to veto outrageous action by the majority. The majority wants protection from being “blackmailed” by a “vetoing” minority shareholder. High income shareholders want to leave the profits in the business for purposes of expansion; lower income shareholders want some sort of guaranteed income. Generally, all shareholders want to be free to operate quickly and flexibly without the concern that disregard to corporate formalities will destroy their limited liability.

Obviously, not all of these interests can be satisfied. However, it is urged that the shareholders of a close corporation should be left free to determine solutions to these problems.

Presently, however, any attempts by the stockholders in a close corporation to escape the needlessly binding formalities of corporate norms must overcome the restrictions imposed by, and the control of the Commissioner of Corporations. It seems difficult to justify the Commissioner’s powers in controlling the methods of arranging the internal affairs of a close corporation since no public interest is there involved.

The traditional corporate framework includes a board of directors who are the actual operational managers. This public issue corporation oriented delegation of powers is of questionable value in a close corporation since the shareholders, directors and officers of a close corporation often are identical. One state, Iowa, has recognized this and has dispensed with the requirement of a board of directors. It would seem that in such a jurisdiction the opposition to management by agreement, or informal management procedures, would be greatly reduced.

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68 The purpose of this expansion is a possible sale of the corporation and the realization of capital gain. E.g., In re Security Finance Co., 49 Cal. 2d 370, 317 P.2d 1 (1957).

69 The theory is also questionable. “The theory that the corporation conducts its normal operations only through directors is based upon the unfounded assumption that there is a traditional division of corporate functions. However, some of today’s so-called ‘norms’ are the precise reverse of earlier practices. Shareholders in the eighteenth century voted directly on certain matters of corporate policy and appointed executive officers.” William H. Neiman, in Panel Discussion, Proceedings at the Annual Meeting of the Section of Corporation, Banking and Business Law, Chicago, Ill., Aug. 16-17, 1954, in 10 Business Lawyer 9, 36 (1954).

California, however, retains the formal requirement of a board of directors in which all corporate power is vested. Any attempts to fix management policies by prior agreement or to circumvent the confining formalities of corporate procedure must contend with section 800 of the Corporations Code which states: 71

Subject to limitations of the articles and of this division as to action which shall be authorized or approved by the shareholders, all corporate powers shall be exercised by or under authority of, and the business and affairs of every corporation shall be controlled by a board of not less than three directors.

Although some shareholder control evidently is allowable, this section, and the philosophy represented thereby, has been used to strike down many types of intra-corporate agreements and policy decisions on the ground that they “withdraw from the directors of the corporation that control and direction of its corporate affairs, business and management which is vested in them by law . . . .” 72 This does not mean, however, that all agreements concerning management of the corporation will be void. 78 The courts have said that those agreements causing only a “slight infringement” 74 on the authority of the directors will be valid. Obviously this provides no guide to future action and an examination of specific problems and possible solutions is necessary.

2. Control Through Stock Ownership

The stockholders in a close corporation being forced to recognize the board of directors as the ultimate authority, will want representation on this board. A minority shareholder especially is interested in having an active voice in the management.

The degree of representation on the board of directors depends on the number of shares held by each shareholder. There would be no problem of attaining equal representation if each shareholder contributed an amount of capital in proportion to the others entitling him to the agreed degree of control. Unfortunately, many prospective shareholders often are not going to invest anything but a nominal amount of capital and the unmeasurable value of their future services.

It would be a perfectly valid arrangement in a partnership for

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71 The requirement of three directors often causes the appointment of “dummy directors.” This can be a dangerous practice if the “dummy” is “bought” by one of the actual owners. See Carroza v. Millington, 142 Cal. App. 2d 28, 297 P.2d 778 (1955); cf. Mannon v. Pesula, 59 Cal. App. 2d 597, 139 P.2d 336 (1943).


such an investor to be given an equal voice in the management. However, in a close corporation it is questionable if the issuance of shares for future services will be proper.

California Corporation Code section 1109 states:

No shares of stock... shall be issued except in consideration...

