The California Statutory Close Corporation: Gateway to Flexibility or Trap for the Unwary?*

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Professor Wang analyzes the close corporation provisions of the recently enacted California General Corporation Law and points out several troubling ambiguities. He discusses both the advantages and the disadvantages of statutory close corporation status, placing special emphasis on federal tax and California Securities Law problems encountered by the statutory close corporation. In addition, the author makes a number of recommendations designed to eliminate impediments to the use of the flexible devices newly created by the corporations code.

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Throughout this article, the following terminology will be used:

Close corporation—This term will be used only to describe California statutory close corporations as defined in CAL. CORP. CODE § 158 (West Supp. 1976). A corporation with a small number of shareholders will be called a closely held corporation.

Shareholders' agreement—This term will be used only to describe the agreements defined in id. § 186 (written agreements among all of the shareholders of a statutory close corporation). Quotation marks will always be placed around the words "shareholders' agreement" to emphasize that it is a term of art. Other contracts or arrangements between shareholders will be called shareholder contracts or shareholder arrangements.

Pooling agreement or voting agreement—These two terms will be used synonymously to refer to a contract among shareholders that their shares will be voted as a unit. Such an agreement may
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contain within it irrevocable proxies. Although the Corporations Commissioner and most commentators use the term voting agreement, I prefer the term pooling agreement because it helps to distinguish this type of contract from other shareholder arrangements such as voting trusts, in which the parties transfer their shares to one or more trustees who vote the shares. See generally Wang, Pooling Agreements Under the New California General Corporation Law, 23 U.C.L.A. L. Rev. 1171 (1976).
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I. INTRODUCTION

On January 1, 1977, the new California General Corporation Law became effective. One of the most important goals of the new code is new flexibility for the statutorily defined "close corporation." There appears, however, to be surprisingly little use of the new close corporation provisions by businesses. At my request, the Secretary of State's office made a survey of 300 articles of incorporation filed in mid-January, 1978. Only twenty-eight percent were close corporations. The overwhelming majority of corporations are closely held; thus, it appears that many small businesses are not taking advan-


2. Throughout this article, the term "close corporation" will mean a § 158 corporation. Corporations with few shareholders will be called "closely held corporations." See generally 18 H. MARSH, supra note 1, § 21.1.

3. Letter from Bill Holden, Staff Counsel, Office of the California Secretary of State, to William K.S. Wang (Mar. 1, 1978) (on file with the San Diego Law Review). In 1977, approximately 40,000 articles of incorporation were filed with the Secretary of State. Id.

4. Professor Alfred Conard has estimated that over 90% of all corporations have 10 or fewer shareholders. A. CONARD, CORPORATIONS IN PERSPECTIVE 118 (1976); Conard, The Corporate Census: A Preliminary Exploration, 63 CALIF. L. REV. 440, 458-59 (1975). See also 1 H. BALLANTINE & G. STERLING, supra note 1, § 60.02[2][a]; M. EISENBERG, THE STRUCTURE OF CORPORATIONS 38-39 (1976).
tage of the new provisions in the statute. Conversations with local attorneys confirm that relatively few closely held corporations are electing statutory close corporation status and that many companies choosing such status are not making use of the devices made available by the new code. In part this may be due to inertia and lack of familiarity with the new law, but it may also reflect ambiguity in the statute, the limited advantages of close corporation status, and the uncertainty about the impact of federal tax law and the California Securities Law on the close corporation.

II. THE CLOSE CORPORATION PROVISIONS OF THE NEW GENERAL CORPORATION LAW

This section of the article will discuss the definition of "close corporation," how a company voluntarily qualifies as a close corporation, and how a corporation might be voluntarily or involuntarily disqualified as a close corporation. The next section will analyze the benefits of close corporation status, with special emphasis on the new close corporation pooling agreement and "shareholders' agreement."

There is no single close corporation subchapter in the new code. One whimsical explanation for this lack is that the "Big Business" lobby was concerned that a separate section for close corporations would appear to split the code into two sections—one covering big business and one covering small business. The legislature might then be tempted to tinker with the section regulating big business. Another fanciful theory is that the close corporation provisions are scattered throughout the code to make the law more confusing and thereby generate legal fees for the experts associated with drafting the law. Both hypotheses are dubious because section 158(g) contains a list of all the sections making specific reference to the close corporation, and it is possible to create one's own close corporation subchapter simply by reading all the provisions listed within this section.

A. Definition of "Close Corporation"

Although the term close or closely held corporation may be defined in various ways, a "close corporation" under the California Corpo-

5. Because "shareholders' agreement" is a term of art under § 186 of the new Code, it will be placed in quotation marks throughout the article.

6. For example, in 1 F. O'Neal, CLOSE CORPORATIONS: LAW AND PRACTICE § 1.02 (2d ed. 1971), a closely held company is defined as "a corporation whose shares are not generally traded in the securities markets." The term was judicially defined in Brooks v. Willcuts, 78 F.2d 270, 273 (8th Cir. 1935), as "a corporation in which the stock is held in few hands, or in few families, and wherein it is not at all, or only rarely, dealt in by buying or selling." See generally 1 H.
rations Code is defined in terms of specific, statutory requirements. First, the name of the corporation must contain the word "corporation," "incorporated," "limited," or abbreviations for these words." Second, the articles of incorporation must include the statement: "This corporation is a close corporation." Third, the articles must have a provision limiting the number of shareholders of record to a specific number not to exceed ten.

B. Qualification as Close Corporation

A company qualifies as a close corporation by voluntarily meeting the three above-mentioned criteria. An existing corporation can elect close corporation status by adding the essential word to its name (if necessary) and the critical provisions to its articles, providing that approval of all shares of all classes (voting or non-voting) is obtained.

C. Definition of "Shareholder"

As noted earlier, a close corporation is permitted a maximum of ten shareholders of record. For the purpose of this limitation, a husband and wife count as one shareholder. A corporation, partnership, or trust also counts as a single shareholder unless it was specifically formed for the purpose of evading the numerical limit.


9. Id. See also 1 H. BALLANTINE & G. STERLING, supra note 1, § 61.01[2][a]; 18 H. MARSH, supra note 1, § 21.2, at 66. The original proposal developed by the Committee on Corporations of the State Bar of California and the Assembly Select Committee on the Revision of the Corporation Code specified that a corporation having no more than 35 shareholders could elect close corporation status. See STATE BAR OF CALIFORNIA, COMMITTEE ON CORPORATIONS, EXPOSURE DRAFT: GENERAL CORPORATION LAW § 159(a) (1974). See also 16 H. MARSH, supra note 1, § 1.7, at 12.

10. CAL. CORP. CODE § 158(b) (West Supp. 1976); 1 H. BALLANTINE & G. STERLING, supra note 1, § 61.02, at 23-24. See generally ORGANIZING AND COUNSELING CLOSELY HELD CORPORATIONS 53-54 (Cal. CEB 1977) [hereinafter cited as ORGANIZING].

11. CAL. CORP. CODE § 158(d) (West Supp. 1976); 1 H. BALLANTINE & G. STER-
D. Termination of Close Corporation Status

Disqualification as a close corporation can be either voluntary or involuntary. A corporation voluntarily terminates its close corporation status simply by amending its articles to delete the two required provisions. If the articles are silent as to the required vote for termination of close corporation status, a two-thirds vote of each class of stock is required.\textsuperscript{12} However, the articles may provide differently. Thus any vote may suffice for disqualification, from a simple majority of each class to unanimous consent of each class. Furthermore, the articles may deny a vote on the matter to any or all classes.\textsuperscript{13} As will be discussed shortly, even greater flexibility as to the de facto required vote for termination is possible through the use of a pooling agreement.\textsuperscript{14}

Close corporation status involuntarily terminates when some event causes the company to have more than the maximum number of shareholders specified in the articles.\textsuperscript{15} This change in the number of shareholders might happen in several ways:

\textit{Death.} One obvious possibility is that a deceased shareholder's stock could be divided among a number of heirs.\textsuperscript{16}

\textit{Divorce.} Because a husband and wife count as one shareholder, an excessive number of shareholders may result if shares are split between two divorced former spouses.\textsuperscript{17}

\textit{Dissolution of the shareholding entity.} As mentioned earlier, for purposes of the maximum shareholder limitation, a trust, partnership, or corporation counts as one shareholder. Therefore, if a trust, partnership, or corporation dissolves while holding shares in a close corporation, the number of shareholders might exceed the max-

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\begin{footnotesize}
\textsuperscript{12} CAL. CORP. \textit{Code} \textsect 158(c) (West Supp. 1976).
\textsuperscript{13} Id. \sect\sect 152, 158(c), 204(a)(5). For a general discussion of voluntary termination, see 1 H. BALLANTINE \& G. STERLING, \textit{supra} note 1, \sect 64.01, at 110-11; 18 H. MARSH, \textit{supra} note 1, \sect 21.5, at 74-77.
\textsuperscript{14} See text accompanying notes 33-44 \textit{infra}. See CAL. CORP. \textit{Code} \textsect 158(a), (f) (West Supp. 1976); 18 H. MARSH, \textit{supra} note 1, \sect 21.5, at 74. For a discussion of whether pooling agreement clauses can be inserted into a "shareholders' agreement," see text accompanying notes 129-31 \textit{infra}.
\textsuperscript{15} Close corporation status may also be voluntarily ended through a statutory merger of the close corporation into a non-close corporation. Such a merger must be approved by the same close corporation shareholder vote as an articles amendment terminating close corporation status. CAL. CORP. \textit{Code} \sect\sect 1111, 1201(e) (West Supp. 1976). See 18 H. MARSH, \textit{supra} note 1, \sect 21.5, at 74-75.
\textsuperscript{16} See 1 H. BALLANTINE \& G. STERLING, \textit{supra} note 1, \sect 64.02, at 111-13; 18 H. MARSH, \textit{supra} note 1, \sect 21.5, at 73-74.
\textsuperscript{17} CAL. CORP. \textit{Code} \textsect 158(e) (West Supp. 1976); 1 H. BALLANTINE \& G. STERLING, \textit{supra} note 1, \sect 64.02[1], at 111; 18 H. MARSH, \textit{supra} note 1, \sect 21.5, at 76.
\end{footnotesize}
imum. The corporation can protect against these contingencies by imposing reasonable restraints on the transfer of stock in the articles, in the by-laws, or in a contract and by noting this fact on the share certificate. Excess shareholders could also result if an existing shareholder transferred his stock to several individuals. The new code's special treatment of such transfers will be discussed shortly.

Once close corporation status has involuntarily terminated, the board of directors is required to file an articles amendment deleting the special provisions relating to close corporations and to "any other provisions not permissible for a corporation which is not a close corporation." This amendment need not be approved by the share-

18. See text accompanying notes 9 & 11 supra.


Restrains on transfer frequently take the form of buy-sell agreements. See generally 1 H. Ballantine & G. Sterling, supra § 63; Buy-Out, supra §§ 3.1-77; A. Guild, Stock-Purchase Agreements and the Close Corporation (2d ed. 1973); Organizing Corporations in California § 2.20 (Cal. CEB 1973).


21. Id. § 212(b)(1).

22. 1A H. Ballantine & G. Sterling, supra note 1, § 210(4)(c); Buy-Out, supra note 19, § 1.9; Financing California Businesses § 4.6 (E. Giacomini ed. 1976); 18 H. Marsh, supra note 1, § 21.18, at 100; Organizing Corporations in California § 1.8 (Cal. CEB 1973). See text accompanying note 152 infra.


24. See text accompanying notes 30-32 infra.

holders. Although the two special close corporation articles provisions are obvious enough, the statute does not expressly describe any other articles provisions available only to a close corporation. Therefore, the reference to "other [impermissible] provisions" is troubling, especially because the board alone can delete such "other" provisions.

III. BENEFITS OF CLOSE CORPORATION STATUS

Thus far, this article has discussed the statutory definition of a close corporation and how a company becomes qualified and disqualified from close corporation status. At this point, the reader is probably wondering about the benefits of close corporation status. Actually, the advantages are few. Some devices that were already permitted by the common law and other devices whose legality was questionable are now expressly approved for close corporations. In addition, close corporations are permitted to waive all the procedural formalities imposed by the General Corporation Law. These various advantages of close corporation status will be discussed in order of increasing importance.

A. Restraints on Voluntary Inter Vivos Transfers

Technically, the new law has a requirement that each share certificate of a close corporation contain a legend stating that the number of shareholders of record cannot exceed the specific number set in the articles. If the shares contain this legend, the statute voids any voluntary inter vivos transfer which would result in the number of shareholders exceeding that set within the articles. Absent such a


27. See text accompanying notes 8-9 supra.


30. Id. § 418(c); 1 H. BALLANTINE & G. STERLING, supra note 1, § 61.04, at 29; 18 H. MARSHE, supra note 1, § 21.3, at 67-68.

31. CAL. CORP. CODE § 418(d) (West Supp. 1976). Thus, the statute appears to impose an absolute restraint on transfers which would result in the maximum shareholder limitation being exceeded. Actually, the Code is not quite this strict. If the close corporation fails to place the legend on the certificates, close corporation status is apparently not lost. 1 H. BALLANTINE & G. STERLING, supra note 1, § 64.02(1). But cf. Jordan, supra note 28, at 1109-10 (suggesting that a court might hold that qualification as a close corporation is conditional on use of the legend). In any event, without the legend, close corporation status can be terminated through a voluntary inter vivos transfer. 1 H. BALLANTINE & G. STERLING, supra § 64.02(2).

Section 418(d) does not refer to the knowledge of the transferee of close corporation shares. If a transferee of close corporation shares knew about the restrictions on transfer, but there were no legend on the shares, one commen-
statutory provision, the courts would probably not permit such an absolute restraint on transfer. As Professor O’Neal has noted, “[f]rom the early cases to the present time, absolute restrictions unlimited in time on the alienability of shares (whether in the articles, in the bylaws, or in shareholders’ agreements) have almost without exception been held invalid.”

B. Close Corporation Pooling Agreements

A pooling agreement (or voting agreement) is a contract among shareholders providing that their shares will be voted as a unit. The contract specifies either how the shares will be voted or the procedures for determining how they are to be voted. The new law expressly validates pooling agreements among shareholders of close corporations and makes these pooling agreements specifically enforceable.

