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William K.S. Wang

*UC Hastings College of the Law*, wangw@uchastings.edu

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# POOLING AGREEMENTS UNDER THE NEW CALIFORNIA GENERAL CORPORATION LAW

William K. S. Wang\*

## INTRODUCTION\*\*

A pooling agreement is a contract among shareholders that their shares will be voted as a unit.<sup>1</sup> Pooling agreements should not be confused with voting trusts. In a pooling agreement, each party retains legal and beneficial ownership of his or her shares. In a voting trust, the parties transfer the shares to one or more trustees in exchange for trust certificates.<sup>2</sup> The voting trust has the advan-

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\* Associate Professor of Law, University of San Diego, School of Law; B.A. 1967, Amherst College; J.D. 1971, Yale Law School. This Article was written in early 1976 while the author was a Visiting Professor of Law at the University of California, Davis.

\*\* Certain citation conventions are employed throughout this Symposium. These conventions are presented at page vii.

<sup>1</sup> See H. BALLANTINE, BALLANTINE ON CORPORATIONS 421 (1946); 2 H. OLECK, MODERN CORPORATION LAW 780 (1959); 1 F. O'NEAL, CLOSE CORPORATIONS: LAW AND PRACTICE § 5.03 (1971) [hereinafter cited as O'NEAL]. Cf. Comment, *Shareholder Pooling Agreements—Validity, Legality and Enforcement*, 24 ARK. L. REV. 501 (1971). Under the usual definition of a pooling agreement, the contracting parties retain the individual right to vote their shares in a predetermined manner. 1 O'NEAL, *supra* at § 5.03; Note, *The Validity of Stockholders' Voting Agreements in Illinois*, 3 U. CHI. L. REV. 640, 641 (1936). However, for the purpose of the present discussion, the term "pooling agreement" will be used in a broader sense to include contracts in which the parties transfer their voting power by irrevocable proxies to a person who votes the stock in one block as contractually provided (e.g., as directed by majority vote). See generally 1 O'NEAL, *supra* at §§ 5.03, 5.36.

According to Fletcher, a pooling agreement does not bind the shareholders to vote or direct their shares to be voted in a certain way and should not be confused with shareholders' agreements containing provisions specifically describing how the parties should vote on certain matters. 5 W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 2064, at 289 (rev. ed. 1967) [hereinafter cited as FLETCHER]. This may be an overly narrow definition. For the purpose of this discussion, the term "pooling agreement" will include contracts in which the parties bind themselves to vote as shareholders in a specified manner (e.g., for specified directors).

However, it is important to distinguish between pooling agreements and contracts governing how the directors themselves are to vote. W. PAINTER, PROBLEMS AND MATERIALS IN BUSINESS PLANNING 28 (1975); W. PAINTER, CORPORATE AND TAX ASPECTS OF CLOSELY HELD CORPORATIONS 111 (1971) [hereinafter cited as PAINTER].

If the proxy holder's vote is not determined by contract, the agreement will not be considered a pooling agreement for the purpose of this discussion. It might instead be labeled an unconditional irrevocable proxy. Cf. *Stein v. Capital Outdoor Advertising, Inc.*, 273 N.C. 77, 82, 159 S.E.2d 351, 355-56 (1968).

<sup>2</sup> The voting trust has been defined as:

tage of being self-executing; the trustee has an irrevocable power to vote the shares.<sup>3</sup> But the holder of voting trust certificates may have fewer rights than a record shareholder,<sup>4</sup> and the certificates

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

5 FLETCHER, *supra* note 1, § 2075, at 365-66. See generally 1 O'NEAL, *supra* note 1, at § 5.31; PAINTER, *supra* note 1, at § 3.2; Baldwin, *Voting Trusts*, 1 YALE L.J. 1 (1891); Burke, *Voting Trusts Currently Observed*, 24 MINN. L. REV. 347 (1940); Gose, *Legal Characteristics and Consequences of Voting Trusts*, 20 WASH. L. REV. 129 (1945); Note, *The Voting Trust: California Erects a Barrier to a Rational Law of Corporate Control*, 18 STAN. L. REV. 1210 (1966); Annot., 98 A.L.R.2d 376 (1964).

<sup>3</sup> 1 H. BALLANTINE & G. STERLING, CALIFORNIA CORPORATION LAWS § 193, at 374.3-375 (1976); 6 Z. CAVITCH, BUSINESS ORGANIZATIONS 114-45 (1976); Sturdy, *The Significance of "Form" and "Purpose" in Determining the Effectiveness of Agreements Among Stockholders to Control Corporate Management*, 13 BUS. LAW. 283, 284-85 (1958).

<sup>4</sup> One disadvantage may be a loss of shareholder rights. See H. BALLANTINE, BALLANTINE ON CORPORATIONS 431-32 (1946); Ballantine, *Voting Trusts, Their Abuses and Regulation*, 21 TEXAS L. REV. 139, 159-61 (1942); Comment, *Corporations: Voting Trusts and Irrevocable Proxies*, 36 CALIF. L. REV. 281, 284-86 (1948); Comment, *Voting Trusts and Irrevocable Proxies*, 41 TEMP. L.Q. 480, 482-84 (1968). Cf. Gose, *Legal Characteristics and Consequences of Voting Trusts*, 20 WASH. L. REV. 129, 139-49 (1945). But cf. TECHNICAL AMENDMENTS BILL § 800(b) and CAL. CORP. CODE § 834(a) (West Supp. 1976) (allowing voting trust certificate holders to bring derivative actions); NEW CODE § 1600(c); TECHNICAL AMENDMENTS BILL § 1601 and CAL. CORP. CODE § 3003 (West 1955) (granting inspection rights to voting trust certificate holders).

Another disadvantage of a voting trust is that a corporation cannot elect Subchapter S status if any of its shares are in a voting trust. Treas. Reg. § 1.1371-1(e) (1969). The Tax Court in dictum has expressed reservations as to the Commissioner's interpretation of the statute. *Catalina Homes, Inc.*, CCH Tax Ct. Mem. 1361, 1368 (1964). Two district courts have specifically rejected the I.R.S. interpretation. *Lafayette Distributors, Inc. v. United States*, 397 F. Supp. 719 (W.D. La. 1975); *A & N Furniture & Appliance Co. v. United States*, 271 F. Supp. 40 (S.D. Ohio 1967). See B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS § 6.02, at n.13 (1971); D. CRUMBLEY & P. DAVIS, ORGANIZING, OPERATING, AND TERMINATING SUBCHAPTER S CORPORATIONS 64-65 (1974); Z. CAVITCH, TAX PLANNING FOR CORPORATIONS AND SHAREHOLDERS § 303[4] (1976); I. GRANT, SUBCHAPTER S TAXATION § 8.3 (1974); D. KAHN, BASIC CORPORATION TAXATION 381-82 (1973); I. SCHREIBER, S. GOLDEN & S. TRAUM, SUBCHAPTER S: PLANNING AND OPERATION § 101.4E (Supp. 1976). See also *W & W Fertilizer Corp. v. United States*, 527 F.2d 621, 627 n.11 (Ct. Cl. 1975). But see *Friend's Wine Cellars, Inc.*, CCH Tax Ct. Mem. 740, 743 (1972).