(c) Services actually rendered.

If authorized in its articles or by-laws, a corporation may issue the whole or any part of its shares or its certificates for shares prior to full payment under such restrictions as are imposed by this division.

This section would seem to be a complete bar to the issuance of stock for future services. It has been widely held in other jurisdictions that the words "work done" or "services rendered" do not include future services. Indeed this is the fair import of these words and the California statute seems to clearly impose this meaning.

It should be noted in this connection that the corporation may issue shares though not fully paid up. Such shares are subject to certain restrictions such as dividends proportionate only to the value paid of the total amount due, and the possible subjection to assessment by creditors. They may, however, be validly issued even though there is to be a future payment of cash or property. Arguably, future payment of services should be treated no differently than future payment of cash or property. All are treated by section 1109 in the past tense: "money paid," "property... received," and "services... rendered." However there is a problem in enforcing a contract for future services that does not appear in contracts for payment of money or property. In spite of such problems, however, it is felt the parties should be allowed to distribute control on the basis of services to be rendered.

An auxiliary problem that must be faced is that arising where stock is issued for future services where the recipient shareholder not only gets a voice in management, but also gets an interest in the corporation's assets which is disproportionate to his investment. This may be objectionable to an investor who, though willing to relinquish some of his control, is not willing to relinquish his interest in his investment.


76 Also the corporation can set a valuation on shares issued other than for cash. Cal. Corp. Code § 1112. The corporation will be estopped to contest the validity of shares it has issued as paid up. California Trona Co. v. Wilkinson, 20 Cal. App. 694, 130 Pac. 190 (1912).


Devices such as classification of stock or use of preferred as well as common stock overcome this problem. However, they also destroy any chance to use Subchapter S.

A minority shareholder can be assured some degree of representation through cumulative voting, which is mandatory in California. A directorship secured through cumulative voting is protected from arbitrary removal by the majority by a provision that the removal of a director may be vetoed by the cumulated votes needed to elect him. However, this may not be satisfactory to a minority shareholder who wants an equal voice and because of his talents is entitled to it.

As said above, a partnership could easily solve this problem by an agreement that each partner should have an equal voice in the management regardless of his capital contribution. Although in Cardoza v. Millington, a California court created equal voting rights where the shareholders’ capital was unequal in order to prevent injustice, it is doubtful that an agreement to distribute voting power in a manner divergent from shareholdings would be allowed either by the Commissioner of Corporations or the courts. Further, it would seem that Corporations Code section 2216 would prohibit use of such a device. It states that “if there is only one class of shares outstanding which is not divided into series, or if there is only one series of shares outstanding, any limitations or restrictions imposed on the voting rights of shareholders shall be ineffective.” It is submitted that to give any shares a disproportionate voting power would have the effect of placing a restriction on the other shares and as such would be a violation of this section. It is thus apparent that a forthright arrangement whereby a stockholder is given more votes than his shares of stock would otherwise warrant will be stricken down. Such arrangements may be possible to a limited extent, however, by more devious means.

79 “Corporations Code Section 1100 now permits the articles to authorize almost all possible combinations of classes, series and kinds of shares, including classes of different par values, par value and non-par, and with full, limited or no voting rights.” Ballantine & Sterling, California Corporation Laws 127 (1949).
80 A tax option can have only one class of stock. Int. Rev. Code of 1954, § 1371 (a)(4).
82 Cal. Corp. Code § 810. Note that a simple majority can remove the whole board. Of course cumulative voting will protect the minority shareholder in a subsequent election.
83 142 Cal. App. 2d 26, 297 P.2d 778 (1956). Here a corporation was formed to continue an active partnership. The incorporation agreement gave each partner a right to stock equivalent to their capital in the partnership. One partner failed to withdraw any capital and thus attempted to claim a larger portion of stock than the other. Cf. Kaufman v. Meyberg, 59 Cal. App. 2d 730, 140 P.2d 210 (1943).
84 See Nickolopoulos v. Sarantis, 102 N.J. Eq. 585, 141 Atl. 792 (Ct. of Err. & App. 1928) (agreement to give holder of 25% of the stock 50% of the voting power was
3. **Pooling Agreements, Voting Trusts, and Proxies**

Other methods by which voting may be controlled or a veto may be created are pooling agreements, proxies, voting trusts, high quorum requirements and requirements for higher than a majority vote. These provisions are not limited merely to the selection of directors but can be used in connection with other aspects of shareholder action.