The new law also explicitly permits close corporation pooling agreements to be made self-executing through irrevocable proxies. In light of the delay and the inconvenience involved in obtaining a

32. 2 F. O’NEAL, supra note 6, § 7.06, at 7-18 (parenthetical original). See also 1A H. BALLANTINE & G. STERLING, supra note 1, § 210(3)[a]; Note, supra note 6, at 454-55; Comment, Corporations—Articles of Incorporation—Restriction on Transfer of Stock, 18 IOWA L. REV. 88 (1932); Annot., 61 A.L.R.2d 1318, 1322 (1958); Annot., 65 A.L.R. 1153, 1165 (1930). Cf. Berger, supra note 19, at 609 (discussing a few non-California cases upholding absolute transfer prohibitions imposed for a specifically limited time period of short duration). See generally 18 H. MARSH, supra note 1, § 21.18.

33. See 1 H. BALLANTINE & G. STERLING, supra note 1, § 62.04(2)[b], at 4-60; Wang, supra note **, at 1171 & n.1. This article will use the terms “pooling agreement” and “voting agreement” synonymously.

34. CAL. CORP. CODE § 706(a) (West Supp. 1976); 1 H. BALLANTINE & G. STERLING, supra note 1, § 62.04[2][b]; 18 H. MARSH, supra note 1, § 21.11, at 88; Bradley, supra note 19, at 874-76; O’Neal & Magill, California’s New Close Corporation Legislation, 23 U.C.L.A. L. REV. 1155, 1162 (1976); Wang, supra note **, at 1174-75.

35. The new Code provides that a proxy is irrevocable, if it so states, when it is held by a person designated by or under a close corporation pooling agreement. CAL. CORP. CODE § 705(e)(5) (West Supp. 1976); Bradley, supra note 19, at 875; Jordan, supra note 28, at 1128-29; Wang, supra note **, at 1181.
judicial decree of specific performance, such irrevocable proxies are an especially valuable means of enforcing pooling agreements. 38

If a third party is designated as proxy-holder of all the shares subject to a pooling agreement, the arrangement resembles a voting trust. 37 Indicative of the new code’s solicitousness toward close corporation pooling agreements is a statutory provision 38 which provides that a close corporation pooling agreement shall not be invalid on the basis that it is a voting trust which fails to comply with the requirements imposed on voting trusts. 39

In order for a close corporation pooling agreement (or any irrevocable proxy) to be binding on transferees, the existence of the agreement and/or proxy must be noted on the share certificate. 40 There is no statutory requirement that pooling agreements be among all the shareholders of the close corporation; 41 nor is there a statutory limit on the duration of the pooling agreement. 42 A pooling agreement

36. 18 H. Marsh, supra note 1, at 21.11, at 93-94; Wang, supra note **, at 1175-76; Comment, The Enforcement of Shareholder Voting Pool Agreements: A Proposed Amendment to the Louisiana Business Corporation Law, 6 Loy. L. Rev. 59, 65 (1951). See also Bradley, supra note 19, at 875-76.

37. See 1 H. Ballantine & G. Sterling, supra note 1, § 62.04[2][c], at 4-63; Bradley, Toward a More Perfect Close Corporation—The Need for More and Improved Legislation, 54 Geo. L.J. 1145, 1169-72 (1966); O’Neal & Magill, supra note 34, at 1163; Wang, supra note **, at 1177.

The voting trust has been defined as:

[a trust] created by an agreement between a group of the stockholders of a corporation and the trustee, or by a group of identical agreements between individual stockholders and 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.


38. CAL. CORP. CODE § 706(c) (West Supp. 1976).

39. Under § 706(b), voting trusts must be renewed every 10 years, and a duplicate of the voting trust agreement must be filed with the secretary of the corporation and made available for inspection. Id. § 706(b). See 1 H. Ballantine & G. Sterling, supra note 1, § 62.04[c]; 1A H. Ballantine & G. Sterling, supra note 1, § 174.02[1]; 18 H. Marsh, supra note 1, § 21.11, at 88-89; 17 H. Marsh, supra note 1, §§ 11.33-36, at 81-86.


41. 1 H. Ballantine & G. Sterling, supra note 1, § 62.04[2][a], at 4-59. See CAL. CORP. CODE § 706(a) (West Supp. 1976).

among close corporation shareholders terminates when close corporation status terminates, except that, if the agreement so provides, it continues after the termination of close corporation status, to the extent it is enforceable apart from the statute.

C. Non-Close Corporation Pooling Agreements

As just stated, the Corporations Code expressly provides that a pooling agreement may continue even after the termination of close corporation status "to the extent it is enforceable apart from [the statute]." This language raises the question whether pooling agreements among non-close corporation shareholders are valid. If they are valid, one apparent advantage of close corporation status disappears. The new code does not provide a specific answer to this question but merely states that the statutory provision on close corporation pooling agreements does not invalidate any other agreement among shareholders not otherwise illegal. The Assembly Select Committee report explained that this language "is intended to preserve any agreements which would be upheld under court decisions even though they do not comply with one or more of the requirements of this section [706], including voting agreements of corporations other than close corporations."

Although most jurisdictions have legitimized pooling agreements, there appears to be only one decision dealing with the validity of pooling agreements in California, Smith v. San Francisco & North Pacific Railway. In 1893, three individuals (Smith, Foster, HeinOnline -- 15 San Diego L. Rev. 697 1977-1978

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44. Id. See also Wang, supra note **, at 1189.
46. Id. § 706(d); Wang, supra note **, at 1174-75. Section 706(d) provides that § 706 "shall not invalidate any voting or other agreement among shareholders or any irrevocable proxy . . . which agreement or proxy is not otherwise illegal."
47. Report of the Assembly Select Committee on the Revision of the Corporations Code 87-88 (1975), reprinted in 18 H. Marsh, supra note 1, app. A at 312. See 1 H. Ballantine & G. Sterling, supra note 1, § 62.04[2][b], at 4-82. The Assembly Select Committee drafted the new General Corporation Law, and the report accompanied the proposed bill sent to the legislature.
49. See 18 H. Marsh, supra note 1, § 21.11, at 90-92. See also Jordan, supra note 28, at 1127-28; Wang, supra note **, at 1174 n.8, 1183 n.18.
50. 115 Cal. 584, 47 P. 582 (1897).
and Markham) mutually agreed to bid for a 42,000 share block of a railroad corporation and upon acquiring the stock to execute a contract whereby the whole block would for five years be voted as a unit. After their bid was accepted, the three entered into a written agreement which provided:

[S]o as to keep the control of the corporation from passing to persons other than themselves . . . , [it is] mutually agreed between said Foster, Markham, and Smith that they will, during said period [five years], retain the power to vote said shares in one body, and that the vote which shall be cast by said shares, whether for directors or for any other purpose, shall be determined by ballot between them or their survivors.51

The stock was split up and held in the names of the three parties individually.52 In 1896, after Foster and Markham had decided by ballot to vote all the stock for certain directorial candidates, Smith attempted to vote his own shares at the annual meeting in breach of the contract. When Foster objected, the officer presiding over the meeting allowed Foster and Markham to vote Smith's shares in compliance with the pooling agreement.53 The California Supreme Court upheld the presiding officer and ruled that the pooling agreement was valid and enforceable. Furthermore, the court held that the contract effectively created contingent, irrevocable proxies for the majority to vote the entire block of stock.54 On the matter of public policy, the opinion was sweeping:

"If there is one thing which more than another public policy requires, it is that men of full age and competent understanding shall have the utmost liberty of contracting, and that their contracts, when entered into freely and voluntarily, shall be held sacred, and shall be enforced by courts of justice." It is not in violation of any rule or principle of law for stockholders, who own a majority of the stock in a corporation, to cause its affairs to be managed in such way as they may think best calculated to further the ends of the corporation, and, for this purpose, to appoint one or more proxies who shall vote in such a way as will carry out their plan. Nor is it against public policy for two or more stockholders to agree upon a course of corporate action, or upon the officers whom they will elect, and they may do this either by themselves, or through their proxies, or they may unite in the appointment of a single proxy to effect their purpose. . . . Whether such an agreement is illegal, so that any action or vote under it can be set aside, or is of such a character that it will not be enforced, will depend upon

51. Id. at 596, 47 P. at 586.
52. Id.
54. 115 Cal. at 600-08, 47 P. at 587-91. The proxies were contingent on a breach of the contract by one party. For a conceptual discussion of "contingent" irrevocable proxies, see Wang, supra note **, at 1176-77.
the object with which it is made, or the acts that are done under it, and will be governed by other rules of law.\textsuperscript{55}

On the basis of the California Supreme Court decision in \textit{Smith}, some commentators, including myself,\textsuperscript{56} have concluded that pooling agreements are valid in California.\textsuperscript{57} However, in light of the paucity of case law, other authorities have concluded that the validity of non-close corporation pooling agreements is in doubt.\textsuperscript{58}

\textsuperscript{55} 115 Cal. at 600-02, 47 P. at 588 (emphasis added) (quoting Printing & Numerical Registering Co. v. Sampson, L.R. 19 Eq. 462, 465 (M.R. 1875)).

\textsuperscript{56} Wang, \textit{supra} note **, at 1174, 1188.

\textsuperscript{57} For example, William Schwarzer has stated: “Since the decision in \textit{Smith} \textit{v. S.F. & N.P. Ry. Co. . . .}, there has been no doubt of the validity of such agreements.” Schwarzer, \textit{Practical Problems of Organizing Closely Held Corporations}, in \textit{Advising California Business Enterprises} 403, 408 (Cal. CEB 1958). In addition, Professor Edwin J. Bradley, an expert on closely held corporations, has commented: “[A]lmost all shareholder agreements were usually sustained. If [in California] the close corporation shareholders plainly agree that upon termination of close corporation status a backstop shareholder voting agreement is to become operative, the chances are good that it will be a valid agreement.” Bradley, \textit{supra} note 19, at 879.

Despite these comments about the general validity of pooling agreements, Professor Bradley feels that, because of the demanding fiduciary duty which close corporation associates owe each other, legislatures should invalidate pooling agreements that are not entered into by \textit{all} the shareholders of a closely held corporation. Thus, he criticizes even § 706(a) as too permissive. \textit{Id.} at 876-78. \textit{See also} Bradley, \textit{Toward a More Perfect Close Corporation—The Need for More and Improved Legislation}, 54 Geo. L.J. 1145, 1173-75 (1966); Wang, \textit{supra} note **, at 1188 n.81.

\textsuperscript{58} 1 H. Ballantine & G. Sterling, \textit{supra} note 1, § 62.04(2)[b], at 4-62; Berger, \textit{supra} note 19, at 599-600. \textit{See} Siegel, Book Review, 24 U.C.L.A. L. Rev. 914, 920 (1977). One commentator has even argued that despite § 706(d), § 706(a) may invalidate non-close corporation pooling agreements. Jordan, \textit{supra} note 28, at 1131-38. This conclusion was in part based on the language of § 706(a) prior to the addition of a clause permitting a close corporation pooling agreement to continue “to the extent it is enforceable apart from this subdivision.” \textit{See} Wang, \textit{supra} note **, at 1189.

Professor Siegel criticizes the California statute for not eliminating this uncertainty. Siegel, \textit{supra} at 920 (1977). For a specific proposal to give statutory sanction to all pooling agreements, see Wang, \textit{supra} at 1187-88.

At my suggestion, on March 7, 1978, the Legislation Committee of the San Diego County Bar Association recommended that the Board of Governors of the State Bar of California sponsor legislation to amend § 706(a) in precisely the manner urged in my previous article. Letter from John C. Stiska, Esq., to William K. S. Wang (Mar. 8, 1978) (on file with the \textit{San Diego Law Review}); Resolution Proposed by the San Diego County Bar Association (Mar. 7, 1976) (on file with the \textit{San Diego Law Review}). My 1976 article also suggested that “it might be appropriate to place the same ten year statutory maximum on both [pooling agreements and voting trusts].” Wang, \textit{supra} at 1188 (emphasis added) (citations omitted). The Legislation Committee adopted the ingenious compromise of proposing a 10-year statutory maximum on the duration of irrevocable proxies in pooling agreements. After the 10-year period, the parties would be forced to request specific performance from a court, which, for equitable rea-
Therefore, shareholders of non-close corporations who wish to avoid uncertainty should use a voting trust to reallocate voting power. The new law allows the shareholders of any corporation, whether close or non-close, to create a voting trust. Unlike pooling agreements, a voting trust is subject to a statutory maximum duration of ten years; it can, however, be extended for successive ten-year periods. To be valid, a duplicate of the voting trust agreement must be filed with the secretary of the corporation and made available for inspection. Unfortunately, voting trust certificates are securities under both California and federal law; voting trust interests are also securities under California law and conceivably under federal statute. Although a voting trust obviously involves more complications than a pooling agreement, it is the only absolutely safe non-close corporation voting arrangement (other than separate classes of stock).

sons, might refuse to enforce the pooling agreement. See Resolution Proposed by the San Diego County Bar Association supra.

59. See Berger, supra note 19, at 595-96. For a definition of "voting trust," see note 37 supra.

60. CAL. CORP. CODE § 706(b) (West Supp. 1976). This section reads in pertinent part:

Shares in any corporation may be transferred by written agreement to trustees in order to confer upon them the right to vote and otherwise represent the shares for such period of time, not exceeding 10 years, as may be specified in the agreement. The validity of a voting trust agreement, otherwise lawful, shall not be affected during a period of 10 years from the date when it was created or last extended as hereinafter provided by the fact that under its terms it will or may last beyond such 10-year period. At any time within two years prior to the time of expiration of any voting trust agreement as originally fixed or as last extended as provided in this subdivision, one or more beneficiaries under the voting trust agreement may, by written agreement and with the written consent of the voting trustee or trustees, extend the duration of the voting trust agreement with respect to their shares for an additional period not exceeding 10 years from the expiration date of the trust as originally fixed or as last extended as provided in this subdivision. Id. (emphasis added). See generally 1A H. BALLANTINE & G. STERLING, supra note 1, § 174.02; 17 H. MARSH, supra note 1, §§ 11.33, .34, .36; Bradley, supra note 19, at 875.

61. See note 60 supra.

62. Id.

63. CAL. CORP. CODE § 25019 (West Supp. 1976); 1 H. MARSH & R. VOLK, PRACTICE UNDER THE CALIFORNIA SECURITIES LAW § 5.16 (rev. ed. 1977). See also 2 H. BALLANTINE & G. STERLING, supra note 1, § 455.04; 17 H. MARSH, supra note 1, § 11.33, at 83-84. Section 25102(f) exempts from qualification any offer or sale of a voting trust interest if, after the "sale," the interests are held by no more than five individuals. CAL. CORP. CODE § 25102(f) (West Supp. 1976).