The Internal Revenue Service at one time took the position that a corporation was disqualified from electing Subchapter S if its stockholders entered into any voting trust or pooling agreement giving one or more shareholders voting power disproportionate to other shareholders. The Commissioner subsequently withdrew this interpretation. See B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF

are securities under California and federal securities laws.<sup>5</sup> Because of these and other complicating aspects of the voting trust, Professor Henry Ballantine has commented that a pooling agreement containing irrevocable proxies is "a much more simple and satisfactory method for authorizing an irrevocable delegation of voting power . . . than the voting trust . . ." and advocated statutory authorization of such voting agreements.<sup>6</sup>

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CORPORATIONS AND SHAREHOLDERS § 6.02, at 6-6, 6-7 (1971); *id.* § 6.02 (Supp. 1975); Z. CAVITCH, TAX PLANNING FOR CORPORATIONS AND SHAREHOLDERS § 3.03[5], at 3-31, 3-32 (1976); W. PAINTER, PROBLEMS AND MATERIALS IN BUSINESS PLANNING 152 (1975); I. SCHREIBER, S. GOLDEN & S. TRAUM, SUBCHAPTER S: PLANNING AND OPERATION § 101.6E (Supp. 1976).

<sup>5</sup> CAL. CORP. CODE § 25019 (West Supp. 1976); Securities Act of 1933, § 2(1), 15 U.S.C. § 77(b)(1) (1970); Securities Exchange Act of 1934, § 3(a)(10), 15 U.S.C. § 78(c)(a)(10) (1970); 1 H. MARSH & R. VOLK, PRACTICE UNDER THE CALIFORNIA SECURITIES LAWS § 5.16 (rev. ed. 1975); 3 H. BLOOMENTHAL, SECURITIES AND FEDERAL CORPORATE LAW § 2.23 (1975); Diczok, *Recent Cases*, 3 SEC. REG. L.J. 183, 190 (1975). See 1 L. LOSS, SECURITIES REGULATION 460 & n.18 (1961). See generally *Reserve Life Ins. Co. v. Provident Life Ins. Co.*, 499 F.2d 715 (8th Cir. 1974), *cert. denied*, 419 U.S. 1107 (1975).

Conceivably, the California Department of Corporations might argue that a pooling agreement constitutes a "sale" of securities under CAL. CORP. CODE § 25017(a) (West Supp. 1976) because it changes the voting rights or privileges of outstanding securities. Letter from Alan J. Barton, Esq., to Walter G. Olson, Esq., June 11, 1975, copy on file with the UCLA Law Review. See generally 1 H. MARSH & R. VOLK, PRACTICE UNDER THE CALIFORNIA SECURITIES LAWS § 7.03 (1975). *But cf.* California Comm'r of Corps., Op. no. 73/73C, involving the following fact situation. A sole shareholder proposed to sell some of his shares and, in order to increase their marketability, proposed to sign an agreement that he would never vote his shares for a resolution authorizing the issuance of more shares unless the resolution provided for preemptive rights. In deciding that the agreement would not constitute a change in the rights of outstanding securities under CAL. CORP. CODE § 25017(a) (West Supp. 1976), the Commissioner stated:

A contractual [sic] arrangement, such as that contemplated in the instant case, arises only by virtue of the personal agreement of the contracting parties and creates a personal obligation of these parties without changing the statutory framework of the corporation, namely, its articles of incorporation, which controls the rights, preferences, privileges and restrictions of or on its shares.

California Comm'r of Corps., Op. no. 73/73C, at 2.

<sup>6</sup> H. BALLANTINE, BALLANTINE ON CORPORATIONS 433 (1946). See 1 O'NEAL, *supra* note 1, § 5.34, at 120 (" . . . in most jurisdictions a shareholders' agreement . . . is usually preferable to a voting trust device for allocating control in a close corporation"); Ballantine, *Voting Trusts, Their Abuses and Regulation*, 21 TEXAS L. REV. 139, 160-61 (1942); Logan, *Methods to Control the Closely Held Kansas Corporation*, 7 KAN. L. REV. 405, 422 (1959). *Cf.* Sturdy, *supra* note 3, at 287.

A disadvantage of the voting trust has been the old law's provision that all voting trusts may be terminated at any time by a majority of the beneficial holders of shares in the trust. CAL. CORP. CODE § 2231 (West Supp. 1976). This troublesome provision has been eliminated in the new law, although the statutory maximum duration of a voting trust has been decreased from twenty-21 to 10 years (with permission to extend). TECHNICAL AMENDMENTS BILL § 706(b). See note 31 *infra*.

For an excellent bibliography of materials on both voting trusts and pooling

The validity of pooling agreements and irrevocable proxies is governed by the law of the state of incorporation.<sup>7</sup> Although California's new corporation law is the first statutory recognition of shareholders' pooling agreements, such agreements have been valid under California case law since at least 1897.<sup>8</sup> Section 706(a) of the new law<sup>9</sup> expressly permits pooling agreements among the shareholders of a close corporation, but provides that the agreement must end when the corporation loses its status as a close corporation. Shareholder agreements made "pursuant" to section 706(a) are clearly valid and specifically enforceable. Section 706(d), however, permits voting agreements outside of section 706(a): "This section shall not invalidate any voting or other agreement among shareholders . . . which agreement . . . is not otherwise illegal."<sup>10</sup> Since nothing in the new law prohibits

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agreements, see MODEL BUS. CORP. ACT. ANN. § 34, at 744-49 (2d ed. 1971); *id.* at 177-78 (Supp. 1973).

<sup>7</sup> 6 Z. CAVITCH, BUSINESS ORGANIZATIONS 114-35 (1976); 1 O'NEAL, *supra* note 1, at § 5.03. This rule has not been changed by the new California Corporations Code. See section 2115(b) of the new law, omitting any mention of sections 705 and 706.

<sup>8</sup> *Smith v. San Francisco & N. Pac. Ry.*, 115 Cal. 584, 47 P. 582 (1897); Schwarzer, *Practical Problems of Organizing Closely Held Corporations*, in ADVISING CALIFORNIA BUSINESS ENTERPRISES 403, 408 (State Bar of Cal., Comm. on Continuing Education of the Bar, 1958); Oppenheim, *The Close Corporation in California—Necessity of Separate Treatment*, 12 HASTINGS L.J. 227, 244-45 (1961). Cf. Note, *Separate Statutory Treatment of the Close Corporation in California: Progress and Problems*, 27 HASTINGS L.J. 433, 465-66 (1975) [hereinafter cited as *Close Corporation*]. For a general discussion of the validity of pooling agreements see Annot., 45 A.L.R.2d 799 (1956).

<sup>9</sup> Notwithstanding any other provision of this division, an agreement between two or more shareholders of a close corporation, if in writing and signed by the parties thereto, may provide that in exercising any voting rights the shares held by them shall be voted as provided by the agreement, or as the parties may agree or as determined in accordance with a procedure agreed upon by them, and the parties may transfer the shares covered by such an agreement to a third party or parties with authority to vote them in accordance with the terms of the agreement. Such an agreement shall not be denied specific performance by a court on the ground that the remedy at law is adequate or on other grounds relating to the jurisdiction of a court of equity. An agreement made pursuant to this subdivision between shareholders of a close corporation shall terminate when the corporation ceases to be a close corporation.

TECHNICAL AMENDMENTS BILL § 706(a). Refer, however, to the Subsequent Developments Note which concludes this article. See generally *Close Corporation*, *supra* note 8, at 463-64:

Section 158(a) of the new law defines "close corporation" as follows: a corporation whose articles contain . . . a provision that all of the corporation's issued shares of all classes shall be held of record by not more than a specified number of persons, not exceeding 10, and a statement "This corporation is a close corporation."

TECHNICAL AMENDMENTS BILL § 158(a). See generally *Review of Selected 1975 California Legislation*, 7 PAC. L.J. 237, 259 (1976). Hereinafter, the phrase "close corporation" shall refer to a corporation satisfying the definition in section 158(a).