Pooling agreements are used to assure that the stock of a group of shareholders will be voted in the manner directed by a specified percentage of that group. It is useful to several smaller shareholders who seek to protect themselves from the dictatorship of a large shareholder, or to unite so as to give themselves control. There is no doubt as to the validity of a pooling agreement in California; the only problem is the enforcement of the agreement.

The usual method of enforcing a pooling arrangement is by means of a proxy system. These proxies may be given to the other members of the agreement or to an independent arbitrator to vote in accordance with the decision of the members to the agreement.

Proxies are limited to a period not exceeding seven years. A pooling agreement created for twelve years giving a proxy to X for the first five years to vote the stock in conformity with the will of the majority of the members of the agreement was void as exceeding the seven year time limit. Note that the whole agreement was void, not just that part in excess of seven years. No justification is evident for not allowing the validity of the proxy for the period within the statutory limits and only voiding the excess.

However, even if a proxy is stated to be created for a term within the seven year limit, it will be revocable unless "coupled with an interest." It is not quite clear what is meant by this phrase.

In *Smith v. S. F. & N. P. Ry. Co.* a five year pooling agreement proxy was created in connection with the purchase of a large block

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86 There is a chance that these proxies would not be enforced. See Ringling Bros. Barnum & Bailey Combined Shows, Inc. v. Ringling, 29 Del. Ch. 318, 49 A.2d 603 (1946), modified, 29 Del. Ch. 610, 53 A.2d 441 (1947).
87 CAL. CORP. CODE §§ 2226, 2228.
89 See note 87 supra. This is based partly on the traditional view that voting rights could not be separated from ownership, and partly on the idea that a proxy is an agency relationship.
90 115 Cal. 584, 47 Pac. 582 (1897).
of stock by the three parties to the agreement. When one of the parties attempted to question an election where his stock had been voted in accord with this agreement the court stated that the agreement was valid and binding on the plaintiff. The proxy was irrevocable because it was created for the mutual promises of each party to purchase the stock involved and was therefore "in the nature of a power coupled with an interest."\(^1\)

This case was one of the originators of the doctrine of irrevocability of proxies when coupled with an interest. Other jurisdictions have cited it often and expanded "interest" to include the power to sell the shares,\(^2\) and a right of first refusal.\(^3\) California, however, does not seem to have progressed as far. In Thomsen v. Yankee Mariner Corp.\(^4\) a proxy given with a conditional contract of sale was considered not coupled with an interest and was revocable.

The concept of power coupled with an interest was adopted to allow irrevocability of a relationship thought to be in the nature of an agency. It is now apparent that in this situation the proxy holder is not a true agent. The fact that it is necessary to exercise the proxy indicates that the proxy holder is acting adverse to his supposed principal's wishes. The proxy really is nothing more than a tool for specific performance of this contract between the shareholders and should be treated as irrevocable regardless of any "interest" in the proxy holder. A sensible approach to the problem would do away with the use of the proxy altogether and would allow specific performance directly.

Another type of voting arrangement, in many ways similar to a pooling agreement, is the voting trust.\(^5\) It, like the pooling agreement, was originally condemned as an illegal separation of voting power from ownership, but it is generally accepted as valid today. However, this early apprehension still finds some recognition. This is illustrated by the leading Delaware case of Ambercrombie v. Davies,\(^6\) where an agreement not conforming with the statute governing voting trusts was void.