65. See authorities cited note 63 supra.

66. See generally authorities cited note 64 supra.
Assuming non-close corporation pooling agreements are valid, the question arises whether they can be made self-executing through irrevocable proxies. The new law provides that a proxy is irrevocable if it so states and “if it is given to secure the performance of a duty.” The last phrase is taken verbatim from the Restatement (Second) of Agency’s definition of “power given as security.” This concept is intended to cover those pseudo-agency powers which, because they are granted for the protection of someone other than the power-grantor, cannot be revoked like normal agency powers. An irrevocable proxy in a pooling agreement is utilized to secure the performance of each party’s duty to comply with the contract. It is created for the benefit not of the grantor but of the other parties. It seems clear that such a proxy would be an irrevocable “power given as security.”

Nevertheless, because section 705(e)(5) expressly allows close corporation pooling agreements to utilize irrevocable proxies, some commentators have suggested that its language may prevent the use of irrevocable proxies in pooling agreements not created under section 705(e).

67. See text accompanying notes 35-36 supra.

The pooling agreement clause creating the proxies might be drafted as follows:

Irrevocable Proxies. Furthermore, if at any time, any party(ies) to this agreement refuse to comply with the agreement, the complying party(ies) shall have the irrevocable power to vote the noncomplying party’s(ies’) shares in compliance with the agreement. This power to vote the noncomplying party’s(ies’) shares shall constitute an irrevocable power (1) coupled with an interest, (2) given as security, and (3) given to secure the performance of a duty, as the term is used in section 705(e) of the California General Corporation Law.

For an example of a pooling agreement form with an irrevocable proxy, see 2 California Legal Forms, form 8.71, at 8-189 to -192 (M. Bender 1977) [hereinafter cited as FORMS].

68. CAL. CORP. CODE § 705(e) (West Supp. 1976); Wang, supra note **, at 1181.
69. 17 H. Marsh, supra note 1, § 11.29, at 76-77; Restatement (Second) of Agency § 138 (1957); Wang, supra note **, at 1181-82.
70. See Restatement (Second) of Agency § 138, Comments a-d (1957); Wang, supra note **, at 1180-81 and authorities cited therein. Cf. Restatement (Second) of Agency § 139, Comments a-d (1957) explaining the circumstances under which a power given as security is not terminated.
72. Actually, § 705(e)(3) does not refer to just § 706(a) agreements but to “[a] person designated by or under an agreement under Section 706.” CAL. CORP. CODE § 705(e)(5) (West Supp. 1976). The reason for the broader reference is not clear. See Wang, supra note **, at 1182 n.54. Cf. Jordan, supra note 28, at 1131 n.87 (arguing that § 705(e)(5)’s reference includes at most subdivisions (a) and (b) of § 706 and cannot include subdivision (d)).
estion 706(a). This argument is unpersuasive. The last sentence of section 705(e) clearly states: "In addition to the foregoing clauses (1) through (5), a proxy may be made irrevocable . . . if it is given to secure the performance of a duty . . . ." Furthermore, the issue of irrevocable proxies in non-close corporation pooling agreements only arises if such agreements are valid. If such contracts are not contrary to public policy, there seems to be no compelling reason to prevent the parties from making them self-executing.

Assuming a non-close corporation pooling agreement is valid, the multi-purpose section 706(d) would also appear to eliminate any danger that the device would be held invalid because it fails to comply with the formalities imposed on a voting trust by section 706(b). The language of section 706(d) is virtually identical to section 218(e) of the Delaware General Corporation Law, which is listed as the source of section 706(d) in the Assembly Select Committee report. The language of section 218(e) has generally been regarded as a legislative reversal of Abercrombie v. Davies, a Delaware decision which held a pooling agreement with irrevocable proxies to be a voting trust and invalidated the entire arrangement because the parties had not complied with the statutory requirements for voting trusts. Therefore, section 706(d) presumably protects all pooling agreements from being invalidated because of their similarity to voting trusts.

73. 18 H. Marsh, supra note 1, § 21.11, at 94; Jordan, supra note 28, at 1131.
75. But cf. note 58 supra (discussing the San Diego County Bar Association Legislation Committee's proposal to impose a 10-year limit on irrevocable proxies in pooling agreements. After the 10-year period, the parties would have to seek specific performance, which might be denied for equitable reasons.).
76. See note 46 supra.
80. Wang, supra note **, at 1178. The presence of § 706(d) is another indication that non-close corporation pooling agreements are not contrary to public policy. Section 706(c) already eliminates the Abercrombie problem for close corporation pooling agreements. Therefore, to the extent that § 706(d) is addressed to the Abercrombie problem, it indicates legislative solicitousness for non-close corporation pooling agreements. But see Jordan, supra note 28, at 1133-34.

A pooling agreement which is too similar to a voting trust might run afoul of either the California Securities Law, which considers certificates or interests in voting trusts as securities, or federal securities law, which includes voting trust
Summary

In conclusion, the pooling agreement device may be available to both close and non-close corporation shareholders, but an advantage of close corporation status is the express statutory sanction for shareholder pooling agreements.

D. "Shareholders' Agreements"

The most advantageous device available to close corporation shareholders is the "shareholders' agreement," a term of art under the new code. Such an agreement can only be entered into by shareholders of a close corporation, must be in writing, and (unlike voting trusts and pooling agreements) must be executed by all the shareholders. A transferee of shares subject to such an agreement is bound by its provisions if two conditions are met: (1) The agreement is filed for inspection with the secretary of the company, and (2) the transferee has actual notice of the agreement, or the existence of the agreement is noted on the stock certificate. A "shareholders' agreement" among close corporation shareholders terminates when close corporation status ends, except that if the agreement so provides, it continues to the extent otherwise enforceable.

The permissible subject matter of a "shareholders' agreement" is not expressly described in the statute, which simply states in pertinent part:

[N]o shareholders' agreement, which relates to any phase of the affairs of a close corporation, including but not limited to management of its business, division of its profits or distribution of its assets on liquidation, shall be invalid as between the parties thereto on the ground that it so relates to the conduct of the affairs of the corporation as to interfere with the discretion of the board or that it is an attempt to treat the corporation as if it were a partnership or to arrange their relationships in a manner that would be appropriate only between partners.

See note 63 & authorities cited note 64 supra.

81. CAL. CORP. CODE § 186 (West Supp. 1976). "Shareholders' agreement" means a written agreement among all of the shareholders of a close corporation, or if a close corporation has only one shareholder between such shareholder and the corporation, as authorized by subdivision (b) of Section 300." Id. (emphasis added). See generally O'Neal & Magill, supra note 34, at 1160-63.

82. See text accompanying notes 33-34 supra. See also note 37 and accompanying text supra.

83. See authorities cited note 81 supra.

84. CAL. CORP. CODE § 300(b) (West Supp. 1976).

85. Id.

86. Id.
The provision is phrased in the negative. It does not provide that certain kinds of clauses in "shareholders' agreements" are absolutely valid but only that all clauses (of any kind) are not invalid because of interference with board discretion or because the shareholders seem to be treating the corporation as a partnership. The statute does not make clear when a clause in a "shareholders' agreement" would be invalid for some other unspecified reason. In other words, the statute says: "No 'shareholders' agreement' shall be invalid because of A, B, or C." It does not prevent a judge from invalidating an agreement because of D, E, F, or any other reason.

The above provision, section 300(b), is based on a provision of the North Carolina close corporation statute which is also phrased in the negative. The principal draftsman of the North Carolina provisions, Professor Latty, acknowledges that "the basic approach is: no [written] arrangement agreed to by all the co-owners . . . is invalid just because it is a partner-like arrangement. A court may pronounce it bad for other reasons, although presumably it would have to be something pretty serious since it was agreed to by everyone." However, Latty defends the language because it preserves flexibility in judicial treatment.

One person's "flexibility" is another's "ambiguity," and several commentators have sharply criticized the uncertainty created by the phrasing of section 300(b). However, the California provision is not without defenders. According to one treatise, most "other" grounds for attacking a "shareholders' agreement" would in actuality relate to the proscribed bases of attack; in other words, most other D, E, or F reasons for invalidating an agreement would really be variants of the improper A, B, or C reasons mentioned in section 300(b). Furthermore, the California Legislature clearly intends to prevent the courts from invalidating "shareholders' agreements" because of deviance from the corporate norm. According to the principal

87. Bradley, supra note 19, at 871; Note, supra note 6, at 448.
89. Latty, The Close Corporation and the New North Carolina Business Corporation Act, 34 N.C. L. REV. 432, 439 (1956). Professor Latty was the author of the North Carolina close corporation statute. 1 H. BALLANTINE & G. STERLING, supra note 1, § 62.03{1}, at 4-34; Bradley, supra note 19, at 871.
91. Bradley, supra note 19, at 870-71; Jordan, supra note 28, at 1115; Note, supra note 6, at 448.
92. 1 H. BALLANTINE & G. STERLING, supra note 1, § 62.03{1}, at 4-34.
93. 18 H. Marsh, supra note 1, § 21.1, at 61. Harold Marsh was the principal draftsman of the new General Corporation Law. See also Bradley, supra note 19, at 871-72.

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draftsman of the North Carolina close corporation provisions, the
thrust of the North Carolina statute was “to set a friendly tone for
incorporated partnership arrangements.”

The controversy over section 300(b) demonstrates the uncertainty
generated by its negative phrasing. Section 300(c) of the new law is
more specific; it permits “shareholders’ agreements” to waive or
alter any provision of the statute, with a few limited exceptions. The
nonwaivable statutory provisions are:

1. section 158, defining a close corporation and regulating the
election and termination of close corporation status;
2. sections 500 and 501, restricting “distributions to sharehold-
ers”;
3. sections 1111 and 1201(e), specifying the votes required for the
merger of a close corporation into a non-close corporation and
for a “reorganization” (a term of art) which results in close
corporation shareholders receiving non-close corporation
shares;
4. section 2009, defining the liability of shareholders for unau-
thorized distributions in a dissolution;
5. sections 2010 and 2011, describing the continuation of the
corporation after dissolution for the purposes of winding up
and litigation;
6. chapter 15, requiring corporate records and reports;
7. chapter 16, defining shareholder inspection rights;
8. chapter 18, describing involuntary dissolution;
9. chapter 22, specifying crimes and penalties;
10. all provisions dealing with the required filing of any document
with the secretary of state.

Assembly Bill 2510, presently pending in the legislature, would

* For a general discussion of the invalidation of shareholder contracts for
being contrary to the corporate norm, see generally H. Henn, CORPORATIONS §§ 257-90
(1961); J. G. Hornstein, CORPORATION LAW AND PRACTICE §§ 151-65 (1959); J. F.
O’Neal, supra note 6, §§ 1.13–15.
94. Latty, The Close Corporation and the New North Carolina Business
Corporation Act, 34 N.C. L. Rev. 432, 438 (1956).
95. See text accompanying notes 7-29 supra.
96. “Distributions to shareholders” is a term of art which includes dividends.
97. See id. § 181 for the definition of “reorganization.” “Reorganization” in
this sense is unrelated to bankruptcy.
98. 1 H. Ballantine & G. Sterling, supra note 1, § 62.03[2]; 18 H. Marsh,
supra note 1, § 21.7, at 79-81.
98a. A.B. 2510, introduced by Assemblyman Knox on Feb. 13, 1978, makes a

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add two more nonwaivable statutory provisions:98b (1) section 417, requiring that, if the shares of a corporation are divided into classes, the share certificates contain a statement of the rights, preferences, privileges and restrictions of each share; (2) section 418, providing that, when applicable, certain types of information appear on a share certificate.

Although section 300(c) explicitly states that "[a]ll other provisions . . . may be altered or waived,"99 several commentators have suggested other provisions that a court might find nonwaivable despite the statutory mandate. Among the areas that have been suggested as especially sensitive are section 300(d)’s shifting of liability to the shareholders to the extent a "shareholders’ agreement" relieves the directors of managerial responsibility;100 chapter 13’s right of dissent and appraisal;101 section 315’s requirement of shareholder approval for corporate loans or for guarantees of loans to officers or directors;102 section 418(a)’s invalidation of restrictions on transfer unless the proper legend is on the share certificates,103 and section 309(a)’s imposition of fiduciary duties of loyalty and care on directors.104

The courts are especially likely to scrutinize closely any waiver of statutory provisions which affects the rights of third parties.105 One authority has gone so far as to suggest that section 300(b) may permit

number of technical and substantive changes in the Corporations Code. A.B. 2510 (on file with the San Diego Law Review). As of May 30, 1978, A.B. 2510 had been passed by the Assembly and was pending before the Senate Judiciary Committee. Telephone conversation with staff member of the Legislative Bill Room (May 30, 1978).

100. 1 H. BALLANTINE & G. STERLING, supra note 1, § 62.03(2), at 4-36; Note, supra note 6, at 453.
101. 1 H. BALLANTINE & G. STERLING, supra note 1, § 62.03(2), at 4-36; Note, supra note 6, at 452-53.
102. See authorities cited note 101 supra.
104. Id., at 1116. One commentator has also suggested that the courts might not permit §§ 300(e) and 310 to be waived. Note, supra note 6, at 452-53. This result seems unlikely. Because § 300(e) is designed to inhibit the courts from disregarding the corporate entity, there is no reason why the shareholders could not unanimously eliminate this self-protection assuming they were foolish enough to do so. See text accompanying notes 169-77 infra.

Section 310 deals with conflict of interest transactions between the directors and the corporation—a sensitive area. Like § 300(b), § 310 has negative phrasing and is therefore ambiguous. A discussion of the resulting uncertainty is beyond the scope of this article. However, for an interpretation of the negative phrasing in provisions somewhat similar to § 300(b), see 1 ABA-ALI MODEL BUS. CORP. ACT ANN. § 41, at 844 (1971); Note, The Status of the Fairness Test Under Section 713 of the New York Business Corporation Law, 76 COLUM. L. REV. 1156 (1976). See also Bulbulia & Pinto, Statutory Responses to Interested Directors’ Transactions: A Watering Down of Fiduciary Standards?, 53 NOTRE DAME LAW. 201 (1977).

waivers and alterations only to the extent that they deal with "management" of the corporation. However, this limitation seems too narrow in view of the legislature's apparent adoption of a two-pronged semi-paternalistic approach to permit flexibility in shareholder agreements and to protect against abuse of minority shareholders by granting to any close corporation shareholder a non-waivable statutory right to compel involuntary judicial dissolution.

Some clarity as to what can be included in a "shareholders' agreement" is furnished by section 204(a), which lists nine types of optional articles provisions and provides that any of them may be contained in a "shareholders' agreement." These provisions deal with the assessment of shares, pre-emptive rights, special qualifications of shareholders, durational limitation of corporate existence, super-majority voting or quorum requirements, restriction of corporate business, conference of voting rights on debt instruments, conference upon shareholders of the right to determine the consideration for stock, and requirements for shareholder approval for certain types of action.