<sup>10</sup> TECHNICAL AMENDMENTS BILL § 706(d).

pooling agreements and the prior case law recognized their validity, it appears that compliance with section 706(a) is not the exclusive method of creating a legal voting pool.<sup>11</sup>

### I. ENFORCING POOLING AGREEMENTS BY IRREVOCABLE PROXIES

A pooling agreement may be valid but useless if the law provides no easy and effective means of enforcing that agreement. Much of the litigation over pooling agreements has centered on the question of enforcement. It is not completely settled whether pooling agreements will be specifically enforced. Although a number of early cases outside California refused to grant specific enforcement of such contracts,<sup>12</sup> most of the recent decisions allow shareholder voting agreements to be enforced by an injunction or a decree of specific performance.<sup>13</sup> Indeed, the California Supreme Court decision of *Smith v. San Francisco & North Pacific Railway*<sup>14</sup> is often cited as a forerunner of the modern trend<sup>15</sup> because it in effect granted specific performance.<sup>16</sup> However, it appears that no reported California opinion has decided the appropriateness of issuing a decree compelling a shareholder to comply with a pooling agreement.

If a pooling agreement contains express irrevocable proxies, the issue of specific performance need never be raised. It is unnecessary for complying members of a pool to seek specific performance through a decree ordering the breaching party to vote his or her shares according to the contract since the complying parties could simply cast the vote of the breaching party's shares pursuant to the proxies in the agreement.<sup>17</sup> The major issue would

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<sup>11</sup> According to Harold Marsh, Jr., Esq., the principal draftsman of the New Code, "[S]ubdivision (d) of Section 706 preserves any voting agreement which would have been upheld under the prior law." Letter from Harold Marsh, Jr., Esq., to William K.S. Wang, October 7, 1975, copy on file with the UCLA Law Review. See *Close Corporation*, *supra* note 8, at 468-69.

<sup>12</sup> See 5 FLETCHER, *supra* note 1, at 325-26 & n.90; 1 O'NEAL, *supra* note 1, § 5.30, at 103, 105 n.4. See Comment, *Corporations: Voting Trusts and Irrevocable Proxies*, 36 CALIF. L. REV. 281, 282 & n.5 (1948).

<sup>13</sup> See 5 FLETCHER, *supra* note 1, at § 2067; 1 O'NEAL, *supra* note 1, at § 5.30; Comment, *Corporations—Specific Enforcement of Shareholder Agreements*, 45 N.C.L. REV. 228, 230 (1966).

<sup>14</sup> 115 Cal. 584, 47 P. 582 (1897).

<sup>15</sup> See, e.g., 1 O'NEAL, *supra* note 1, § 5.30, at n.10; Comment, *Corporations—Specific Enforcement of Shareholder Agreements*, 45 N.C.L. REV. 228, 230 n.10 (1966).

<sup>16</sup> 1 O'NEAL, *supra* note 1, § 5.30, at n.10; Comment, *Specific Enforcement of Shareholder Voting Agreements*, 15 U. CHI. L. REV. 738, 741 (1948).

<sup>17</sup> See Comment, *Shareholder Pooling Agreements—Validity, Legality, and Enforcement*, 24 ARK. L. REV. 501, 519-21 (1971); Comment, *The Enforcement*

then be whether the express proxies in the agreement can be revoked even though stated to be irrevocable.<sup>18</sup>

Because of the delay and inconvenience involved in obtaining a judicial decree of specific performance, one commentator has gone so far as to suggest that irrevocable proxies are the only method of effectively enforcing pooling agreements.<sup>19</sup> Although this may overstate the inconvenience of specific performance, there is no question that irrevocable proxies are at least as effective a method of enforcing pooling agreements as specific performance by judicial decree.<sup>20</sup>

The use of irrevocable proxies to make pooling agreements self-enforcing has spawned a wide variety of proxies.<sup>21</sup> Some proxies are implied by a court; others are created by express provisions of the pooling agreement. Proxies may be contingent or "vested." A contingent proxy comes into existence only when a party refuses to comply with the pooling agreement; normally each party votes his own shares.<sup>22</sup> If vested irrevocable proxies are used, the proxy-holder always votes all shares.

Each contracting shareholder may grant proxies to a single party—a third party or one of the parties to the agreement. Alternatively, each stockholder may grant cross-proxies to every other

*of Shareholder Voting Pool Agreements: A Proposed Amendment to the Louisiana Business Corporation Law*, 6 LOYOLA L. REV. 59, 62 (1951) [hereinafter cited as *The Enforcement of Shareholder Voting Pool Agreements*].

<sup>18</sup> See *The Enforcement of Shareholder Voting Pool Agreements*, *supra* note 17, at 62. See also 6A ME. REV. STAT. ANN. tit. 13-A, §§ 617(2), (3) (1974).

<sup>19</sup> The legal "mechanics" of the situation are such that if it is impossible to talk about an "irrevocable" proxy, it is likewise impossible to have a voting pool agreement susceptible of effective enforcement . . . . Only a decree of specific performance could then enforce the agreement. Specific performance requires a new election.

*The Enforcement of Shareholder Voting Pool Agreements*, *supra* note 17, at 65.

<sup>20</sup> In California, the relationship between proxies and pooling agreements is especially close. Some commentators have even suggested that a pooling agreement among shareholders of a California corporation is itself a type of proxy agreement. See Schwarzer, *Practical Problems of Organizing Closely Held Corporations*, in *ADVISING CALIFORNIA BUSINESS ENTERPRISES* 403, 408 (State Bar of Cal., Comm. on Continuing Education of the Bar, 1958), citing *Dougherty v. Cross*, 65 Cal. App. 2d 687, 702-03, 151 P.2d 654, 661-62 (2d Dist. 1944), and *Simpson v. Nielson*, 77 Cal. App. 297, 246 P. 342 (1st Dist. 1926); *Sturdy*, *supra* note 3, at 288, citing *Smith v. San Francisco & N. Pac. Ry. Co.*, 115 Cal. 584, 47 P. 582 (1897).

<sup>21</sup> Cf. H. HENN, *HANDBOOK OF THE LAW OF CORPORATIONS AND OTHER BUSINESS ENTERPRISES* 570 (2d ed. 1970); 1 O'NEAL, *supra* note 1, § 5.27, at 95; PAINTER, *supra* note 1, at § 3.4; O'Neal, *Protecting Shareholders' Control Agreements Against Attack*, 14 BUS. LAW. 184, 197 (1958); *The Enforcement of Shareholder Voting Pool Agreements*, *supra* note 17, at 64.

<sup>22</sup> Cf. 6A ME. REV. STAT. ANN. tit. 13-A, §§ 617(2), (3) (1974); 1 O'NEAL, *supra* note 1, § 5.36, at n.1 (Supp. 1975).

party. Normally, a cross-proxy is contingent on a breach of contract; in the event of a breach, the complying party or parties can vote the shares of the non-complying party.

An attorney drafting a pooling agreement might use the terms "express contingent irrevocable cross-proxies," "express vested irrevocable single-party proxies," or some other combination.<sup>23</sup>

It may be tempting to select someone outside the contracting group as holder of vested irrevocable proxies in an arrangement similar to a voting trust, but this similarity may be hazardous in some jurisdictions. In *Abercrombie v. Davies*,<sup>24</sup> the Delaware Supreme Court examined a shareholder pooling agreement with express vested irrevocable single-party proxies and found it to be a voting trust. The court then invalidated the entire arrangement because the parties had not complied with the statutory requirements for voting trusts.<sup>25</sup>

After discussing *Abercrombie*, one commentator stated: "It is doubtful that this result would be reached in California."<sup>26</sup> The article cited *Boericke v. Weise*<sup>27</sup> and the permissive rather than

<sup>23</sup> See Logan, *Methods to Control the Closely Held Kansas Corporation*, 7 KAN. L. REV. 405, 420 (1959), and authorities cited in note 21 *supra*. If express contingent irrevocable cross-proxies are employed, all the parties normally vote their own shares in accordance with the agreement; but if one party breaches, the non-complying party's shares are voted by the complying parties. In the case of express vested irrevocable single-party proxies, the participants in the pooling agreement grant irrevocable proxies to one party who votes all the shares in one block in accordance with the contract. For an example of this type of agreement see *Simpson v. Nielson*, 77 Cal. App. 297, 246 P. 342 (1st Dist. 1926).