It is doubtful that this result would be reached in California. California Corporations Code section 2230 authorizes the creation of voting trusts by stating, "Shares of stock in any corporation may be transferred to trustees in order to confer upon them the right to vote and

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\(^1\) Id. at 600, 47 Pac. at 587.
\(^5\) See Ballantine, Voting Trusts, Their Abuses and Regulation, 21 Texas L. Rev. 139 (1942).
\(^6\) 130 A.2d 338 (Del. 1957).
otherwise represent the shares.” In Boericke v. Weise, it was held that the voting trust was valid even though no stock had been transferred to a trustee, and in Doherty v. Cross, an agreement held invalid as a voting trust was held to be a valid proxy. These two cases, and the permissive rather than obligatory language of the Code seem to dispose of the Ambercrombie problem in California.

Voting trusts are nothing more than pooling agreements and would be made almost useless by adoption of a provision allowing specific performance of a pooling agreement without resorting to proxies “coupled with an interest.” The voting trust is presently advantageous, however, in that it provides a system of enforcing a pooling type agreement, and can be made irrevocable for a period of twenty-one years rather than the seven year limit on proxies.

It should be noted that presently voting trust agreements are required to be submitted to the Commissioner of Corporations. Probably a pooling agreement connected with the issuance of stock will also be subject to his official scrutiny. It is difficult to see any interest that the public would have in the regulation of these private voting agreements between the shareholders of a close corporation that justifies this regulation.

Pooling agreements and voting trusts are effective to unify the strength of several minority shareholders. It is doubtful that they could be used to change the ratio between an individual’s stockholdings and his voting power. As was stated above, such a disproportionate voting power arrangement could be a very useful tool to a close corporation. It would seem advisable to allow the shareholders to perfect such arrangement without resort to devious means. This is not possible under the present law.

To remedy this situation a statute should be passed clearly specifying that the shareholders may distribute voting power in any manner they see fit even though unrelated to the stockholding ratio of the shareholders. The following is the type of statute recommended:

Each share of stock of a close corporation shall be entitled to one vote unless otherwise stated in the articles or by-laws. This section shall not prevent an agreement among the shareholders that allows a shareholder a proportion of the voting power that is different than his proportionate share of the voting stock outstanding.

99 CAL. CORP. CODE § 2231.
101 schwarzer, CEB 408.
4. Higher Than Majority Vote and Quorum Requirements

Two other methods of giving a minority shareholder some measure of control over corporate affairs are the use of greater than majority vote and greater than majority quorum requirements. These devices will not give a minority shareholder the ability to dictate corporate policy, but they will provide him with a protective veto against any policy antagonistic to his interests. Even if the statute suggested above was adopted, these devices would still be useful in situations where it is desired to give a minority shareholder a voice or a veto but not affirmative control.

High majority requirements may be imposed on director as well as shareholder action. California Corporations Code section 817 provides that the articles or by-laws or both may require any number greater than a majority of the directors present to authorize corporate action or make corporate decisions. Whether this section allows a requirement of unanimous assent to be placed on directors' actions is doubtful.\textsuperscript{102}

California Corporation Code section 816 allows the articles to determine the number of directors necessary to constitute a quorum. In no case shall this number be less than two, or one-third of the number of directors, whichever is greater. The quorum requirement finally chosen should resolve the conflict between the following factors. A low quorum requirement would allow more freedom and flexibility in the operations of the corporation. It could, however, put the minority shareholders at the mercy of the majority. A high quorum requirement arms the minority with a veto exercisable by the simple act of not attending meetings. Since once a quorum is present, the meeting cannot be voided by a shareholder leaving,\textsuperscript{103} a high quorum requirement is useless to the minority stockholders without strict notice requirements concerning the business to take place at the forthcoming meeting. This is a return to formalism. The function served by a high quorum requirement could be better served by greater than majority vote requirements.