Despite the uncertainty surrounding sections 300(b) and 300(c), it also seems clear that "shareholders' agreements" may contain provisions covering such subjects as the following:

1. who will be the officers and/or directors;
2. whether long-term employment contracts will be awarded;
3. what salaries will be paid;
4. how much time each party to the "shareholders' agreement" will devote to the business;

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106. Metz, Organization, Shareholder and Voting Agreements, in 2 New Cal. GCL, supra note 1, at 125.
107. See notes 163-68 and accompanying text infra.
108. See 1 H. BALLANTINE & G. STERLING, supra note 1, § 62.03(2), at 4-36.
110. For a further discussion of super-majority voting provisions in shareholders' agreements, see 1 H. BALLANTINE & G. STERLING, supra note 1, §§ 62.03(3)(a); 18 H. MARSH, supra note 1, § 21.13.
111. CAL. CORP. CODE § 204(a) (West Supp. 1976); 1 H. BALLANTINE & G. STERLING, supra note 1, §§ 51.03-08; 18 H. MARSH, supra note 1, §§ 3.26-36.
112. See O'Neal & Magill, supra note 34, at 1161 (from which this list is drawn). For another list of permissible provisions, see 2 FORMS, supra note 67, at 8-204 to -212. For a discussion of shareholders' contracts in other jurisdictions, see 1 F. O'NEAL, supra note 6, § 5.02. For forms for shareholders' contracts, see 8 J. RABKINS & M. JOHNSON, CURRENT LEGAL FORMS WITH TAX ANALYSIS ch. 20 (1977); 6 J. RABKINS & M. JOHNSON, supra ch. 15.
(5) what veto power each party to the “shareholders’ agreement” will have over major decisions;\footnote{113}
(6) when and how much of a dividend will be declared;
(7) what methods of resolving disputes will be employed.\footnote{114}

Furthermore, as expressly sanctioned by section 300(b), a “shareholders’ agreement” can reallocate corporate distributions and abridge board discretion.\footnote{115}

It is unclear whether the clause on abridging board discretion significantly changes prior case law in California. Courts in many jurisdictions have held that contractual provisions abridging the discretion of the board of directors are invalid because they are contrary to the statutory norm of board control.\footnote{116} The California case law in this area is sparse.\footnote{117} Nevertheless, several opinions have held that shareholder contracts among all shareholders of a closely held corporation are enforceable even though the norm of board control is violated.\footnote{118} Although section 300(b) may simply codify the common law in California, conservative counsel will certainly be more comfortable with the express statutory permission to abridge director discretion.

\footnote{113} 1 H. Ballantine & G. Sterling, supra note 1, § 62.03(3)[a].
\footnote{114} 18 H. Marsh, supra note 1, § 21.7, at 80.
\footnote{115} 1 H. Ballantine & G. Sterling, supra note 1, § 62.03(4)[b]; 18 H. Marsh, supra note 1, § 21.15.
\footnote{116} E.g., McQuade v. Stoneham, 263 N.Y. 323, 189 N.E. 234 (1934). See A. Frey, J. Choper, N. Leech, & C. Morris, Cases and Materials on Corporations 577 (2d ed. 1977); 1 F. O’Neal, supra note 6, § 5.06; Berger, supra note 19, at 601; Note, supra note 6, at 445.
\footnote{117} Jordan, supra note 28, at 1113. See Note, supra note 6, at 447. One authority has suggested that statutory close corporations as well as nonstatutory closely held corporations may conceivably be granted considerable flexibility in corporate governance by three statutory sections: Cal. Corp. Code § 204(d) (West Supp. 1976) (permitting the articles to contain “[a]ny other provision \textit{not in conflict with the law}, for the management of the business and for the conduct of the affairs of the corporation”) (emphasis added); \textit{id.} § 212(b) (permitting the by-laws to contain “any provision, \textit{not in conflict with law} or the articles for the management of the business and for the conduct of the affairs of the corporation”) (emphasis added); and \textit{id.} § 312(b) (providing that officers shall be chosen by the board except as otherwise provided in the articles or by-laws). Bradley, supra note 19, at 879-80. As Bradley himself notes, however, this reasoning is highly speculative. \textit{Id.} See Jordan, supra at 1160; Note, supra at 447.
\footnote{119} 1 H. Ballantine & G. Sterling, supra note 1, § 62.02(2); 18 H. Marsh, supra note 1, § 21.8; Jordan, supra note 28, at 1113-14.
It is possible that a "shareholders' agreement" may also reallocate the voting rights of shareholders, but there is some uncertainty as to the form the provision must take. Assume a corporation has three shareholders with certificates for 100, 200, and 300 shares respectively, nominally of one class of stock.

Three questions arise:

1. Can a "shareholders' agreement" convert the certificates into three classes of stock (classes A, B, and C) with each share of class A having one one-hundredth of a vote, each share of class B having one two-hundredth of a vote, and each share of class C having one three-hundredth of a vote so that each shareholder would have exactly one vote?

2. Can a "shareholders' agreement" simply provide that each of the shareholders has only one vote regardless of the number of shares owned—that is, one shareholder, one vote?

3. Can a "shareholders' agreement" require that all three shareholders vote their shares in one block in accordance with the vote of a majority of the three? In other words, can one clause of a "shareholders' agreement" be a pooling agreement?

All three arrangements would have the same effect so long as the three owners held the same number of shares and remained the sole stockholders. As to the first question, section 203 of the code states: "Except as specified in the articles or in any shareholders' agreement, no distinction shall exist between classes or series of shares or the holders thereof." Although this section indicates that a "shareholders' agreement" can specify the rights of classes of stocks, it is not clear that the agreement can create classes. Subdivisions (1) and (2) of section 202(e) require the articles to specify the classes of shares and the number of shares authorized. Although this type of provision is not among the nine types of provisions expressly mentioned in section 204(a) as includible in "shareholders' agreements," section 202(e) presumably may be waived by a "shareholders' agreement" pursuant to section 300(c). As discussed earlier, this provision's list of nonwaivable provisions may not be exhaustive. However, subdivision (e) of section 202, unlike other subdivisions of

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120. Jordan, supra note 28, at 1117. See also O'Neal & Magill, supra note 34, at 1161.
121. A slightly different example is given in Jordan, supra note 28, at 1117.
123. See text accompanying notes 109-11 supra.
124. See 1 H. BALLANTINE & G. STERLING, supra note 1, § 61.03[1].
125. See text accompanying notes 100-06 supra.
the section, does not seem essential for the protection of third parties or existing shareholders. Moreover, other valid arrangements could accomplish virtually the same result. Therefore, a "shareholders' agreement" apparently may create different classes of stock and specify their rights, even if the articles misleadingly state that only one class of stock is authorized.

As to the second question posed earlier, one commentator has concluded that a "shareholders' agreement" could provide that all shareholders have one vote regardless of the number of shares owned. Under such an agreement there would remain only one class of stock, but voting would be "one shareholder, one vote," not "one share, one vote." Again, there would seem to be no policy reason to deny close corporation associates the flexibility of this kind of arrangement.

The third question is whether one clause of a "shareholders' agreement" may be a pooling agreement which provides that all three shareholders vote their shares in one block in accordance with the vote of a majority. The last sentence of section 300(b) reads: "This provision does not apply to an agreement authorized under subdivision (a) of section 706." Section 706(a) makes close corporation pooling agreements valid and specifically enforceable. I have speculated elsewhere whether close corporation shareholders can opt out of section 706(a) by entering into a pooling agreement which expressly states that it is not made pursuant to section 706(a). It is possible, however, that the courts would treat all pooling agreements entered into between close corporation shareholders as "authorized" under section 706(a) and therefore outside section 300(b). In other words, if a pooling agreement were clause (f) of a document entitled "Section 186 Shareholders' Agreement," the courts would unquestionably enforce this clause and would treat it not as clause (f) of a "shareholders' agreement" but as the sole clause of a separate pooling agreement authorized by section 706(a). This distinction is more than semantic. Unlike a "shareholders' agreement," a section 706(a) pooling agreement need not be filed with the secretary of the corporation to be binding on transferees. Furthermore, irrevocable

126. See text accompanying notes 33-36 & 60-66 supra.
128. CAL. CORP. CODE § 300(b) (West Supp. 1976) (emphasis added).
129. See text accompanying notes 33-34 supra.
130. Wang, supra note **, at 1186. For a discussion of an analogous issue, see text accompanying notes 159-61 infra.
131. 1 H. BALLANTINE & G. STERLING, supra note 1, § 62.04[2][a], at 4-59; Jordan, supra note 28, at 1117-18.
132. CAL. CORP. CODE § 300(b) (West Supp. 1976); 1 H. BALLANTINE & G. STERLING, supra note 1, § 62.04[2][a].
proxies in section 706(a) pooling agreements have an express statutory sanction\textsuperscript{133} while section 705(e) does not explicitly refer to proxies in “shareholders' agreements.”\textsuperscript{134} Pooling agreements and “shareholders' agreements” may also be treated differently under the California Securities Law\textsuperscript{135} and conceivably under federal tax law.\textsuperscript{136}

In any event, an attorney choosing among the three different arrangements would probably be well-advised to select the section 706(a) pooling agreement. The statute expressly sanctions such contracts, makes them specifically enforceable, and allows them to be made self-executing through irrevocable proxies.\textsuperscript{137} In addition, pooling agreements are less likely to cause federal tax or California Securities Law problems than are “shareholders' agreements.”\textsuperscript{138}

As noted earlier,\textsuperscript{139} a “shareholders' agreement” may waive virtually all the provisions of the General Corporation Law. Rather than retain power in the board and/or the shareholders and execute contracts limiting voting discretion, close corporation associates could also use a “shareholders' agreement” to shift power away from the board and/or the shareholders to a single individual or group of individuals.\textsuperscript{140} This realignment of control is distinct from the abridgment of board discretion. Rather than obligate directors to do certain acts—for example, mandate that they declare specified dividends or employ certain individuals—the directors (or even the shareholders) are simply stripped of most control over corporate affairs. To illustrate, a “shareholders' agreement” might provide that all corporate powers be exercised by a “Managing Shareholder” or “President” to the extent permitted by the General Corporation Law.\textsuperscript{141} To the extent that any “shareholders' agreement” re-

\textsuperscript{133} CAL. CORP. CODE § 705(e)(5) (West Supp. 1976). See text accompanying note 35 supra.

\textsuperscript{134} This does not mean that such proxies could not be made irrevocable. See text accompanying notes 87-75 supra.

\textsuperscript{135} See text accompanying notes 235-304 infra.

\textsuperscript{136} See text accompanying notes 178-235 infra.

\textsuperscript{137} CAL. CORP. CODE §§ 706(a), 705(e)(5) (West Supp. 1976). See text accompanying notes 33-36 supra. Another option would be a voting trust. See CAL. CORP. CODE § 705(b) (West Supp. 1976). See also note 37 and text accompanying notes 92-96 supra.

\textsuperscript{138} See text accompanying notes 178-304 infra.

\textsuperscript{139} See text accompanying notes 95-108 supra.

\textsuperscript{140} See 1 H. BALLANTINE & G. STERLING, supra note 1, § 62.03[3][e].

\textsuperscript{141} 2 Forms, supra note 67, forms 8.81, at 8-231 to -232, 8.82, at 8-237; “Shareholders' Agreement” form drafted by O’Harn Company (on file with the San Diego Law Review). For a similar form, see ORGANIZING, supra note 10, at 63-66.
lies the directors of managerial duties, the new code shifts liability to the shareholders who are parties to the agreement.142

Unfortunately, it is unclear whether a "shareholders' agreement" may eliminate the board entirely.143 In practice, a corporation would be well advised to retain a board if for no other reason than to ease dealing with third parties.144 Nevertheless, the lack of a statutory provision permitting elimination or sterilization of the board produces uncertainty as to whether the board must have some minimum residual power, and if so, to what extent.145

The principal advantage of depriving the board and/or the shareholders of power is the procedural convenience of far fewer board and/or shareholder actions (at a meeting or by written consent).146 A "shareholders' agreement" does not really give more flexibility in the allocation of power because even with a normally functioning board and group of shareholders, it is still possible to allocate power to one individual through classes of stock, a voting trust, or a pooling agreement.147

Another common desire of closely held corporation associates is to create restrictions on the transfer of stock.148 Section 300(b) does not explicitly refer to such restrictions.149 Conceivably, the provision's tolerance toward treating the corporation like a partnership could be interpreted to permit even an absolute restraint on the transfer of shares because partners may agree that without unanimous consent no partner could transfer his interest.150 This reasoning is highly


142. CAL. CORP. CODE § 300(d) (West Supp. 1976).
143. 1 H. BALLANTINE & G. STERLING, supra note 1, § 62.03[3][c]; Jordan, supra note 28, at 1120-21; Note, supra note 8, at 451-52.
144. See authorities cited note 143 supra.
145. Bradley, supra note 19, at 872-73. See Berger, supra note 19, at 603.
147. Bradley, supra note 19, at 873. See note 37 supra. See also text accompanying notes 33-44 supra.
148. 1A H. BALLANTINE & G. STERLING, supra note 1, § 210, at 10-36; 2 F. O'NEAL, supra note 6, § 7.02; Note, supra note 6, at 453. See BUY-OUT, supra note 19, § 1.6.
149. Note, supra note 6, at 458-59. See Bradley, supra note 19, at 889. As noted earlier in the text accompanying notes 30 and 31 supra, § 418(d) voids any voluntary inter vivos transfer that would result in the number of shareholders exceeding that set in the articles, provided the share certificates bear the legend specified in § 418(c).
150. 1 H. BALLANTINE & G. STERLING, supra note 1, § 62.03[8][b], at 4-51; Note, supra note 6, at 459. See also A. BROMBERG, CRANE AND BROMBERG ON PARTNER-
speculative, however, and courts might well invalidate restrictions they consider unreasonable. Because restraints on transfer may be imposed by contract, it may be tempting to insert transfer restrictions in a "shareholders' agreement," and several formbooks contain "shareholders' agreements" with mandatory buy-out arrangements and restrictions on transfer. Placing such restrictions in "shareholders' agreements," however, may create problems under the California Securities Law.

Recently, the Corporations Commissioner adopted rules which treat the execution of a "shareholders' agreement" as a sale of a security requiring qualification. Under these new rules, share transfer restrictions in the agreement would appear to be exempt from qualification under subdivision (e)(11) of section 25103, which refers only to "restrictions upon the transfer of shares in the articles of incorporation or by-laws," although the Commissioner conceivably might take a contrary position.

Even though there is nothing to prevent the insertion of identical or consistent transfer restrictions in the articles, by-laws, "shareholders' agreements," or contracts, it may be worthwhile to minimize California Securities Law complications by using only a contract. It is unlikely that the courts will treat a transfer restric-

SHIP 43-44, 130-31, 239-40 (1968). An absolute restraint on transfer might jeopardize the firm's status as a corporation under the Internal Revenue Code. See text accompanying notes 178-86 infra. See also note 192 infra.