The term "single-party" proxy is intended simply to exclude all cross-proxies. Technically, a "single-party" proxy might be granted to a group of individuals. For an example of an "express vested irrevocable single-party proxy" granted by a shareholder to three individuals, refer to the proxy printed in *Callister v. Graham-Paige Corp.*, 146 F. Supp. 399, 402 n.1 (D. Del. 1956).

<sup>24</sup> 36 Del. Ch. 371, 130 A.2d 338 (Sup. Ct. 1957).

<sup>25</sup> This danger has been largely eliminated in Delaware by the 1967 revision of the Delaware corporation statute. DEL. CODE ANN. tit. 8, §§ 218(c), (e) (1974) [prior to July 15, 1969, section 218(e) was section 218(d)]; E. FOLK, REVIEW OF THE DELAWARE CORPORATION LAW 26-27 (1968); E. FOLK, THE DELAWARE GENERAL CORPORATION LAW 235 (1972); 1 O'NEAL, *supra* note 1, at § 5.33; Comment, *Shareholder Pooling Agreements—Validity, Legality and Enforcement*, 24 ARK. L. REV. 501, 512 (1971).

<sup>26</sup> Oppenheim, *The Close Corporation in California—Necessity of Separate Treatment*, 12 HASTINGS L.J. 227, 245-56 (1961). *Accord*, *Close Corporation*, *supra* note 8, at 466.

<sup>27</sup> 68 Cal. App. 2d 407, 156 P.2d 781 (1st Dist. 1945) (voting trust was valid although no stock had been delivered to the trustee). See Annot., 98 A.L.R.2d 376, 402 (1964). Both the Oppenheim article (*supra* note 26, at 246) and the Hastings note (*supra* note 8, at 466) additionally cite *Dougherty v. Cross*, 65 Cal. App. 2d 687, 151 P.2d 654 (2d Dist. 1944), but the *Abercrombie* issue does not appear to have been raised or discussed in that case. See Opening Brief for Appellant; Brief for Respondent; Closing Brief for Appellant, *Dougherty v. Cross*, 65 Cal. App. 2d 687, 151 P.2d 654 (2d Dist. 1944). Indeed, as noted in the appellant's opening brief: "At the date of the December [1926] agreement

obligatory language of section 2230 of the old law,<sup>28</sup> which does not impose mandatory formalities on voting trusts.<sup>29</sup> For example, the section provides that "A duplicate of the voting trust agreement may be filed in the office of the corporation."<sup>30</sup>

The new law's language is more restrictive. Under section 706(b), duplicates of the trust agreement and any extension "shall be filed with the secretary of the corporation."<sup>31</sup> However, section 706(c) of the new law expressly provides that no pooling agreement made pursuant to section 706(a)<sup>32</sup> will be invalidated on the grounds that it is a voting trust not complying with section 706(b). Furthermore, section 706(d) provides:

This section [including 706(b)] shall not invalidate any voting or other agreement among shareholders or any irrevocable proxy complying with subdivision (e) of Section 705, which . . . is not otherwise illegal.

Virtually identical language in the Delaware Corporation Law<sup>33</sup> has generally been regarded as a legislative reversal of *Abercrombie*.<sup>34</sup> Therefore, section 706(d) presumably protects all pooling agreements from being invalidated because of their likeness to a voting trust.<sup>35</sup>

there was no provision in the Civil Code for a voting trust such as was created by that agreement, and it was not until 1931 that a new section, 321a, was added to the code providing for voting trusts." Opening Brief for Appellant at 62, *Dougherty v. Cross*, 65 Cal. App. 2d 687, 151 P.2d 654 (2d Dist. 1944).

<sup>28</sup> CAL. CORP. CODE § 2230 (West 1955).

<sup>29</sup> However, CAL. CORP. CODE § 2231 (West Supp. 1976) does impose a 21 year maximum on voting trusts.

<sup>30</sup> CAL. CORP. CODE § 2230 (West 1955) (emphasis added).

<sup>31</sup> TECHNICAL AMENDMENTS BILL § 706(b) (emphasis added). Section 706(b) also provides that no voting trust will be effective for a term of more than ten years; within two years prior to its expiration, however, the trust may be extended for up to ten years at a time.

<sup>32</sup> Section 706(a) of the New Code makes pooling agreements among shareholders of close corporations expressly valid and specifically enforceable. See note 9 *supra*.

<sup>33</sup> DEL. CODE ANN. tit. 8, § 218(e) (1974) (section 218(d) prior to July 15, 1969). This Delaware provision is described as the source of section 706(d) of the new law. SECOND EXPOSURE DRAFT § 706(d).

<sup>34</sup> E. FOLK, REVIEW OF THE DELAWARE CORPORATION LAW 27 (1968); PAINTER, *supra* note 1, at 104, 446; 1 O'NEAL, *supra* note 1, at § 5.33; Comment, *Shareholder Pooling Agreements—Validity, Legality and Enforcement*, 24 ARK. L. REV. 501, 512 (1971). Professor Folk was one of the draftsmen of DEL. CODE ANN. tit. 8, § 218(e). PAINTER, *supra* note 1, at 446.

<sup>35</sup> One commentator has suggested that section 706(c) alone "may serve as an explicit rejection in California of any rule that a voting agreement can fall within the ambit of a voting trust statute and be invalid because it does not comply with the statute's provisions . . . [as was held in] *Abercrombie v. Davies*. . . ." *Close Corporation*, *supra* note 8, at 464 n.197.

A pooling agreement which was too similar to a voting trust might, however, run afoul of either federal securities law, which includes voting trust certificates in the definition of "security," or California securities law, which considers certificates or interests in voting trusts as securities. See note 5 *supra*.

Although the *Abercrombie* problem has been eliminated, the common law of agency is another obstacle to the use of proxies to enforce pooling agreements. The holder of a proxy is an agent, and the grantor of the proxy is a principal.<sup>36</sup> Because of the consensual and personal nature of the principal-agent relationship, courts of equity will not grant specific performance of agency contracts.<sup>37</sup> The courts are especially unwilling to specifically enforce stock proxies because of a general public policy against disenfranchisement of shareholders.<sup>38</sup> This reluctance is all the more remarkable since in general the remedy of damages is inadequate.<sup>39</sup>

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For general precautions to observe in drafting pooling agreements see 1 O'NEAL, *supra* note 1, at § 5.27; Schwarzer, *Practical Problems of Organizing Closely Held Corporations*, in *ADVISING CALIFORNIA BUSINESS ENTERPRISES* 403, 411-12 (State Bar of Cal., Comm. on Continuing Education of the Bar, 1958); E. BELSHEIM, *MODERN LEGAL FORMS* § 3011.1 (1966); Sturdy, *supra* note 3, at 291-92; 46 MICH. L. REV. 70, 75-76 (1947).

For sample pooling agreement forms, see E. BELSHEIM, *MODERN LEGAL FORMS* §§ 3013.1 clauses 2 & 3, 3013.2 clause 1, 3013.5 (1966); 2A M. WOLF, *FLETCHER CORPORATION FORMS ANNOTATED* §§ 2036 clause 1, 2037, 2054, 2054.1 (1973, Supp. 1975); M. FOGELMAN, *WEST'S MCKINNEY'S FORMS, BUSINESS CORPORATION LAW* §§ 7.07 clause 1, 7.08 clause 1, 7.09 clause 8(a), 7.10 (containing an irrevocable proxy) (1965); 2 O'NEAL, *supra* note 1, at §§ 10.32, 10.33 clause 7, 10.35. Oddly, most of these forms do not suggest the use of express contingent irrevocable cross proxies stated to be coupled with an interest. Nor do they include an express provision that the contract is specifically enforceable. Either provision would be valuable.