No section in the Corporations Code provides for shareholders the blanket authorization of greater than majority vote requirements which is authorized for the directors by section 817. Such authorization is granted for some specific types of shareholder action, however.\textsuperscript{104}

\textsuperscript{102}Id. at 425. See also, Benintendi v. Kenton Hotel, 294 N.Y. 112, 60 N.E.2d 829 (1945).
\textsuperscript{103}\textsc{Cal. Corp. Code} § 2212. No similar provision is set forth as to quorum for directors' meetings. It would seem to be an analogous situation, however.
\textsuperscript{104}E.g., \textsc{Cal. Corp. Code} § 3632 (an amendment of articles); \textsc{Cal. Corp. Code} § 3901 (sale of substantially all assets).
Even absent express authorization it is not seen why a shareholders' agreement could not specify the percentage of votes necessary to authorize action. It is doubtful, however, that a provision requiring unanimous approval would be upheld.\footnote{Cf. Benintendi v. Kenton Hotel, supra note 102. It should be noted that the result of this case has been changed by statute in New York, N.Y. STOCK CORP. LAW § 55. The philosophy of the decision may still have weight elsewhere, however.}

Greater than majority vote requirements and other provisions protecting minority interests found in the articles and by-laws are of no value if such provisions can be changed by a majority of the shareholders. Therefore, two of the most important sections authorizing a greater than majority vote requirement for shareholder action are sections 500 and 3632 of the Corporations Code. They allow a greater than majority vote requirement restricting the right of shareholders to amend the by-laws and the articles respectively.

Section 3632 allows the articles to require for their amendment “consent of the holders of any greater percentage or fraction of the outstanding shares . . . .” Section 500 says only that “the articles or by-laws may require the vote or written assent of the shareholders entitled to exercise more than a majority of the voting power . . . .” in order to amend the by-laws. The words “percentage or fraction” found in 3632 but not 500, imply less than all. Does the difference between these sections attempt to create a distinction between the by-laws and articles by allowing a unanimous vote requirement for the amendment of by-laws but not for amendment of the articles? No valid reason for making such a distinction is apparent.

The following statute is recommended to assure that any greater than majority arrangement, including unanimity requirements, desired by the shareholders will be valid:

The articles or by-laws of a close corporation may require, in any instance where consent of the shareholders is necessary or where a vote of the shareholders is to be had, any vote greater than a majority including a unanimous vote if that is desired. Nothing in this section shall be interpreted to limit the right of the shareholders to insert similar greater than majority requirements in agreements among themselves.

5. Control by Agreement

The previous discussion was concerned primarily with control at the shareholder level. Under the present corporate structure there is also a problem of control at the level of the board of directors. To a great extent a majority shareholder can guarantee himself control at both levels. What we are now concerned with, however, is how a
minority shareholder can be secured in to some measure of control at
the board or officer level. Further, the situation is not uncommon
where one of the shareholders is the driving force of the business. He
may be willing to give his full efforts to the business only if he has full
control of the management thereof. The other stockholders may agree
to this but do not want to give up voting rights in their stock. A similar
situation arises where a person will invest only on a guarantee that a
particular person will remain in active management of the corporation.
The following is a brief discussion of the problems faced in seeking to
achieve such ends.

It is generally accepted that the shareholders can, by means of a
contract among themselves, agree that a specified person be main-
tained as a director. This contract may become invalid, however, if
it includes a provision that such person shall also be an officer. The
often stated distinction is that shareholders may agree upon a course
of action among themselves but they cannot restrict the board’s dis-
cretion. This rationale is used in the cases involving the power of
the corporation to enter into, or the power of the shareholders to bind
the corporation to long-term employment contracts. The cases reach
divergent results and it is sometimes difficult to determine when a
valid employment contract becomes an invalid usurpation of the di-
rectors’ powers.

Representative of the cases in this area are the cases of Kennerson
v. Burbank Amusement Co. and Merlino v. West Coast Macaroni
Mfg. Co.

The Kennerson case involved two related corporations. One (A
corporation) owned the land on which a theatre was to be built. The
other (B corporation) was to manage the theatre. Plaintiff seized
control of B corporation and had it adopt a cancellable contract making
him manager of that corporation with “exclusive right to fix and estab-
lish all policies to be followed in the operation of the . . . [corporation]
. . . .” Pending a merger of the two corporations which undoubtedly
would have resulted in termination of his contract, plaintiff caused


Dulin v. Pacific Wood & Coal Co., 103 Cal. 357, 35 Pac. 1045, 37 Pac. 207
(1894).