151. See note 150 supra. For a discussion of what constitutes a reasonable restraint on transfer, see authorities cited notes 19 & 32 supra.

152. See authorities cited note 22 supra.

153. See 1 H. BALLANTINE & G. STERLING, supra note 1, § 62.03(3); 1A H. BALLANTINE & G. STERLING, supra § 210[2][c].


155. See generally notes 235-37 and accompanying text infra.

156. Note 156 has been omitted.

157. See notes 275-96 and accompanying text infra.


159. See 1A H. BALLANTINE & G. STERLING, supra note 1, § 210[2][d]; 6 Z. CAVITCH, BUSINESS ORGANIZATIONS § 113.02(3) (1963).

160. But cf. notes 246-48 and accompanying text infra (stating that such a contract apparently must be included as an exhibit in permit applications).
tion contract executed by *all* the shareholders any less tolerantly than a “shareholders’ agreement.” Therefore, a transfer restriction contract among all the shareholders of a close corporation may attempt to opt out of sections 300(b) and 186 with a clause such as the following: “This agreement is *not* made pursuant to section 300(b) of the California Corporations Code and is *not* a ‘shareholders’ agreement’ as defined in section 186 of the California Corporations Code.” Because the new statute was intended to create more—rather than less—flexibility for close corporation associates, the courts would probably permit this opting out. Ironically, under certain circumstances, the California Securities Law may cause the “shareholders’ agreement” to become a trap rather than a new useful device as intended.\(^{161}\)

Summary

The “shareholders’ agreement” is a new device available only to shareholders of a statutory close corporation. Such an agreement can abridge board discretion, reallocate corporate distributions, waive virtually all the provisions of the General Corporation Law, and eliminate the necessity of most shareholders’ meetings and board meetings by shifting power away from the board and the shareholders. Unfortunately, the negative phrasing of section 300(b), although designed to increase flexibility, may instead have generated uncertainty and confusion as to what other types of provisions validly may be included in a “shareholders’ agreement.” Because of the ambiguity of section 300(b), and because of federal tax and California Securities Law complications,\(^{162}\) a “shareholders’ agreement” generally should not be used to reallocate voting power or to impose transfer restrictions.

IV. ADVANTAGES OF THE CLOSE CORPORATION AND POTENTIAL HAZARDS OF UTILIZING CLOSE CORPORATION DEVICES

A. Shareholder Right to Petition for Involuntary Judicial Dissolution

Any shareholder of a close corporation has a statutory right to file

\(^{161}\) See text accompanying notes 283a & 283b infra. For a general discussion of the California Securities Law problems of the close corporation, see text accompanying notes 235-304 infra.

\(^{162}\) See text accompanying notes 178-304 infra.
a complaint for involuntary judicial dissolution of the company.\textsuperscript{163} This right cannot be waived in a “shareholders’ agreement.”\textsuperscript{164}

One of the several grounds for involuntary dissolution of any corporation (close or non-close)\textsuperscript{165} is that those in control have been persistently unfair toward any shareholder.\textsuperscript{166} If a corporation has thirty-five or fewer shareholders, another ground for involuntary dissolution is protection of the rights or interests of the complaining shareholder.\textsuperscript{167} The legislature may have relied on this provision to prevent the flexibility of the close corporation provisions from being used to oppress minority shareholders.\textsuperscript{168}

B. Disregard of the Corporate Entity (The Alter Ego Doctrine)

Under certain circumstances a court either will hold the shareholders of a corporation personally liable to one or more corporate creditors\textsuperscript{169} or will equitably subordinate debts owed by a corpora-

\textsuperscript{164} \textit{Id.} Section 300(c) provides that none of the statutory provisions dealing with involuntary dissolution may be waived by a “shareholders’ agreement.” \textit{See} text accompanying note 98 \textit{supra}.

The non-waivable right to petition for dissolution is certainly not a benefit of close corporation status. The articles of any corporation (close or non-close) can give anyone the right to petition for involuntary dissolution. \textit{Id.} § 1800(a)(4).

\textsuperscript{165} \textit{Id.} § 1800(b); \textsc{1A H. Ballantine & G. Sterling, supra} note 1, § 320.03; \textsc{18 H. Marsh, supra} note 1, § 20.2; \textit{Note, California’s New General Corporation Law: Prospects for Minority Shareholders}, 7 \textit{Pacific L.J.} 706, 739-42 (1976). \textit{See generally} Comment, \textit{Dissolution Under the California Corporations Code: A Remedy for Minority Shareholders}, 22 \textit{U.C.L.A. L. Rev.} 595 (1975).


\textsuperscript{168} \textsc{See 1 H. Ballantine & G. Sterling, supra} note 1, § 62.03(2); \textsc{Bradley, supra} note 19, at 895; \textsc{Jordan, supra} note 28, at 1144-46.

\textsuperscript{169} For an extensive review of the California cases dealing with this doctrine, see \textit{Associated Vendors Inc. v. Oakland Meat Co.}, 210 \textit{Cal. App.} 2d 825, 26 \textit{Cal. Rptr.} 806 (1962); \textsc{1A H. Ballantine & G. Sterling, supra} note 1, §§ 295-300;
tion to its own shareholders.\textsuperscript{170} The latter generally arises in the context of federal bankruptcy proceedings\textsuperscript{171} but is governed by the same general principles as the former.\textsuperscript{172} One of the factors which may influence a court to grant either remedy is the failure of the corporation to comply with corporate formalities.\textsuperscript{173} The new Code provides that if a close corporation fails to hold meetings of the directors or shareholders pursuant to a “shareholders’ agreement,” the failure to observe corporate formalities “shall not be considered a factor tending to establish that the shareholders have personal liability for corporate obligations.”\textsuperscript{174} This protection is quite narrow. It does not prevent a court from piercing the corporate veil for some other reason\textsuperscript{175} such as inadequate capitalization, commingling of assets, or general considerations of equity;\textsuperscript{176} nor does it even prevent a federal bankruptcy court from subordinating shareholder debt claims in part because corporate formalities were waived in a “shareholders’ agreement.” Although equitable subordination in a bankruptcy proceeding would be governed by federal law,\textsuperscript{177} section 300(e) should still have some influence on a federal court.


\textsuperscript{171} Costello v. Fazio, 256 F.2d 903 (9th Cir. 1958); E. Latty & G. Frampton, Basic Business Associations: Cases, Text, Problems 730-36 (1963); 17 H. Marsh, supra note 1, § 15.26.

\textsuperscript{172} See authorities cited note 170 supra.


\textsuperscript{175} Note, supra note 6, at 471-72.

\textsuperscript{176} See authorities cited note 169 supra.

\textsuperscript{177} See Taylor v. Standard Gas & Electric Co., 306 U.S. 307 (1939); Costello v. Fazio, 256 F.2d 903 (9th Cir. 1958); W. Blum & S. Kaplan, Corporate Readjustments and Reorganizations 395-403 (1976); 3 J. Moore, Collier on Bankruptcy ¶¶ 57.14, 65.08, 65.06 (14th ed. 1977); 6 J. Moore, supra ¶ 3.17 n.14 (14th ed. 1977); Rosenberg, Intercorporate Guaranties and the Law of Fraudulent Conveyances: Lender Beware, 125 U. Pa. L. Rev. 235, 236 n.2 (1976). See also Herzog & Zweibel, The Equitable Subordination of Claims in Bankruptcy, 15 Vand. L. Rev. 83, 85-86 (1961), in which the authors carefully distinguish between subordination and disallowance, although they note that courts have frequently confused the two concepts or have considered the question academic.
C. Federal Tax Problems

Close corporation devices may create a number of federal tax problems.

1. Denial of Corporate Status for Internal Revenue Code Purposes

Some commentators have warned that if a “shareholders’ agreement” dispenses with corporate formalities, the firm’s status as a corporation under the Internal Revenue Code might be jeopardized.\textsuperscript{178} I am not so pessimistic.

The Internal Revenue Code states that “[t]he term ‘corporation’ includes associations, joint-stock companies, and insurance companies.”\textsuperscript{179} The definition of “partnership” includes “a syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a trust or estate or a corporation.”\textsuperscript{180} Arguably, the reference to “other unincorporated organizations” would exclude any closely held corporation from the definition of partnership.\textsuperscript{181} Nevertheless, the courts and the Internal Revenue Service have adopted a functional analysis to determine whether a business entity is a corporation.\textsuperscript{182} The landmark case in this area, \textit{Morrissey v. Commissioner},\textsuperscript{183} specified the following as the principal character-


\textsuperscript{179} I.R.C. § 7701(a)(3) (emphasis added).

\textsuperscript{180} Id. § 7701(a)(2) (emphasis added).


\textsuperscript{182} B. BITTKER & J. EUSTICE, supra note 181, ¶ 2.01, at 2-3 to -4.

\textsuperscript{183} 296 U.S. 344 (1935).
istics of an "association" taxable as a corporation under the Internal Revenue Code:

(a) associates; (b) an objective to carry on a trade or business and divide the profits; (c) continuity of life of the enterprise, notwithstanding the death, disability or withdrawal of its members; (d) centralized management by representatives of the owners; (e) limited liability for the owners; and (f) free transferability of beneficial interests in the organization.\textsuperscript{184}

In 1960, these criteria were adopted by the Commissioner in Treasury Regulation 301.7701-2, with a requirement that an association have more of the significant corporate characteristics than noncorporate characteristics to be classified as a corporation.\textsuperscript{185} Whether these criteria are met is to be determined by state law.\textsuperscript{186}

By and large, closely held corporations have been treated as corporate entities for tax purposes.\textsuperscript{187} The Treasury's attempt in the 1960's to deny corporate status to professional corporations was a resounding failure.\textsuperscript{188}

While conceding that under the present state of the law closely held corporations are taxed as corporations, one commentator has argued that, in general, closely held corporations do not really meet the \textit{Morrissey} criteria.\textsuperscript{189} Nevertheless, the California statutory close corporation seems no more vulnerable to attack than are closely held


\textsuperscript{186} Treas. Reg. § 302.7701-1, 2 T.D. 6503, 1960-2 C.B. 412-20; B. BITTKER & J. EUSTICE, supra note 181, ¶ 2.01, at 2-2; Note, supra note 181, at 566.

\textsuperscript{187} 2 F. O'NEAL, supra note 6, at 8-136; Note, supra note 181, at 553. If most closely held corporations were taxed as partnerships, double taxation would be avoided, with uncertain effects on Treasury revenue. Of course, many of those closely held corporations harmed by double taxation have already elected Subchapter S status. See notes 200-01 and accompanying text infra.

\textsuperscript{188} In 1965, the IRS added a set of amendments to the definition of "association" which were designed to deny corporate status to professional corporations. After a series of judicial decisions holding the amendments invalid, the IRS finally capitulated in 1970. B. BITTKER & J. EUSTICE, supra note 181, ¶ 2.02, at 2-7 to -8; Note, supra note 181, at 570-73. See Scallen, Federal Income Taxation of Professional Associations, 49 MINN. L. REV. 603 (1965). Indeed, the Commissioner now treats a professional corporation as a corporation solely on the basis of the state label without bothering to apply the \textit{Morrissey} criteria. Rev. Rul. 77-31, 1977-1 C.B. 409.

\textsuperscript{189} Note, supra note 181, at 553, 573-75. Another commentator has warned that counsel for Pennsylvania statutory close corporations must engage in careful drafting to avoid the corporation being classed as a partnership. See Note, The Pennsylvania Technical Close Corporation v. Commissioner of Internal Revenue: A Hypothetical, 31 U. PITT. L. REV. 275 (1969).
corporations generally. The principal devices available to the California close corporation are the section 706(a) pooling agreement and the “shareholders’ agreement.” None of the Morrissey criteria would seem affected by a pooling agreement, and the only Morrissey factor directly affected by a “shareholders’ agreement” would be “centralized management,” which is explained in Treasury Regulation 301.7701-2 as follows:

Centralized management. To satisfy this factor, the exclusive, continuing power to make necessary management decisions must be concentrated in a managerial group (composed of less than all the members), who have the authority to act on behalf of the organization independently of its members. What is crucial is the focus of necessary operating authority in the hands of a particular group, unlike the “mutual agency” relationship of a partnership, where each member can bind the organization by his acts; viz., the corporate form “abhors anarchy of authority.”

Despite the reference in section 300(b) to partnership-like arrangements, the thrust of most “shareholders’ agreements” will be to shift control away from the board or the shareholders. Although this does violence to the traditional, almost Jeffersonian, structure of the corporation (shareholders—board—officers), such agreements may actually increase centralization of management by shifting power to a single “managing shareholder,” “president,” or other small group. It would be exceedingly unlikely that close corporation associates would want to convert all the shareholders into agents for the corporation. So long as the “shareholders’ agreement” is au-

190. See text accompanying notes 33-34 supra.
191. See text accompanying notes 81-151 supra.
Conceivably, a “shareholders’ agreement” might contain transfer restrictions, but for the reasons already discussed, such provisions are more likely to be inserted in separate contracts. As noted earlier, absolute restraints on transfer are of dubious validity. Even if valid, such restraints would violate the Morrissey requirement of free transferability of beneficial interests in the organization. See text accompanying notes 145-61 supra.
194. CAL. CORP. CODE § 300(b) (West Supp. 1976).
196. See notes 140-41 and accompanying text supra.
197. Such a “shareholders’ agreement” would seem ill-advised in light of the Morrissey criteria.
through instead of anarchic, it should not jeopardize the firm's treatment as a corporation.