<sup>36</sup> 1 O'NEAL, *supra* note 1, § 5.36, at 124; PAINTER, *supra* note 1, at 121; Annot., 159 A.L.R. 307 (1945).

<sup>37</sup> 1 F. MECHEM, *A TREATISE ON THE LAW OF AGENCY* §§ 563, 565-67 (1914) [hereinafter cited as F. MECHEM]; W. SEAVEY, *HANDBOOK OF THE LAW OF AGENCY* § 46 (1964) [hereinafter cited as SEAVEY]; Chayes, *Madame Wagner and the Close Corporation*, 73 HARV. L. REV. 1532, 1535 (1960).

In the words of one authority:

It is elementary that one man can not bind another by act or contract without that other's assent; and such assent, in order to be effective, must exist at the moment the act is performed or the contract is entered into. Hence, though authority has been given an agent to perform an act or make a contract in behalf of a principal, the act or contract will not bind the principal if the authority has been withdrawn before its execution; for in such a case, assent to be bound would not exist at the moment the act was done or the contract was entered into. At any time before its execution, a principal may revoke authority. The law will not force him against his will into what is essentially a voluntary transaction merely because at a prior time he had indicated a willingness to enter into the same by appointing an agent to represent him.

S. STEELE, *A STUDENT'S TEXT ON THE LAW OF PRINCIPAL AND AGENT* 94-95 (1909).

<sup>38</sup> Oppenheim, *The Close Corporation in California—Necessity of Separate Treatment*, 12 HASTINGS L.J. 227, 244 n.89 (1961); Comment, *Irrevocable Proxies*, 43 TEXAS L. REV. 733 (1965). See 1 O'NEAL, *supra* note 1, §§ 5.04, at 11-12, 5.36, at 123; 47 MICH. L. REV. 547, 548-50 (1949). For criticism of this public policy doctrine see Rohrlich, *Corporate Voting: Majority Control*, 7 ST. JOHN'S L. REV. 218, 224-28 (1933).

<sup>39</sup> Damages for the loss of votes would of necessity be quite speculative. Cf. Comment, *Corporations: Voting Trusts and Irrevocable Proxies*, 36 CALIF.

Certain exceptional agency relationships cannot be terminated by the principal once he contracts not to revoke; these are the so-called "powers coupled with an interest."<sup>40</sup> If the agency is created for the protection of the agent, it would be unjust to allow the principal to revoke.<sup>41</sup> For example, a pledgee of stock might demand an irrevocable proxy from the owner of stock; or someone who purchased stock after the record date might demand such a proxy from the selling record holder. In either situation, the courts would specifically enforce the contract not to revoke.<sup>42</sup> In fact, some of the cases indicate that the courts will find an implied contract not to revoke where a proxy is coupled with an interest, even when the proxy is not expressly stated to be irrevocable.<sup>43</sup>

Certain commentators have cogently argued that "powers coupled with an interest" are not agency powers at all.<sup>44</sup> An agency relationship is created mainly to benefit the principal, and the agent owes a fiduciary duty to the principal.<sup>45</sup> "Powers coupled with an interest," however, are not created for the benefit of the principal but for the benefit of the power-holder.<sup>46</sup> Therefore, these powers are not agencies at all, but pseudo-agencies not subject to the laws of agency.<sup>47</sup>

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L. REV. 281, 283 (1948); Note, *Voting Trusts and Irrevocable Proxies*, 41 TEMP. L.Q. 480, 480-81 (1968); 96 U. PA. L. REV. 121, 122 n.7 (1947).

<sup>40</sup> Hunt v. Rousmanier's Adm'rs, 21 U.S. (8 Wheat.) 174 (1823); Jay v. Dollarhide, 3 Cal. App. 3d 1001, 1023, 84 Cal. Rptr. 538, 551-52 (5th Dist. 1970); Todd v. Superior Court of San Francisco, 181 Cal. 406, 417, 184 P. 684, 688-89 (1919); W. SELL, AGENCY § 229 (1975); Annot., 28 A.L.R.2d 1246 (1953); Annot., 64 A.L.R. 380 (1929). See CAL. CIV. CODE § 2356 (West Supp. 1976); RESTATEMENT (SECOND) OF AGENCY §§ 138-39 (1957).

<sup>41</sup> 1 F. MECHEM, *supra* note 37, at §§ 569-70; F. MECHEM, OUTLINE OF THE LAW OF AGENCY §§ 265-66 (4th ed., P. Mechem editor 1952) [hereinafter cited as P. MECHEM]; SEAVEY, *supra* note 37, at § 11C.

<sup>42</sup> Pledgee: Deibler v. The Chas. H. Elliot Co., 368 Pa. 267, 81 A.2d 557 (1951); Annot., 159 A.L.R. 307, 309 (1945); Comment, *Irrevocable Proxies*, 43 TEXAS L. REV. 733, 744 (1965); Comment, *Irrevocable Proxies*, 28 ST. JOHN'S L. REV. 155, 157 (1953). See PAINTER, *supra* note 1, at 120-21; Annot., 68 A.L.R.3d 680, 687-88 (1976). Purchaser: E. ARANOW & H. EINHORN, PROXY CONTESTS FOR CORPORATE CONTROL 347 (1957). See PAINTER, *supra* note 1, at 121. See generally Annot., 159 A.L.R. 307 (1945); Comment, *Irrevocable Proxies*, 43 TEXAS L. REV. 733, 736-47 (1965).

<sup>43</sup> 1 O'NEAL, *supra* note 1, at § 5.36. Cf. F. MECHEM, *supra* note 37, at § 584. The RESTATEMENT (SECOND) OF AGENCY § 139 (1957) states: "Unless otherwise agreed, a power given as security is not terminated by . . . revocation by the creator of the power . . ." (emphasis added). But cf. M. FERSON, PRINCIPLES OF AGENCY §§ 201, 206 (1954).

<sup>44</sup> W. CARY, CASES AND MATERIALS ON CORPORATIONS A-104 (1969); F. MECHEM, *supra* note 37, at § 655; P. MECHEM, *supra* note 41, at § 266; SEAVEY, *supra* note 37, at §§ 11, 42G; Seavey, *Termination by Death of Proprietary Powers of Attorney*, 31 YALE L.J. 283 (1922).

<sup>45</sup> RESTATEMENT (SECOND) OF AGENCY §§ 1, 13, 376-94 (1957).

<sup>46</sup> See authorities cited in note 44 *supra*.

<sup>47</sup> *Id.*

Furthermore, many of the authorities on agency law have found the term "power coupled with an interest" too restrictive because it suggests that the courts must find a property "interest" in the subject matter of the "agency" itself.<sup>48</sup> Rather than force the courts to strain to find an "interest," the Restatement (Second) of Agency uses the term "power given as security":

A power given as security is a power to affect the legal relations of another, created in the form of an agency authority, but held for the benefit of the power holder or a third person and *given to secure the performance of a duty* or to protect a title, either legal or equitable, such power being given when the duty or title is created or given for consideration.<sup>49</sup>

This concept is intended to cover all those pseudo-agency powers which are created for the protection of someone other than the power-grantor.<sup>50</sup>

## II. IRREVOCABLE PROXIES UNDER THE NEW LAW

The new law expressly declares when a proxy can be made irrevocable:

A proxy which states that it is irrevocable is irrevocable for the period specified therein . . . when it is held by any of the following or a nominee of any of the following:

(1)-(4) [The statute lists the holders of certain specific kinds of proxies "coupled with an interest" or "given as security," e.g., pledgees, option holders, creditors, purchasers, and employees.]