Dyer Bros. Iron Works v. Central Iron Works, 182 Cal. 588, 189 Pac. 445 (1920);
120 Cal. App. 2d 157, 260 P.2d 823 (1953); Smith v. California Thorn Cordage, Inc., 129
Cal. App. 93, 18 P.2d 393 (1933).

Supra note 108.

Supra note 106.

Supra note 108, at 162, 260 P.2d at 826.
B corporation to withdraw the cancellation clause in the contract. Plaintiff then had a five year non-cancellable contract to manage B. In this action to recover wages lost by plaintiff because of his dismissal, the court found that by this contract with plaintiff "... the board has attempted to confer upon him the practical control and management of substantially all corporate powers." In denying plaintiff recovery, the court then stated:

California has recognized the rule that the board cannot delegate its function to govern. As long as the corporation exists, its affairs must be managed by the duly elected board. The board may grant authority to act, but it cannot delegate its function to govern. If it does so, the contract so providing is void.

The court in the Kennerson case indicated that their decision was based on the "quantum of delegation" involved. Certainly this would seem to be an important factor, but the Merlino case casts some doubt on its validity as a test.

The Merlino case also involved two related corporations. A and B each owned 50 per cent of X corporation. X owned all the stock of Y corporation. A and B agreed that so long as A owned 50 per cent of X corporation A would be in active control of Y corporation at a salary of 9,000 dollars per year. B later seized control of X corporation and ousted A from this position. A brought suit to recover damages for breach of contract. The court upheld the validity of the contract as a valid agreement between shareholders of a close corporation without discussing the fact that it infringed on the function of the board of directors.

Certainly, this contract giving a shareholder exclusive management of a corporation as long as he holds 50 per cent of the stock of a different corporation is as great an infringement on the board's powers as was the contract in the Kennerson case. It would seem that the distinguishing characteristics of these cases, and perhaps the basis for decision of the more recent cases, is the factor of equality of bargaining power at the time the contract was made, coupled with the presence or absence of fraud on the part of the person asserting the validity of the contract.

There does not appear to be as urgent a need to protect the shareholders in a close corporation from a break in the normal corporate chain of command as is necessary for stockholders in a public issue corporation. Since it is usually the case in a close corporation that

112 Id. at 173, 260 P.2d at 832.
113 Id. at 173, 260 P.2d at 832-33.
114 Id. at 174, 260 P.2d at 833.
directors, officers and shareholders are substantially identical, it is foolish to void a contract made by a shareholder in one capacity because it infringes on his rights in another capacity. While it is likely that the courts will not make such an extreme finding in a close corporation situation in absence of other circumstances such as fraud or over-reaching, in order to eliminate uncertainty and recognize reality the following statute is recommended:

A close corporation shall be managed by the board of directors unless the articles or by-laws specify otherwise. It is not necessary that the ultimate authority for corporate action be vested in the board of directors.

A contract such as that found in the Merlino case serves at least two important purposes. First, it assures a shareholder of an influential voice in the management of the corporation. Second, it provides a method for withdrawing funds from the corporation other than by doubly taxed dividends. The advent of Subchapter S destroys much of the importance of this second reason, but even so, a “management contract” is a useful tool for placing the control of the corporation in the hands of a selected stockholder.

The adoption of a statute similar to the one suggested above would overcome the objection that “management contracts” infringed on the powers of the board of directors. However, it still could be urged that an action on such contract was really a suit for specific performance of an employment contract. The action in the Merlino case was treated as on a contract to divide profits rather than on an employment contract. This seems to be a handy peg on which to hang a decision enforcing management contracts. Lack of mutuality should not be assertable to bar a shareholder from maintaining and exercising his bargained for managerial rights.