Although it is dangerous to speculate on the Internal Revenue Service's motivation, it seems unlikely that the Commissioner would bother to challenge the corporate status of California close corporations. The Treasury's potential revenue gain would be minimal, for a close corporation always has the option of avoiding "shareholders' agreements." In any event, any zealous attempt by the IRS to treat statutory close corporations or closely held corporations as partnerships would probably be greeted with hostility not only by the courts but by Congress, the latter having been traditionally solicitous toward small business. For example, Subchapter S of the Internal Revenue Code198 was enacted in 1958 to enable businessmen "to select the form of business organization desired, without the necessity of taking into account major differences in tax consequences."199

2. Disqualification from Subchapter S Election

Subchapter S of the Internal Revenue Code allows a corporation to be taxed in a manner similar to a partnership.200 One of the prerequisites for this election is that the corporation have only one class of stock.201 The question arises whether a "shareholders' agreement" might be treated as creating a separate class of stock disqualifying a corporation from Subchapter S status.202 The intent of the single class of stock requirement was to avoid accounting complications and to ensure simplicity in passing through income and loss to the Subchapter S corporation's shareholders.203

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198. See notes 200 & 205-07 and accompanying text infra.
In 1963, the IRS ruled that a voting trust, pooling agreement, or irrevocable proxy creating "disproportionate" voting rights constituted a second class of stock.\textsuperscript{204} This view was criticized by several commentators\textsuperscript{205} and rejected by two courts (including the Tax Court)\textsuperscript{206} on the basis that voting arrangements have absolutely no effect on the pass-through of income and that the rigid Treasury attitude consequently frustrated Congress's intent to grant flexibility to small businesses.\textsuperscript{207}

Finally, the Commissioner conceded that pooling agreements, ir-
revocable proxies, and other such voting arrangements do not constitute a second class of stock, but he indicated that he would still argue that disproportionate voting rights in the articles of incorporation create a second class of stock. Although voting trusts were no longer treated as creating a second class of stock, there remained the possibility that they might violate the requirement that all shareholders of a Subchapter S corporation be individuals or estates. Accordingly, Congress amended the Code in 1976 to make it clear that voting trusts could be shareholders of corporations electing Subchapter S status.

In light of the judicial decisions, the Commissioner's acquiescence, and the Congressional solicitude re-demonstrated by the recent addition of section 1371(f) to the Code, it now seems settled that contractual voting arrangements among shareholders will not affect the election. Unless the Commissioner takes the position that "shareholders' agreements" are the equivalent of articles of incorporation, voting provisions in "shareholders' agreements" will not dis-


209. See authorities cited note 208 supra. See also 1 H. Ballantine & G. Sterling, supra note 1, § 62.04[2][d].


For purposes of subsection (a), the following trusts may be shareholders:

. . .

(2) A trust created primarily to exercise the voting power of stock transferred to it.

. . .

In the case of a trust described in paragraph (2), each beneficiary of the trust shall, for purposes of subsection (a)(1) [ten shareholder maximum], be treated as a shareholder.

Id. (emphasis added).

Significantly, the new provision refers to "subsection (a)," not just subsection (a)(2), which requires the shareholders to be individuals or estates. Arguably, the language of new subsection (f) also pertains to subsection (a)(4) (the one class of stock requirement), in which case the statute would preclude a voting trust from creating a second class of stock for Subchapter S purposes.

I.R.C. § 1371(f)(1), (3), as added by Tax Reform Act of 1976, Pub. L. No. 94-455, § 902(c)(2)(A), 90 Stat. 1520 (1976), also permits a shareholder of a Subchapter S corporation to be a grantor trust (in which the grantor is taxable on the income) and a testamentary trust (for a 60-day period only). See B. Bittker & J. Eustice, supra at § 6-2; Z. Cavitch, supra § 3.03[4].

213. 1 H. Ballantine & G. Sterling, supra note 1, § 62.04[2][d], at 4-64; Bradley, supra note 18, at 881 n.51.

213. One authority views this as a "subject of concern." 1 H. Ballantine & G. Sterling, supra note 1, § 62.03[3][d].

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qualify the corporation from Subchapter S election. The IRS probably will take a tolerant view, but conservative counsel may wish to obtain an IRS ruling or to avoid the problem entirely by inserting voting clauses in pooling agreements rather than in “shareholders’ agreements.”

Provisions of “shareholders’ agreements” which reallocate corporate distributions (dividends or liquidation payments) are an entirely different matter. Such agreements would create the pass-through complications which Congress wished to avoid by imposing the single class of stock requirement. Therefore, any “shareholders’ agreement” reallocating dividends, liquidation payments, or other corporate distributions probably disqualifies the company from Subchapter S status.

3. Section 351

Section 351 of the Internal Revenue Code provides that no gain or loss will be recognized if property is transferred to a corporation solely in exchange for its stock or securities, provided that the transferor or transferees control the corporation immediately after the exchange. The term “control” is defined in section 368(c) of the Code to mean the ownership of at least eighty percent of the total combined voting power of all classes of stock entitled to vote, plus at least eighty percent of the total number of shares of all other (non-voting) classes of stock of the corporation. It is not clear concern-

214. See Wisner, supra note 178, at 197.
215. Under California law, a pooling agreement clause in a “shareholders’ agreement” may be treated as a contract completely separate from the “shareholders’ agreement.” See text accompanying notes 129-33 supra.
216. 1 H. BALLANTINE & G. STERLING, supra note 1, § 62.03[4][b], [5][b]. See Wisner, supra note 178, at 197. The Treasury and a federal district court in California have both ruled that if the California Corporations Commissioner compels differences in the stockholders’ “rights and interest in the control, profits and assets” of the corporation, Subchapter S status is lost. Paige v. United States, 36 Am. Fed. Tax R.2d ¶75-5122 (C.D. Cal. 1975) (emphasis added), discussed in Bradley, supra note 19, at 881 n.51; Rev. Rul. 71-522, 1971-2 C.B. 316.
217. Wisner, supra note 178, at 197. See 1 H. BALLANTINE & G. STERLING, supra note 1, § 62.03[4][b], [5][b].

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ing the latter requirement whether the several classes of stock should be lumped together for the purposes of calculating the necessary “eighty percent of the total number.” The Internal Revenue Service has ruled that the transferors must have eighty percent of each class. 220

A “shareholders’ agreement” could create two problems. First, even though a nontransferor—for example, a pre-existing shareholder who does not transfer property—owns less than twenty percent of the stock, a “shareholders' agreement” might be construed as giving a nontransferor a percentage of control equal to or greater than twenty percent. 221 Second, it is conceivable that a “shareholders’ agreement” could be construed as creating separate classes of stock held by each shareholder, each class having different rights. In other words, each shareholder would hold a different class of stock. 222 Any nontransferor would own one hundred percent of his class of stock, and the transferors would own zero percent. As previously mentioned, the Service takes the position that the transferors must have eighty percent of each class of non-voting stock. If the nontransferor’s class of stock were considered “non-voting,” the exchange would not be tax-free under section 351. 223

Unfortunately, the law in this area is so uncertain that it is impossible to resolve these two issues. Surprisingly, there has not even been a resolution of the impact of pooling agreements on the eighty percent of “total combined voting power” prerequisite. At least one authority states that the term “control” relates only to ownership and not to whether the transferors actually control the corporate affairs through their voting power. 224 Another authority, however, is more equivocal:

[T]here are almost no guides to the meaning of “total combined voting power” or of “stock entitled to vote.” It is usually assumed that the computation of “total combined voting power” is not to take account of shareholders’ voting agreements or similar arrangements even though they may alter the balance of power; but the question is not foreclosed by case law or rulings. 225

In an attempt to avoid any “insufficient control” problem, the transferors may be tempted to enter into the “shareholders’ agreement” subsequent to the transfer. If there is a pre-existing obligation

221. Nelson, supra note 178, at 211; Wisner, supra note 178, at 198-99.
222. See text accompanying notes 201-17 supra.
223. See B. Brittxer & J. Eustice, supra note 181, ¶ 3.08, at 3-30 n.45. These two problems are analogous in some respects to the separate class of stock Subchapter S problem discussed earlier. See text accompanying notes 201-17 supra.
225. B. Brittxer & J. Eustice, supra note 181, ¶ 3.08, at 3-29 to -30.
to enter into the "shareholders' agreement," the two transactions
would probably be integrated; but if there is no contractual com-
mitment to enter into the subsequent agreement, the control require-
ment will probably be unaffected. However, it is exceedingly dif-
ficult to make generalizations in this area of the law.226

In light of the uncertainty, any individuals wishing to make a
section 351 tax-free exchange should not use a "shareholders' agree-
ment" or a pooling agreement to reallocate corporate distributions or
voting power in any manner which might conceivably jeopardize the
eighty-percent control requirement.227

4. Section 1244

A corporation which satisfies the requirements of section 1244
enables its common stockholders to treat losses on their investment
as ordinary rather than capital loss (up to a maximum of $25,000 a
year per shareholder, $50,000 on a joint return).228 To be eligible for
this special treatment, the securities must be "common stock."229 If a
"shareholders' agreement" were to create dividend or liquidation
preferences, the stock so benefited might be considered ineligible
"preferred stock."230 Unfortunately, it remains unsettled what sort of
preferences disqualify stock from section 1244.231 Furthermore, if
"preferred stock" is issued at the same time as "common stock," even
the common stock is ineligible for section 1244.232 This problem
might be partially avoided by entering into the "shareholders' agree-
ment" subsequent to the issuance of the shares.233

226. Z. Cavitch, supra note 200, § 4.06[2]. Compare B. Bittker & J. Eustice,
supra note 181, ¶ 3.10, with J. Mertens, supra note 201, § 20.47, at 170-72. See
also 3 J. Rabkin & M. Johnson, Federal Income Gift and Estate Taxation §
31.02[4](1977).
227. See Nelson, supra note 178, at 211; Wisner, supra note 178, at 198-99.
228. I.R.C. § 1244. See 2 H. Ballantine & G. Sterling, supra note 1, § 483.05;
B. Bittker & J. Eustice, supra note 181, ¶ 4.11; Z. Cavitch, supra note 200, §
4.05; W. Painter, supra note 48, § 4.4.
229. See authorities cited note 228 supra.
230. See Evers, Threshold Checklist for California Close Corporations, in 2
New Cal. GCL, supra note 1, at 216.
231. See B. Bittker & J. Eustice, supra note 181, ¶ 4.11, at 4-46.
232. Treas. Reg. §§ 1.1244(c)-1(c)(1), 1.1244(c)-1(b)(1) (1976); Z. Cavitch, supra
note 200, § 4.05[2][g]; 3B J. Mertens, supra note 201, § 22.90c.
233. Another prerequisite of § 1244 stock is that it be issued pursuant to a
written plan which offers the stock for a specified period not exceeding two
years. I.R.C. § 1244(c)(1). See Z. Cavitch, supra note 200, § 4.05[2][b]; 3B J.
Mertens, supra note 201, § 22.90f. Once the plan has been adopted, there can be
no subsequent offering of "non-plan stock" while stock under the plan remains
unissued. The Commissioner considers any modification of a § 1244 plan as a
5. Disproportionate Liquidation Distributions

If assets are distributed upon liquidation other than in proportion to stock ownership, the disproportionate "excess" payment may be taxed as ordinary income rather than as capital gains.234

6. Summary

A "shareholders’ agreement” should not jeopardize an entity’s


"Plan-stock" issued after such a subsequent offering of “non-plan stock” would not qualify under § 1244, although the subsequent offering of "non-plan stock" would not retroactively disqualify any previously issued “plan stock.” See I.R.C. § 1244(c)(1); Treas. Reg. § 1.1244(c)-1(b) (1976); B. BITTKE & J. EUSTICE, supra note 181, ¶ 4.11, at 4-47; 3B J. MERTENS, supra § 2290g.

The Treasury could take three possible positions regarding the subsequent execution of a "shareholders’ agreement” which reallocated corporate distributions and/or created preferences:

(1) The execution of the agreement does not constitute the offering of any stock. But cf. text accompanying notes 275-80 infra (discussing the California Corporations Commissioner’s position that the execution of a “shareholders’ agreement” is a “sale” of securities to the contracting parties).

(2) The execution of the agreement constitutes the issuance of “non-plan” stock to any shareholders who gain preferences under the contract but does not constitute a reissuance of stock to any shareholders who do not gain preferences.

(3) The execution of any “shareholders’ agreement” reallocating corporate distributions (even if preferences are not created) constitutes a reissuance of “non-plan” stock to all shareholders whose distribution rights are reallocated. The old stock would be “extinguished” and the "new" stock would not qualify under § 1244.

The first position is the most likely.

234. See I.R.C. §§ 331, 333, 337; Kintz, Tax Considerations in Forming, Operating and Dissolving Corporations Under the New California General Corporation Law, in 2 NEW CAL. GCL, supra note 1; Nelson, supra note 178, at 211; Wisner, supra note 178, at 9. See generally I.R.C. §§ 911(b), 1348; B. BITTKE & J. EUSTICE, supra note 181, ¶ 4.20-.22; Z. CAVITCH, supra note 200, §§ 11.02-.03; W. PAINTER, supra note 48, §§ 10.2-.4; Kintz, supra at 104; Wisner, supra at 195.

The disproportionate allocation of profits in a "shareholders’ agreement” should not mix salary and dividends. Otherwise a shareholder who receives disproportionately large dividends under a "shareholders' agreement” will be forced to pay taxes at a rate higher than the maximum 50% rate which would have been imposed had the payment been in the form of salary. See I.R.C. §§ 911(b), 1348; Kintz, supra at 104; Wisner, supra at 195.

One commentator has raised the issue whether the execution of a "shareholders’ agreement" creating disproportionate profit sharing could itself be considered a taxable event or could result in taxes being due when profits were earned even if not paid out. Id. at 194. See Kintz, supra at 103-04. Cf. Sol Diamond, 56 T.C. 530 (1971), aff’d 492 F.2d 286 (7th Cir. 1974), noted in Comment, Income Regulation of Future Interests in Partnerships Profits and Losses—Taxation—Federal Income Tax—Diamond v. Commissioner (T.C. 1970), 9 SAN DIEGO L. REV. 373 (1972), Cowan, Receipt of an Interest in Partnership Profits in Consideration for Services: The Diamond Case, 27 TAX L. REV. 161 (1972), Note, The Right to Income as Taxable Income, 26 BAYLOR L. REV. 649 (1974), Note, Federal Taxation—Is Diamond a Syndicator’s Worst Friend?, 10 WAKE FOREST L. REV. 785 (1974) (holding that a partner who receives a partner-
status as a corporation under the Internal Revenue Code. Although voting provisions in a “shareholders’ agreement” probably would not affect the Subchapter S election, it would be wise to circumvent the problem through the use of pooling agreements (or voting trusts), which definitely do not create a disqualifying separate class of stock. A disproportionate reallocation of corporate distributions in a “shareholders’ agreement” would make the corporation ineligible for Subchapter S and would create other tax complications as well. If at all possible, therefore, a corporation should avoid these problems by issuing stock in direct proportion to economic interests (without any reallocation of distributions) and use a pooling agreement or a voting trust to differentiate the pattern of control from that of economic ownership.