(5) A person designated by or under an agreement under Section 706.

. . . In addition to the foregoing clauses . . . , a proxy *may be made irrevocable* . . . if it is *given to secure the performance of a duty* or to protect a title, either legal or equitable, until the happening of events which, by its terms, discharge the obligations secured by it.<sup>51</sup>

Subdivision (5) means that irrevocable proxies can be used to enforce any pooling agreement created under section 706(a), which applies to close corporation shareholders. Proxies in other pooling agreements can also be made irrevocable if "given to

<sup>48</sup> M. FERSON, *PRINCIPLES OF AGENCY* §§ 201, 213 (1954); F. MECHEM, *supra* note 37, at §§ 576, 588; P. MECHEM, *supra* note 41, at §§ 269, 270. See RESTATEMENT (SECOND) OF AGENCY §§ 138-39 (1957); Seavey, *Termination by Death of Proprietary Powers of Attorney*, 31 YALE L.J. 283 (1922).

<sup>49</sup> RESTATEMENT (SECOND) OF AGENCY § 138 (1957) (emphasis added).

<sup>50</sup> See *id.* at § 138, comments a-d. Cf. *id.* at § 139, comments a-d.

<sup>51</sup> NEW CODE § 705(e) (emphasis added).

secure the performance of a duty or to protect a title, either legal or equitable." This phrase is taken verbatim from the definition of "power given as security" in the Restatement.<sup>52</sup> It seems clear that a proxy created to ensure compliance with any pooling agreement would be an irrevocable "power given as security."<sup>53</sup> The proxy is created to secure the performance of each party's duty to comply with the contract.<sup>54</sup>

One commentator, however, has questioned the application of this Restatement language to close corporations. Professor Abram Chayes has remarked:

To be sure, the *Restatement of Agency* definition of powers given for security fits a proxy given in connection with a pooling agreement neatly enough. The power to vote the shares is readily seen to be given to secure the performance of the duty of the obligor to vote in accordance with the provisions of the agreement.<sup>55</sup>

Chayes then notes, however, that none of the comments and examples to section 138 of the Restatement involve the kind of close and continuing relationship found among close corporation shareholders, and he suggests that courts may still refuse to enforce irrevocable proxies in pooling agreements that "run afoul of equitable principles against specific enforcement."<sup>56</sup> Nevertheless, as Chayes' article itself acknowledges,<sup>57</sup> the California Supreme Court

<sup>52</sup> See text accompanying note 49 *supra*. NEW CODE § 705(e) uses the phrase "may be made irrevocable," while RESTATEMENT (SECOND) OF AGENCY § 139(1) (1957) provides: "Unless otherwise agreed, a power given as security is not terminated by (a) revocation by the creator of the power . . ." (emphasis added). Presumably, a proxy would not be irrevocable in California unless specifically stated to be irrevocable.

<sup>53</sup> Bradley, *Toward a More Perfect Close Corporation—The Need for More and Improved Legislation*, 54 GEO. L.J. 1145, 1165 (1966). Cf. 1 O'NEAL, *supra* note 1, § 5.36, at 127.

<sup>54</sup> As noted earlier, section 705(e) provides that "A proxy which states that it is irrevocable is irrevocable for the period specified therein . . . when it is held by . . . (5) A person designated by or under an agreement *under* Section 706" (emphasis added).

Since clause (5) is not limited to agreements under 706(a), it presumably also includes agreements "under" subdivisions (b), (c), or (d). Section 706(b) refers to voting trusts, where the trustee has record title and irrevocable proxies are not necessary. Subdivision (c) covers agreements made pursuant to section 706(a) and protects them from invalidation on the basis of similarity to a voting trust. See text accompanying notes 32-35 *supra*.

Conceivably, it might be argued that clause (5) includes agreements "under" section 706(d), which provides that section 706 does not invalidate any voting agreement which is not otherwise illegal. Under this interpretation, section 705(e)(5) would allow a person designated in *any* legal pooling agreement to hold an irrevocable proxy.

<sup>55</sup> Chayes, *Madame Wagner and the Close Corporation*, 73 HARV. L. REV. 1532, 1543 (1960).

<sup>56</sup> *Id.* at 1545.

<sup>57</sup> *Id.* at 1542.

in *Smith* enforced irrevocable proxies implied from a pooling agreement.<sup>58</sup> However, the new law in effect rejects Chayes'

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<sup>58</sup> As Chayes also concedes, *id.*, in *Abercrombie v. Davies*, 35 Del. Ch. 599, 123 A.2d 893, 906-07 (Ch. 1956), *rev'd on other grounds*, 36 Del. Ch. 371, 130 A.2d 338 (Sup. Ct. 1957), the Delaware Chancellor expressed "enthusiasm for the device [of irrevocable proxies in pooling agreements]."

A recent note in the *Hastings Law Journal* comments that *Smith* "has not been followed with enthusiasm, and it is by no means clear that irrevocable proxies could today be created so easily." *Close Corporation*, *supra* note 8, at 466-67. One case and one law review article are cited for this proposition. The case is *Thomsen v. Yankee Mariner Corp.*, 106 Cal. App. 2d 454, 235 P.2d 234 (4th Dist. 1951). The law review article simply states:

Other jurisdictions have cited it [*Smith*] often and expanded "interest" to include the power to sell the shares, and a right of first refusal. California, however, does not seem to have progressed as far. In *Thomsen v. Yankee Mariner Corp.* a proxy given with a conditional contract of sale was considered not coupled with an interest and was revocable.

Oppenheim, *The Close Corporation in California—Necessity of Separate Treatment*, 12 *HASTINGS L.J.* 227, 245 (1961) (footnotes omitted).

Because of its highly unusual fact situation, *Thomsen* provides no support for the statement in the *Hastings* note and little support for Oppenheim's comment. The *Thomsen* case involved a disagreement over whether *Yankee Mariner Corporation* should be dissolved. *Yankee Mariner's* largest shareholder, *San Diego Packing Company*, was the leader of the pro-dissolution group, which held a majority of the stock. See Brief for Respondents at 6-12, *Thomsen v. Yankee Mariner Corp.*, 106 Cal. App. 2d 454, 235 P.2d 234 (4th Dist. 1951). For unexplained reasons, three of the shareholders in this faction signed a conditional contract selling their shares to the *San Diego Packing Company*, with the understanding that, in addition to the named purchase price, the three were entitled upon dissolution to their pro rata share of any surplus remaining after the reimbursement of all shareholders for the original issue price. See Opening Brief for Appellants, *supra* at 4-8.

With the intention of removing the existing board and taking control of the corporation, all those in support of dissolution signed proxies irrevocably granting power to vote their shares to Mr. J.A. Donnelly, the attorney for *San Diego Packing Company*. Perhaps out of excessive zeal, however, most of the members of the faction voted their shares in person at the annual meeting, in full cooperation with Mr. Donnelly, who remained the spokesman for the group and expressly announced that he had no objection to the members of his faction voting their own stock. The pro-dissolution group succeeded in gaining control of the corporation. See Opening Brief for Appellants, *supra* at 8-14; Brief for Respondents, *supra* at 13-17.

The anti-dissolution faction (the appellants) attacked the legality of the shareholder vote by focusing upon the conditional sales contract between *San Diego Packing Company* and three other shareholders in the pro-dissolution faction. According to the anti-dissolution group, the conditional "sale" violated an articles provision granting the other shareholders a right of first refusal. "Therefore, in the proportion to which the other shareholders were entitled to purchase said stock, it should be deemed to be held in trust for the optionees." Opening Brief for Appellants, *supra* at 15.