A much more difficult problem is presented where the non-managing stockholders seek to bind the managing stockholder to the management contract. All the policies against specific performance of employment contracts weigh against enforcing this contract. However, not enforcing the contract would be a great hardship on the non-managing stockholders who are relying on the manager’s talents for the success of the corporation. Unfortunately, however, no sound remedy for these stockholders, other than specific performance, is apparent. Perhaps, however, an injunction of the type found in Lumley v. Wagner would be an appropriate remedy. The defecting manager could be enjoined from engaging in any other business within the sphere of competition of the close corporation. California Civil Code
section 3423 would seem to support the use of such an injunction if the contract is in writing and the value of the service is over 6,000 dollars per year. There is no requirement in this statute that the contract contain a negative covenant. It is necessary, however, to show that the services are "of a special, unique, unusual, extraordinary or intellectual character, which gives it peculiar value" not adequately compensable for by damages. The nature of management corporations might bring them within this category. If not it could be provided for by statute. This remedy perhaps seems harsh but it must be remembered that such contracts are usually at the insistence of the party who is to be manager.

D. Dissolution and Deadlock

The many minority protecting devices, and the provisions allowing flexibility in a close corporation may have the disadvantageous effect of creating deadlocks and strong differences of opinion. When such situations arise, it is difficult, if not impossible, for a partnership-like organization such as a close corporation to function at its peak efficiency. Provisions must be made available to the shareholders allowing them to effectively resolve these differences, or dissolve if the differences are insoluble.

It has been suggested that arbitration be used as a tool of resolving intra-corporate disputes. Two connected problems immediately arise, the effectiveness and enforceability of the agreement to arbitrate. It would never be successful unless the parties are bound to submit to its use. It is necessary that the parties agree to arbitration before the dispute arises. Furthermore, some method for enforcing the arbitrator's decision must be available.

California Code of Civil Procedure section 1280 provides that an agreement to settle by arbitration "a controversy thereafter arising out of the contract or the refusal to perform the whole or any part thereof, or . . . an existing controversy" is valid, enforceable and irrevocable. This changes the common law and allows specific performance of agreements to arbitrate future disputes. However, it is doubtful that management controversies in a close corporation are arbitrable disputes within the terms of this section. They are more in the nature of policy problems rather than controversies involving inter-

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117 See generally, 2 O'Neal 189-222; Schwarzer, CEB 438; O'Neal, Resolving Disputes in Closely Held Corporations: Intra-Institutional Arbitration, 67 Harv. L. Rev. 786 (1954).
118 2 O'Neal 191; Schwarzer, CEB 438.
pretation of contracts or “arising out of the contract.” Even so, it is not readily seen why the parties should not be allowed to submit their management controversies to arbitration. It would seem a desirable alternative to dissolution.

A further problem in arbitration agreements is the enforcement of the arbitrator’s award. A simple method of enforcement would be to give the arbitrator, or the other shareholders, proxies to vote in conformity with the arbitrator’s award. A famous Delaware case, however, while upholding the arbitrator’s award, failed to cause the proxies to be voted in conformity with the award. Until provision is made for the enforcement of the arbitrator’s award, the process will remain practically worthless to close corporations. Perhaps an adoption of the recommendation made on the section on proxies (i.e., allowing a proxy to be irrevocable even though not technically coupled with an interest) would aid also in the effectiveness of arbitration.

If all other attempts to resolve intra-corporate differences and deadlocks fail, the only recourse is dissolution. California recognizes two types of corporate dissolution, voluntary and involuntary. Theoretically, voluntary dissolution is the choice of the corporation rather than the stockholders. It is governed by Corporations Code section 4600 which states: “Any corporation may elect to wind up its affairs and voluntarily dissolve by the vote or written consent of shareholders . . . representing 50 per cent or more of the voting power.” Though this section says the vote may be by shareholders representing “50 per cent or more of the voting power,” the Commissioner of Corporations will not file any articles authorizing a vote for voluntary dissolution by any other percentage.