D. California Securities Law Problems

As is generally known, California has its own Corporate Securities Law which regulates the offer and sale of securities within the state.\textsuperscript{235} Such an offer or sale must be approved or “qualified” by the Department of Corporations, unless an exemption is available.\textsuperscript{236} Close corporation voting arrangements and “shareholders’ agreements” may run into difficulties under several provisions of the California Corporate Securities Law.\textsuperscript{237}

1. Attachment as Exhibit to Applications for Permit

In June, 1976, the Department of Corporations stated that an applicant’s “most reasonable approach” in obtaining a permit for the original issuance of shares would be to include a copy or description of “all agreements, including shareholder agreements that are known to the applicant . . . which . . . would be considered necessary in order to determine whether the proposed transaction is fair, just, and equitable.”\textsuperscript{238}


\textsuperscript{236} Cal. Corp. Code §§ 25110, 25120, 25130 (West Supp. 1976); 2 H. Ballantine & G. Sterling, supra note 1, § 439. The head of the Department of Corporations is the Corporations Commissioner.

\textsuperscript{237} Buxbaum, Aspects of State and Federal Securities Regulation Under the New Code, in 2 New Cal. GCL, supra note 1, at 401, 403-05.

\textsuperscript{238} Corp. Sec. Newsletter, June, 1976, at 5.
On February 9, 1977, the Commissioner proposed a set of regulations to deal with the problems created by the statutory close corporation provisions of the new General Corporation Law. In light of the comments received, a revised set of proposed regulations was released on September 14, 1977; and, after more changes, a set of rules was finally adopted on May 12, 1978. The February and the September proposals and the finally adopted rules added "shareholders' agreements" to the definition of "charter documents." The May, 1978 rules also added the following to the exhibits required in applications for qualification by permit:

charter documents [and] a copy of any agreement made or to be made by or among shareholders of the issuer which materially affects, or will materially affect, any of the rights, preferences, privileges or restrictions of or on securities of the issuer or the management of the issuer including any voting agreement, irrevocable proxy or shareholders' agreement [or a description of the agreement if a copy is not available to the issuer].

In short, "shareholders' agreements," pooling agreements, and irrevocable proxies will have to be disclosed in permit applications. Voting trusts are not specifically mentioned but apparently must also be filed with or described on the permit application. Release 55-C, which accompanied the May 12, 1978 rules, states that the permit application forms "have been amended to require the inclu-

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242. Adopted Amendments to Items 21(A) and (D) of § 260.113, 10 CAL. ADMIN. CODE § 260.113 (1978), Items 15(C) and (E) of § 260.121.1(a), id. § 260.121.1, Items 14(C) and (G) of § 260.121.1(b), id. § 260.121.1 (May 12, 1978) (on file with the San Diego Law Review). The February, 1977 and September, 1977 versions of the proposed rules contain almost identical amendments.

243. In the case of qualification by permit, the burden is on the applicant to show that the transaction is fair, just, and equitable. Otherwise, the Department of Corporations may refuse to issue a permit. CAL. CORP. CODE § 25140(b) (West Supp. 1976); R. Jennings & H. Marsh, Securities Regulation—Cases and Materials 587 (3d ed. 1972); 1 H. Marsh & R. Volk, supra note 63, § 8.01.

244. An interest or certificate in a voting trust is a security under the California Securities Law. See note 63 supra. Section 25102(f) of the Corporations Code exempts from § 25110 any offer or sale of a voting trust interest if, after the "sale," the interests are held by no more than five persons. See note 63 supra. (Section 25110 requires the qualification of "issuer transaction" offers and sales). Although interests in a voting trust need not be qualified under § 25110,
sion . . . of agreements among shareholders, including but not limited to shareholders’ agreements, voting agreements and irrevocable proxies."\textsuperscript{244a} It would be anomalous if voting trusts did not need to be disclosed, because they have much the same effect as pooling agreements.\textsuperscript{245}

A contract among the shareholders imposing restraints on the transfer of shares materially affects the rights and restrictions of shares\textsuperscript{246} and apparently must be described or included as an exhibit in a permit application.\textsuperscript{247} Oddly, thus far there has been no proposal to amend Rule 260.140.8,\textsuperscript{247a} which refers to “charter documents” only and which previously has been interpreted to preclude review of transfer restrictions in private contracts.\textsuperscript{248}

2. The Small Offering Exemption

The most frequently used\textsuperscript{249} Corporate Securities Law issuer exemption is section 25102(h),\textsuperscript{250} which deals with “small offerings.”

the trust might still have to be disclosed in an application for a permit to issue other securities.

\textsuperscript{244a} Dep’t of Corporations Release 55-C, at 8-9 (May 19, 1978) (emphasis added) (on file with the \textit{San Diego Law Review}) [hereinafter cited as Release 55-C].

\textsuperscript{245} \textit{See} Wang, supra note **, at 1176-78 and authorities cited therein. \textit{See also} id., at 1171-73 and authorities cited therein.

\textsuperscript{246} Cf. note 242 and accompanying text supra (discussing the proposed changes in the exhibits required in an application for qualification by permit).

\textsuperscript{247} Among the new exhibits required in applications for qualification of recapitalizations and reorganizations are copies of “any contract to be made by the issuer affecting any of the rights, preferences, privileges, or transferability of the securities.” Adopted Amendments to Item 15(D) of § 260.121.1(a) and Item 14(E) of § 260.121.1(b) (May 12, 1978) (emphasis added) (on file with the \textit{San Diego Law Review}). Copies of such contracts were already required as exhibits in general permit applications. Item 21(c) of Rule 260.113, 10 \textit{Cal. Admin. Code} § 260.113 (1978).


\textsuperscript{248} 1 H. MARSH & R. VOLK, supra note 63, § 8.02(3)[k][v]. \textit{See} 3 H. BALLANTINE & G. STERLING, supra note 1, at A-121 n.16. \textit{See also} 1 H. BALLANTINE & G. STERLING, supra § 63.05(1)[h], at 4-89.

\textsuperscript{249} 2 H. BALLANTINE & G. STERLING, supra note 1, § 438.01, at 876.6.

\textsuperscript{250} Id. § 438. \textit{See generally} 1 H. MARSH & R. VOLK, supra note 63, § 4.02. Although both § 25102(h) and § 158(d) (defining the statutory close corporation) have a 10-shareholder limitation, the definition of “shareholder” is not the same. Section 158 refers to shareholders “of record.” \textit{See} authorities cited note 11 and accompanying text supra. On the other hand, § 25102(h) uses a beneficial ownership test. Although § 158(d) in most cases counts a partnership, corporation, or trust as one shareholder, § 25102(h) would treat as beneficial holders each of the partners, shareholders, and (subject to limited exceptions) trust beneficiaries. \textit{Cal. Corp. Code} § 25102(h)(5) (West Supp. 1976); Rule 260.102.5, 10 \textit{Cal. Admin. Code} § 260.102.5 (1978); Rule 260.102.5(b) (May 12, 1978) (on file with the San
This section exempts from qualification any offer or sale of voting common if, after issuance, there will be only one class of stock owned beneficially by no more than ten persons. Certain additional requirements must be met. Among these is a stipulation that upon the initial organization of a corporation the same consideration per share must be paid by each shareholder.251

In the past, the Corporations Commissioner's rules and forms referred to this exemption as the "Close Corporation Exemption," but section 25102(h) is independent of the definition of "close corporation" in section 158.252 Therefore, the Department of Corporations has changed the name of the section 25102(h) exemption in its rules and forms to the "small offering" exemption. Actually, this term is slightly misleading, because the dollar amount of the issue need not be small. A more accurate name would be the "limited distribution" or "small number of shareholders" exemption, but these terms presumably are too cumbersome. Henceforth, this article will adopt the new term: "small offering exemption."

In a release and in newsletters in 1977, the Commissioner warned that a "shareholders' agreement" or other arrangement such as a pooling agreement may make the small offering exemption unavailable by in effect creating a second class of stock253 or by reallocating dividends and other corporate distributions in such a way as to nullify the section 25102(h)(3) requirement that the same consideration per share be paid upon initial organization.254

The first part of this warning was incorporated in Rule 260.102.4(b), which provides:

A corporation does not have "only one class of stock" outstanding if, at the time its shares are issued, there exists or is presently intended to be executed a shareholders' agreement pursuant to which any of the rights, preferences, privileges, or restrictions upon its shares, as

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252. See 1 H. BALLANTINE & G. STERLING, supra note 1, § 60.01(2)(b); 18 H. MARSH, supra note 1, § 21.4, at 70; 1 H. MARSH & R. VOLK, supra note 63, § 4.02.

253. See also note 250 supra.

enumerated in Subdivision (e) of Section 25103 of the Code.\textsuperscript{254a} are or would be modified as to any such shares, or as to the holders of any such shares, in a manner not applicable to all outstanding shares.\textsuperscript{255}

Clearly, the Department's goal is to make a company ineligible for the small offering exemption if there will be a "shareholders' agreement" creating disproportionate rights. In many cases, however, it will be difficult to determine whether shareholder rights are disproportionate.\textsuperscript{257} This article earlier gave an example of a "shareholders' agreement" which provided that each shareholder had one vote regardless of the number of shares held (one shareholder, one vote).\textsuperscript{258} If the shareholders own different numbers of shares, from one point of view there is a disproportionate dilution of the voting power of each shareholder. From another perspective, however, all shares are disenfranchised in favor of the individual shareholders, so that all shares are equally adversely affected.

Suppose a "shareholders' agreement" retained the board of directors but shifted almost all power away from the board to a "Managing Shareholder" for an indefinite term. On the one hand, it might appear that such an agreement has a disproportionate effect because all shares except those held by the "Managing Shareholder" are deprived of any meaningful power. On the other hand, because the directors have little function, all shares arguably lose significant voting rights.\textsuperscript{259}

A further complication is added by section 25102(h)'s requirement that all stock be "voting common."\textsuperscript{260} When the board has little function, the Commissioner could conceivably argue that all the shares are effectively non-voting despite some residual power—for example, approval of organic changes, articles amendments, and new issuances of stock\textsuperscript{261}—and despite their right to elect directors. AL-

\textsuperscript{254a} Included in § 25103(e)'s list are changes in dividend, liquidation, and voting rights. See note 290 and accompanying text infra.
\textsuperscript{255} Rule 260.102.4(b) (May 12, 1978) (emphasis added) (on file with the San Diego Law Review).
\textsuperscript{256} Note 256 has been omitted.
\textsuperscript{257} See 18 H. Marsh, supra note 1, § 21.4, at 72-73. Marsh gives two examples of "shareholders' agreements," one of which clearly would create a second class of stock, and one of which clearly would not. He then notes that there are an "almost infinite number of variations... between the two extremes... used as illustrations." Id., at 73.
\textsuperscript{258} See text accompanying note 121 supra.
\textsuperscript{259} Cf. text accompanying notes 293-96 infra (discussing potential inconsistencies between the Department's positions in this and in an analogous area).
\textsuperscript{260} CAL. CORP. CODE § 25102(h) (West Supp. 1976).
\textsuperscript{261} See generally 2 FORMS, supra note 67, forms 8.80, at 8-221, 8.81, at 8-231 to 232.
though the Department has warned that voting agreements may create disqualifying “non-voting” common,262 it has not given any explanation—much less a rule defining what constitutes disenfranchisement.

A company must file a form notifying the Commissioner when the section 25102(h) exemption is utilized.263 Item 2 of the form is a statement that, immediately after the issuance and sale of the shares, the issuer had only one class of stock outstanding.264

The May, 1978 amendments add to this form a question whether the issuer is a “close corporation” and whether, to the issuer’s best knowledge, “its shareholders or proposed shareholders have not entered into or granted, and presently do not intend entering into or granting, a shareholders’ agreement, voting agreement, irrevocable proxy or other arrangement the effect of which would cause the statements contained [therein] to be incorrect.”265 This question is extremely difficult to answer. First, it is not clear whether the phrase “other arrangement” encompasses a voting trust. Second, the Department’s new rules do not indicate when, if ever, pooling agreements, irrevocable proxies,266 and voting trusts create a second class of stock267 (or a disqualifying disenfranchisement of stock). As previously mentioned, Rule 260.102.4(b) provides that a “shareholders’ agreement” can effectively create a second class of stock; but it says nothing about other voting arrangements which accomplish the same reallocation of voting power. However, Release 55-C, which accompanied the May, 1978 rules, warned that “voting agreements or irrevocable proxies may be inconsistent with the requirements of [section] 25102(h) . . . depending upon the circumstances and/or upon

262. Release 55-C, supra note 244a, at 7; Release 50-C, supra note 253, at 5; Corp. Sec. Newsletter, March, 1977, at 10.
266. Under § 705(e), a bare proxy may still be revoked, even if stated to be irrevocable, unless “it is given to secure the performance of a duty.” But cf. Berger, supra note 19, at 593-95 (suggesting an interest in the corporation generally may be sufficient to enable a proxy to be made irrevocable under § 705(e)). Nevertheless, an irrevocable proxy contained in a pooling agreement should be irrevocable under § 705(e) because it is given to secure the performance of a contractual obligation to vote in a certain manner. See Wang, supra note **, at 1181-85 and authorities cited therein.

267. See also Bradley, supra note 19, at 881 n.51, which states: “No reason exists to think that shareholder agreements, proxies, voting trusts or anything of the sort will jeopardize the [§ 25102(h)] exemption.”
whether or not the arrangement is a part of a plan to evade the protective provisions of the small offering exemption.”\textsuperscript{267a}

In 1973, the Commissioner gave the following opinion:

The first question . . . is whether the voting trust certificates constitute a second class of stock of Libby so as to disqualify Libby for the Section 25102(h) exemption, which is not available to an issuer if immediately after the issuance there is more than one class of stock of the issuer outstanding. We concur . . . that Libby is not the issuer of the voting trust certificates, and that therefore these securities do not constitute a second class of stock of Libby.\textsuperscript{268}

The nexus between the two sentences is elusive. Even though a corporation is not the issuer of voting trust certificates, the trust can affect the voting rights of shares of which the corporation is an issuer, and this could be viewed as creating separate classes of stock. The opinion, however, seems to presume that second classes of stock are only created when the corporation itself issues stock with different rights. This implicit rationale is far-reaching and would prevent all contractual voting arrangements from disqualifying an issuer from section 25102(h). In Release 55-C, the Department expressly qualified this earlier ruling and noted that certain voting trusts create a disparity in voting rights and that under these circumstances “the securities law contemplates that the qualification process will be used.”\textsuperscript{269}

“Shareholders' agreements,” voting trusts, pooling agreements, irrevocable proxies, and other such arrangements present the Department of Corporations with a formidable line-drawing problem. At one extreme is a charter provision creating disparate voting rights; at the other extreme is a voting arrangement entered into by a small minority of the shareholders (e.g. an irrevocable proxy granted by one shareholder to another for a short period). “Shareholders’ agreements” are executed by all the shareholders of the corporation and arguably are akin to charter provisions. This argument, however, leads to a classic conceptual slippery slope. Voting trusts and pooling agreements among all the shareholders of a close corporation are indistinguishable in effect from voting provisions in “shareholders’ agreements.” Treating the three differently would not only be illogical but would also create the nightmarish problem of identifying borderline arrangements as one or the other. Pooling agreements in

\begin{itemize}
\item \textsuperscript{267a} Release 55-C, \textit{supra} note 244a, at 7.
\item \textsuperscript{268} Dept of Corporations, State of California, Commissioner’s Opinion No. 73/43C, at 2. \textit{See} 2 H. BALLANTINE & G. STERLING, \textit{supra} note 1, § 455.04[2].
\item \textsuperscript{269} Release 55-C, \textit{supra} note 244a, at 8. \textit{See} authorities cited note 253 \textit{supra}.
\end{itemize}
which all the parties grant irrevocable proxies to one party are very much like voting trusts. In addition, as mentioned earlier, the courts may treat a voting clause in a “shareholders’ agreement” as a pooling agreement completely separate from the other parts of the “shareholders’ agreement.”