The anti-dissolution group did not claim that Donnelly held a proxy coupled with an interest. Indeed, the phrase "coupled with an interest" does not appear in either brief, except incidentally within the respondent's (pro-dissolution faction's) verbatim quotation of section 2228 of the old law (CAL. CORP. CODE § 2228 (West 1955)). Brief for Respondents, *supra* at 18.

For several reasons, it is impossible to generalize from *Thomsen* about the revocability of proxies coupled with a contract of sale. First, the conditional contract of sale was ineffective because no right of first refusal had been granted to

views by explicitly making pooling agreements among shareholders of close corporations specifically enforceable,<sup>59</sup> and expressly permitting such pooling agreements to contain irrevocable proxies.<sup>60</sup> Furthermore, the new law states that "a proxy may be made irrevocable . . . if it is given to secure the performance of a duty . . . ."<sup>61</sup> In light of this unqualified statutory language and the *Smith* precedent, it seems almost certain that California courts lack the discretion suggested by Chayes and would routinely enforce irrevocable proxies in all pooling agreements.

Unfortunately, this tidy chain of logic does not fully explain section 706(a) of the new law. That section seems designed to facilitate the use of specifically enforceable pooling agreements, but its benefits are limited to close corporation shareholders.<sup>62</sup> If sections 706(d) and 705(e) have the meaning that I have given them, section 706(a) is redundant at best. Indeed, as I will suggest,<sup>63</sup> the effect of 706(a) may be to disadvantage shareholders in close corporations.

The legislative history suggests that this anomaly has its roots in political accident. In the first and second exposure drafts of the proposed new law, section 706(a) was limited to close corporations, and section 705(e) lacked its present last sentence permitting all proxies given as security to be made irrevocable. Under this version, irrevocable proxies could be used only in close corporation pooling agreements.

Section 705(e)'s present last sentence<sup>64</sup> was added to the preprint version of the bill because there might be other "proxies coupled with an interest" which would have been irrevocable under the common law but were not covered by clauses<sup>65</sup> (1) through (5).<sup>66</sup> The specific language from the Restatement was suggested

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the other shareholders as required in the articles of incorporation. See *Thomsen v. Yankee Mariner Corp.*, 106 Cal. App. 2d 454, 457, 235 P.2d 234, 236 (4th Dist. 1951). Second, the conditional contract of sale was peripheral to the goals of the parties and was evidently abandoned. As the court noted: "Before any of the necessary steps to consummate the sale were taken the parties proceeded along other lines." *Id.* at 456, 235 P.2d at 235. Third, both the proxy-grantor and the proxy-holder consented to the revocation of the proxies. See Brief for Respondents, *supra* at 14-15, 22-23. Indeed, the attorney for the pro-dissolution faction, Donnelly (the proxy-holder himself) argued to the court that the proxies were irrelevant.

<sup>59</sup> TECHNICAL AMENDMENTS BILL § 706(a). See note 9 *supra*.

<sup>60</sup> NEW CODE § 705(e)(5); TECHNICAL AMENDMENTS BILL § 706(a).

<sup>61</sup> NEW CODE § 705(e).

<sup>62</sup> See note 9 *supra*.

<sup>63</sup> See text accompanying notes 71-73 *infra*.

<sup>64</sup> For the language of section 705(e) see text accompanying note 51 *supra*.

<sup>65</sup> Clauses (1) through (5) list certain specific types of powers "coupled with an interest" or "given as security." See text accompanying note 51 *supra*.

<sup>66</sup> Letter from Harold Marsh, Jr., Esq., to William K. S. Wang, Feb. 9, 1976, copy on file with the UCLA Law Review; Telephone interview with R. Roy

by Professor Richard Jennings as a more modern formulation of the concept "coupled with an interest."<sup>67</sup> The effect of the change in section 705(e), however, was to permit self-executing irrevocable proxies in all pooling agreements.

The introduced version of the bill deleted the words "close corporation" from the first sentence of section 706(a). The effect of the deletion was to apply section 706(a) to all corporations, and not just close corporations.<sup>68</sup> The Department of Corporations vigorously objected, however. As a result of the Department's position, section 706(a) was restored to its original form and confined to close corporations. Oddly, the Department made no objection to the recently added last sentence of section 705(e), and that provision remained intact.<sup>69</sup>

### III. AVOIDING SECTION 706(a)

Whatever the reason for the new law's awkwardness, practitioners will have to live with it. Mere redundancy is of no great concern, but the ironic result under the new law is that shareholders in close corporations may have less, not more, freedom to make enforceable shareholder agreements. The last sentence of section 706(a) states:

An agreement made *pursuant to this subdivision* between shareholders of a close corporation shall terminate when the corporation ceases to be a close corporation.<sup>70</sup>

Section 706(d) makes it clear that the language just quoted does not invalidate any non-706(a) pooling agreements not otherwise illegal. In other words, no attempt is made by the New Code to regulate the duration of any pooling agreement not made "pursuant" to section 706(a).<sup>71</sup>

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Finkle, Esq., Consultant, Assembly Select Committee on Revision of the Corporations Code, Jan. 7, 1976.

<sup>67</sup> See authorities cited in note 66 *supra*.

<sup>68</sup> Inexplicably, the drafters retained the last sentence of section 706(a), which provides that a pooling agreement between shareholders of a close corporation shall terminate when the company ceases to be a close corporation. Refer, however, to the Subsequent Developments Note which concludes this Article.

<sup>69</sup> Telephone interview with R. Roy Finkle, Esq., Consultant, Assembly Select Committee on Revision of the Corporations Code, Jan. 7, 1976.

<sup>70</sup> TECHNICAL AMENDMENTS BILL § 706(a) (emphasis added). This section has recently been amended, which may affect some of the comments made herein. Refer to the Subsequent Developments Note which concludes this Article.

<sup>71</sup> Conceivably, a court might invalidate a pooling agreement with a *perpetual* duration. One commentator has suggested that a pooling agreement "must be for a purpose not against public policy, [and] be for a term commensurate with that purpose . . ." Sturdy, *supra* note 3, at 289 (emphasis added). Cf. Laughlin v. Johnson, 230 Ill. App. 25 (1923) (perpetual irrevocable proxies are void as against public policy).

On the other hand, another researcher found only two cases, *Morel v. Hoge*, 130 Ga. 625, 61 S.E. 487 (1908) and *Rosenkrantz v. Chattahoochee Brick Co.*, 147 Ga. 730, 95 S.E. 225 (1918), which invalidated or refused to enforce a share-

The meaning of "pursuant" is unclear. Obviously, if the corporation does not meet the definition of close corporation in section 158(a),<sup>72</sup> no pooling agreement among its shareholders is made pursuant to section 706(a). It is not clear, however, whether the shareholders of a close corporation can avoid the duration limitation of section 706(a) by such techniques as the following:

(1) Entering into a pooling agreement which expressly states that it is not made pursuant to section 706(a);

(2) Entering simultaneously into two separate long-term pooling agreements, identical in all respects except that the first expressly states that it is made pursuant to section 706(a), while the second expressly states that it is not. While the first agreement would terminate if the company ceased to be a close corporation, the second would perhaps be allowed to continue;

(3) Entering into a two-layer pooling agreement, the first layer consisting of a section 706(a) agreement and the second consisting of a non-section 706(a) agreement to take effect if and when close corporation status terminates.