Until recently, voluntary dissolution under section 4600 was thought to be completely within the control of the shareholders. However, in In re Security Finance Co., the California Supreme

120 CAL. Corp. Code § 4600.
121 CAL. Corp. Code § 4650.
122 “Under section 4600 the election to dissolve is the election of the corporation, not merely shareholders representing 50 per cent of the voting power, although it is through their consent that the election is made.” In re Security Finance Co., 49 Cal. 2d 370, 377, 317 P.2d 1, 5 (1957). It is perhaps for this reason that no “buy out” provisions are attached by statute to voluntary dissolution but are statutorily created for involuntary dissolution. See note 129 infra.
123 Aspey, Suggestions and Precautions in Drafting Articles of Incorporation, Organizing and Advising Small Business Enterprises, 162, 172 (State Bar of Cal., Comm. on Continuing Education of the Bar, 1954). See also Comment, 43 CALIF. L. REV. 514 (1955).
Court said: 125

Shareholders representing 50 per cent of the voting power do not have an absolute right under section 4600 to dissolve a corporation . . . to defraud the other shareholders . . . to "freeze out" minority shareholders . . . or to sell assets of the dissolved corporation at an inadequate price.

The opinion did not indicate where the burden of proof lay. It did say, however, that the plaintiff seeking dissolution in the case showed good faith. If this is interpreted as placing the burden of proof of good faith on the dissolving shareholder, the doctrine would appear too restrictive of the right of voluntary dissolution. However, this would seem to be proper as an affirmative defense. In this connection, it should be noted that the compulsory buy out provisions of section 4658 are probably not available to shareholders dissenting from a voluntary dissolution. Section 4658 applies to any "such suit," which would seem to refer only to section 4651.

Involuntary dissolution may be brought about by the petition of holders of one-third of the total shares outstanding who have been shareholders for not less than six months. 126 It is commonly known as dissolution for cause. Section 4651 lists the causes justifying the filing of a complaint for involuntary dissolution and states that "the court . . . may entertain proceedings for the involuntary winding up or dissolution . . . " 127 on a finding that one or more of those causes exists. (Emphasis added.) This section implies that the court has discretion to refuse the request for dissolution even though proper cause is shown. 128 This is difficult to justify when the partnership characteristics of the close corporation are considered. Furthermore, when a suit for involuntary dissolution is commenced, the opposing stockholders, if they have 50 per cent of the stock, may elect to buy out the petitioning shareholders. 129 This election does not operate to estop the opposing shareholders to contest the dissolution, 130 and the courts have no discretion to refuse consent to this purchase 131 even if the shareholders have previously contested the dissolution.

The partnership-like character of close corporations would seem to indicate the application of partnership-like rules for dissolution. The Corporations Code, however, is somewhat more restrictive in its

125 Id. at 376-377, 317 P.2d at 5.
approach to corporate dissolution than to partnership dissolution. Individual treatment of close corporations could remedy this undesirable difference without impairing the control over public issue corporations. To this end the following statute is recommended:

A close corporation may be dissolved by the petition of any shareholder. In any such action, the non-petitioning shareholders, or any number of them, may avoid the dissolution by purchasing the shares of stock owned by the petitioning shareholders at their fair cash value. It may be shown as an affirmative defense to this action that the petitioning shareholder is not acting in good faith. Nothing in this section shall be construed to bar the formation of an agreement among the shareholders governing dissolution, even though in a manner not described by this section.132

If dissolution is made more readily available to the shareholders, precautions must be taken to assure adequate notice to creditors so that dissolution may not be used as a tool to defraud them.

Conclusion

This article has attempted to point up a few of the problems affecting close corporations in California. In a few instances, statutory reform was suggested. Any statutes set forth were intended only as guides to the needs of close corporations. They are not intended as examples of expert draftsmanship and often their phrasing may create more problems than they solve. However, the drafts proposed are important in that they represent the type of legislation necessary in this area.

132 It is contemplated that provisions similar to those presently found in Cal. Corp. Code § 4658 will exist to govern the valuation of the stock.