The first technique poses the question whether close corporation shareholders can avoid a provision that was intended to give them more flexibility but in fact does not. One major thrust of the new law is to accommodate the needs of close corporation stockholders. Since it would certainly be anomalous to grant close corporation shareholders less flexibility than non-close cor-

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holders' agreement primarily because of excessive duration. Logan, *Methods to Control the Closely Held Kansas Corporation*, 7 KAN. L. REV. 405, 418-19 (1959). In fact, even these two cases may have placed as much emphasis on the nature of the contracts involved as their duration.

*Rosenkrantz* involved an agreement to pool shareholder votes for specified individuals as corporate officers. The court viewed the case as simply a suit for specific performance of a long-term employment contract and dismissed the suit on the ground that a court of equity cannot grant such relief. Because the court found it unnecessary to consider the validity of the contract, the case is not relevant. Furthermore, because the contract specified how the shareholders should vote for corporate officers, it was a somewhat unusual pooling agreement.

The case of *Morel v. Hoge* involved a pooling agreement between two factions stipulating that one faction would permanently elect three of five directors. The opinion apparently held all pooling agreements invalid because of a public policy against separation of voting power from stock ownership. See 6 Z. CAVITCH, BUSINESS ORGANIZATIONS 114-35 & n.7 (1976); FLETCHER, *supra* note 1, at 306 & n.32. The court expressly rejected the holding of *Smith v. San Francisco & N. Pac. Ry.*, 115 Cal. 584, 47 P. 582 (1897), which involved a pooling agreement with a term of only five years. 130 Ga. at 631, 61 S.E. at 490.

Thus, the validity of perpetual pooling agreements is far from settled. In a book emphasizing New York law, Carlos Israels makes the following remark about shareholders' agreements: "[t]here would appear to be no legal objection to perpetual duration, and many shareholders' agreements provide that they shall remain in force so long as any of the original parties remain a shareholder." C. ISRAELS, CORPORATE PRACTICE 94 (1974) (footnote omitted).

<sup>72</sup> See note 9 *supra*.

poration shareholders in the use of pooling agreements, there is no public policy reason to prevent close corporation shareholders from waiving both the "benefits" and the limitations of section 706(a).

The second and third approaches toward avoiding the duration limitation of section 706(a) are attempts to have one's cake and eat it too. If successful, the slight advantage of these two techniques is that until the termination of close corporation status, express statutory language would make the pooling agreement valid, immune from attack on the basis of similarity to a voting trust,<sup>73</sup> and enforceable by irrevocable proxy or judicial decree.

It is difficult to anticipate how the courts would deal with either the second or the third techniques. If the first approach is legal, the second technique would also appear to be permissible. On the other hand, the third technique has effects identical to the second but might well be held illegal as too blatant a circumvention of section 706(a).<sup>74</sup> The discussion of these various subterfuges illustrates the underlying problem. Section 706(a) does not confer any benefits on close corporation shareholders that are not granted to the shareholders of all corporations under other provisions of the new law. Therefore, section 706(a)'s attempt to limit its benefits to close corporation shareholders leads to absurd results.

#### IV. SUGGESTED CHANGES IN THE NEW CALIFORNIA GENERAL CORPORATION LAW

In my opinion, California should adopt provisions similar to those of New York which expressly validate all shareholder pooling agreements and permit an irrevocable proxy to be granted to any person designated in a pooling agreement.<sup>75</sup> This recommendation could be implemented by deleting the words "close corporation" from the beginning of section 706(a) of the new law and deleting the last sentence of section 706(a), with the following beneficial results:

(1) Section 706(a) would validate and make specifically enforceable *all* pooling agreements;

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<sup>73</sup> Section 706(c) of the new law provides that no section 706(a) agreement shall be invalid because it is a voting trust which does not comply with the statutory formalities of section 706(b). This protection is not very valuable; section 706(d) effectively gives the same protection to all pooling agreements, including those not made pursuant to section 706(a). See text accompanying notes 32-35 *supra*.

<sup>74</sup> Refer, however, to the Subsequent Developments Note which concludes this Article.

<sup>75</sup> N.Y. BUS. CORP. LAW § 609(f)(5) (McKinney 1963); *id.* § 620(a) (McKinney Supp. 1975). See C. ISRAELS, CORPORATE PRACTICE § 4.21 (1974).

(2) Section 705(e)(5), which refers to section 706, would permit a person designated in *any* pooling agreement to hold an irrevocable proxy;<sup>76</sup>

(3) Section 706(c) would protect *all* pooling agreements from being invalidated because of non-compliance with the statutory formalities required for voting trusts under section 706(b).<sup>77</sup>

It might also be wise to place a maximum on the term of a pooling agreement, as is done in Delaware.<sup>78</sup> Such a provision might also provide that any proxies created pursuant to a pooling agreement would be subject to the same statutory maximum duration. The selection of the specific year limitation would be arbitrary, but in light of the similarity between voting trusts and pooling agreements with irrevocable proxies,<sup>79</sup> it might be appropriate to place the same ten year statutory maximum<sup>80</sup> on both types of agreements.<sup>81</sup>

### CONCLUSION

Section 706(a) of the new law should make specifically enforceable all pooling agreements, not just those of close corporations. Such agreements have been recognized as generally valid in most states<sup>82</sup> and in California since at least 1897.<sup>83</sup> There is no reason why the new law should be more restrictive than the previous law governing pooling agreements.

A careful examination of sections 705(e) and 706(d) indicates that all pooling agreements can be made self-executing

<sup>76</sup> See text accompanying note 51 *supra*.

<sup>77</sup> See text accompanying note 32 *supra*.

<sup>78</sup> See DEL. CODE ANN. tit. 8, § 218(c) (1974). For advocacy of such a limitation on the duration of pooling agreements see Comment, *Corporations: Voting Trusts and Irrevocable Proxies*, 36 CALIF. L. REV. 281, 288-89 (1948).

<sup>79</sup> Bradley, *supra* note 53, at 1171.

<sup>80</sup> Section 706(b) places a ten year maximum on the duration of a voting trust, with permission to extend. See note 31 *supra*.

<sup>81</sup> Professor Bradley, a vigorous proponent of identical statutory treatment for pooling agreements and voting trusts, suggests that such arrangements between shareholders of close corporations be free of any time limitation and that all other voting trusts and pooling agreements be subject to a ten year limitation. He also contends that voting trusts or pooling agreements that are participated in by less than all shareholders of a close corporation should be illegal. Bradley, *supra* note 53, at 1170-74.

<sup>82</sup> 6A A. CORBIN, CORBIN ON CONTRACTS 522 (1962); H. HENN, HANDBOOK OF THE LAW OF CORPORATIONS AND OTHER BUSINESS ENTERPRISES § 267 (1970); W. PAINTER, PROBLEMS AND MATERIALS IN BUSINESS PLANNING 27 (1975). See Annot., 45 A.L.R.2d 799 (1956); FLETCHER, *supra* note 1, at § 2064 (1967); 1 O'NEAL, *supra* note 1, at § 5.12; RESTATEMENT OF CONTRACTS § 569, illustration 3 (1932).

<sup>83</sup> *Smith v. San Francisco & N. Pac. Ry.*, 115 Cal. 584, 47 P. 582 (1897).

through the use of irrevocable proxies. Therefore, section 706(a) is largely superfluous, and the limitation of its coverage to close corporations is ineffectual, anomalous, and misleading.

#### SUBSEQUENT DEVELOPMENTS NOTE

After this Article was completed, the Technical Amendments Bill added the following italicized clause to the last sentence of section 706(a):

*An agreement made pursuant to this subdivision between shareholders of a close corporation shall terminate when the corporation ceases to be a close corporation, except that if the agreement so provides it shall continue to the extent it is enforceable apart from this subdivision.*

The new language is an improvement because it makes it clear that section 706(a)'s duration limitation can be circumvented. The change, however, highlights the superfluosity of section 706(a).