If voting trusts and pooling agreements among all the shareholders of a close corporation can disqualify the issuer from the section 25102(h) exemption, what about voting arrangements among most or some of the shareholders of close or non-close corporations? As to the investor whose voting rights are adversely affected or eliminated, such arrangements can have the same effect as charter provisions or unanimous shareholder contracts. Thus, by creating the “shareholders’ agreement,” the new Code has precipitated a re-examination by the Commissioner of the effect of all shareholder voting contracts on the small offering exemption. Ironically, this re-examination appears to have resulted in less flexibility for shareholders of both close and non-close corporations; but the Department has been unwilling to draw a line on the slippery conceptual slope just discussed. Release 55-C gives little guidance as to when voting arrangements are inconsistent with the requirements of section 25102(h).

The February, 1977 proposed version of the rules denied the small offering exemption “with respect to any transaction which, although in technical compliance with such exemption, is part of a plan or scheme to evade the qualification provisions . . . contrary to the objectives of Subdivision (h) of Section 25102 and the purposes and policies underlying the Corporate Securities Law of 1968.” This language was deleted from the final version of the regulations, with the explanation that:

The Department believes that the foregoing is an accurate forecast of the position which would be taken by the courts with respect to an issuance under the small offering exemption involving the use of shareholders’ agreements, voting agreements, irrevocable proxies or other arrangements in a manner inconsistent with the terms of that exemption (People v. Davenport, 15 Cal.2d 381; SEC v. Harwijn Industries Corp., 326 F. Supp. 943 (1971); Oil Lease Service, Inc. v. Stephenson, 162 Cal.2d 100) and that it is therefore unnecessary, and possibly inappropriate, to include such a statement in the rules.

The three cases cited by the Department did not involve section 25102(h). Davenport and Oil Lease Service both state that in deciding whether an instrument is a “security” under the California Secu-

270. See notes 37-39 & 76-80 and accompanying text supra.
271. See text accompanying notes 129-31 supra.
271a. See note 267a and accompanying text supra.
rities Law, the courts may look through mere form to substance. Harwyn involved federal rather than California securities law.273a

The official “Notice of Issuance of Shares” under the section 25102(h) exemption requires an opinion of counsel that the exemption is available.274 Attorneys will be extremely reluctant to sign the opinion if any shareholders have executed or intend to execute a pooling agreement or a voting trust. Rather than use uncertainty as a weapon, the Commissioner should directly confront the problem of the effect of pooling agreements and voting trusts on the section 25102(h) exemption.

3. Sale Because of a Change in the Rights of an Outstanding Security

Section 25017(a) of the California Securities Law defines a change in the “rights, preferences, privileges or restrictions of or on outstanding securities” as a sale of securities. Such a “sale” must be qualified or approved by the Department of Corporations unless an exemption is available.275 The broad definition of “sale” produces two issues: Under what circumstances does the execution of a “shareholders’ agreement” or other shareholders’ arrangement constitute a “sale” of securities under section 25017(a), and under what circumstances does an existing company’s election or termination of close corporation status constitute a sale of securities under section 25017(a)?

a. “Shareholders’ Agreements” and Other Shareholder Arrangements as a Sale

Since the enactment of the Corporate Securities Law of 1968, the Department of Corporations has consistently accepted the position


274. CAL. CORP. CODE § 25102(h)(5) (West Supp. 1976); Rule 269.102.3, 10 CAL. ADMIN. CODE § 260.102.3 (1978); 1 H. MARSH & R. VOLK, supra note 83, § 4.02(13).

that shareholder contracts which "change the rights, preferences, privileges, or restrictions of or on outstanding securities, without affecting the charter documents of the corporation, are not subject to the qualification requirements of the Corporate Securities Law." 276 The Commissioner announced in March, 1977, that he was modifying this traditional position in light of section 204 of the new General Corporation Law, which allows certain provisions to be included in "shareholders' agreements" rather than in the articles. 277

In May, 1978, the Department adopted the following rule:

260.017.2. Changes Effected Through Shareholders' Agreements.
The term "any change in the rights, preferences, privileges, or restrictions of or on outstanding securities" as used in Subdivision (a) of Section 25017 of the Code includes changes in the rights, preferences, privileges, or restrictions of or on outstanding securities of a corporation effected through the adoption, modification or termination of provisions of a shareholders' agreement, which provisions, except for the second sentence of Section 204(a) or other provision of the Code, or a substantially similar provision of the law of a foreign jurisdiction, would be required to be in the articles of incorporation or bylaws to be effective. 278

The modification or termination of a "shareholders' agreement" described by the rule includes an involuntary modification or termination resulting from cessation of close corporation status, whether voluntary or involuntary. 278a A.B. 2510, 278b presently pending in the legislature, would amend the Securities Law to provide an exemption from qualification for the termination of a "shareholders' agreement" pursuant to section 300(b). 278c

The February, 1977 version of Rule 260.017.2 included within the definition of "sale" any change in the rights of the securities of any corporation (close or non-close) effected through the execution, modification, or termination of any "shareholders' agreement," voting agreement, or irrevocable proxy. The finally adopted version covers

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After A.B. 376 (the new General Corporation Law) was introduced, it was at one point amended to provide for regulation of voting agreements under the Securities Law, but this language was subsequently deleted. Jordan, supra at 1136-38.

A majority of the State Bar Committee which drafted the new General Corporation Law concluded that the Corporations Commissioner's jurisdiction should not extend to § 706(a) pooling agreements. McKenzie, supra note 6, at 496.


278a. Release 55-C, supra note 244a, at 3.


278c. See text accompanying note 85 supra.

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close corporations only and deliberately omits reference to voting agreements or irrevocable proxies. As noted in his May, 1978 Release, the Commissioner has decided not to treat the execution of pooling agreements and irrevocable proxies as section 25017(a) “sales.”

The ironic result is that, apparently, the shareholders of both close and non-close corporations can use either section 706(a) or non-section 706(a) pooling agreements (containing irrevocable proxies) or voting trusts (with five or fewer beneficiaries) to reallocate control without having to worry about qualification, while the same provisions in a close corporation “shareholders’ agreement” might well require qualification. As mentioned earlier, if one clause of a “shareholders’ agreement” resembles a pooling agreement, the General Corporation Law may treat that clause as a section 706(a) pooling agreement completely separate from the “shareholders’ agreement.” Because the Commissioner has defined a “shareholders’ agreement” as a “charter document,” it is unclear whether he would take such a charitable view toward pooling agreement clauses in “shareholders’ agreements,” although the courts might force such a position upon him.

In any event, under the new rules, the insertion of voting provisions

280. See generally McKenzie, supra note 6, at 468; Wang, note ** supra. Under § 705(e), a bare proxy stated to be irrevocable may still be revocable unless “it is given to secure the performance of a duty.” CAL. CORP. CODE § 705(e) (West Supp. 1978). But see Berger, supra note 59, at 593-95. Nevertheless, an irrevocable proxy contained a pooling agreement is irrevocable under § 705(e) because it is given to secure the performance of a contractual obligation to vote in a certain manner. See Wang, supra at 1181-85 and authorities cited therein. Because of the questionable validity of bare irrevocable proxies, the remainder of the discussion will emphasize voting trusts and pooling agreements.

281. An interest or certificate in a voting trust is a security under the California Securities Law. See notes 63 & 80 supra. Section 25102(f) of the Corporations Code exempts from § 25110 any offer or sale of a voting trust interest if, after the “sale,” the interests are held by no more than five individuals (§ 25110 requires the qualification of “issuer transaction” offers and sales). CAL. CORP. CODE § 25102(f) (West Supp. 1978). Thus, under certain circumstances, the “issuance” of voting trust interests need not be qualified.

However, § 25102(f) creates an exemption only from § 25110 and not from § 25120, the latter requiring the qualification of “issuer transactions” (transactions for the issuer’s benefit) involving changes in the rights of outstanding securities. (Under § 25120, the “issuer” involved would be the corporation and not the trust). Thus, the question whether the creation of a voting trust is a § 25017(a) “sale” is separate from the issue whether voting trust interests (which are themselves securities) must be qualified.

282. See text accompanying notes 129-31 & 135 supra.
283. See text accompanying notes 240-41 supra.

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into a close corporation "shareholders' agreement" is a trap for the unwary. When liquidation or dividend preferences are not desired, close corporation shareholders would be well-advised to avoid "shareholders' agreements" entirely by allocating economic interests through the number of shares and reallocating voting interests through voting trusts (with less than five beneficiaries) or pooling agreements containing irrevocable proxies. Indeed, if shareholders of a close corporation wish to make their reallocation of voting power self-executing, a voting trust or section 706(a) pooling agreement would have a slight advantage over voting provisions in a "shareholders' agreement."\textsuperscript{284}

Another anomalous result of the Commissioner's rules is that a group of ten or fewer individuals could organize a corporation, utilize the section 25102(h) exemption, and after a "suitable" time interval, execute a voting trust (with five or fewer beneficiaries), a pooling agreement, or irrevocable proxies without notifying the Department of Corporations. As long as the voting agreements were not "intended to be executed" at the time the small offering exemption was utilized,\textsuperscript{285} there would be no violation of the California Securities Law.

Under the new securities rules, it is uncertain whether a \textit{unanimous} contract among close corporation shareholders will sometimes be considered a "shareholders' agreement" even though the contract is not labeled a "shareholders' agreement" or expressly states that it is not a "shareholders' agreement." Assuming that a unanimous shareholder contract abridging board discretion is valid under the common law,\textsuperscript{285a} close corporation shareholders might conceivably try to opt out of sections 300(b) and 186 and thereby avoid qualification.\textsuperscript{285b} Other firms might choose to eliminate the entire problem simply by avoiding close corporation status.

Even if the execution, modification, or termination of a "shareholders' agreement" were submitted for a permit, it is uncertain what standards the Department should apply. Sections 25110 and 25120 of the Code require the qualification of different types of "issuer transactions," while section 25130 requires the qualification of "non-issuer transactions." It is not clear whether "shareholders' agreement" transactions are "issuer" or "non-issuer" transactions (or

\textsuperscript{284} Proxies under a § 706(a) pooling agreement are \textit{expressly} permitted to be irrevocable under § 705(e). See Wang, \textit{supra} note **, at 1181-85. Proxies in § 186 "shareholders' agreements" are not expressly mentioned in § 705(e), although the general language of that provision ("to secure the performance of a duty") would permit proxies in a "shareholders' agreement" to be irrevocable. See \textit{Id}.

\textsuperscript{285} See text accompanying note 255 \textit{supra}.

\textsuperscript{285a} See notes 116-19 and accompanying text \textit{supra}.

\textsuperscript{285b} See text accompanying notes 160-61 \textit{supra}.
both). “Non-issuer transactions” are defined as transactions “not directly or indirectly for the benefit of the issuer.”286 Although the statute does not define the term “issuer transaction,” the clear implication is that any transaction for the direct or indirect benefit of the issuer is an “issuer transaction.”287 A reallocation of the control and the profits of a corporation is for the benefit of the owners and not for the benefit of the company itself. It could therefore be argued that a change in the rights of outstanding securities resulting from a “shareholders’ agreement” is a “non-issuer transaction” covered by section 25130. Both the Commissioner and the leading commentators, however, seem to assume that all section 25017(a) changes in rights are “issuer transactions.”288

If the execution of a “shareholders’ agreement” were a non-issuer transaction, it might still be exempt from qualification under section 25104, which creates exemptions from section 25130. However, none of the subdivisions of section 25104 seem to apply to changes in shareholder rights. In all likelihood, the legislature never contemplated the problem of “non-issuer” changes in shareholder rights. If, as is almost universally assumed,289 all section 25017(a) changes in the rights of securities are always “issuer transactions,” section 25103(e) would be the only applicable exemption provision. This section deals with “issuer transactions” and exempts from sections 25110 and 25120 all changes in the rights, preferences, privileges, or restrictions of or on outstanding shares, except those which (1) materially and adversely affect any class of shareholders and (2) are mentioned in a specific list of types of changes.290 Included in the list

288. See Release 50-C, supra note 253, at 3; 2 H. BALLANTINE & G. STERLING, supra note 1, § 454.05[1][a], [b]; 1 H. MARSH & R. VOLK, supra note 63, § 7.05, at 7-27. Proposed Rule 260.05.24(b) (Sept. 14, 1977) refers to changes in shareholder rights “not otherwise exempted from qualification under section 25120 of the Code.” Section 25130 is not mentioned. As will be discussed shortly, § 25103(e) creates exemptions to “issuer transactions” required to be qualified under § 25110 and § 25120. Both the Department of Corporations and the commentators seem to assume that § 25103(e) (dealing with “issuer transactions”) is the only exemption available to § 25017(a) changes in rights. See CORP. SEC. NEWSLETTER, March, 1977, at 11; 1 H. MARSH & R. VOLK, supra § 7.08; McKenzie, supra note 6, at 487. But see Release 55-C, supra note 244a, at 2: “The exemption most pertinent . . . [to § 25017(a)] is Section 25103(e)” (emphasis added).
289. See authorities cited note 288 supra.
290. CAL. CORP. CODE § 25103(e) (West Supp. 1976); 2 H. BALLANTINE & G. STERLING, supra note 1, § 454.05[1][a],[b]; 1 H. MARSH & R. VOLK, supra note 63, §
are changes in dividend, liquidation, and voting rights. This provision strongly suggests that the legislature considered all such changes to be “issuer transactions” even though it might be difficult in some cases to find a direct or indirect benefit to the issuer. The language of A.B. 2510 lends support to this interpretation. The bill amends section 25103(e) to provide an issuer transaction exemption for the termination of a “shareholders’ agreement.” If, as virtually everyone assumes, the section 25103(e) exemption is available to “shareholders’ agreements,” many close corporation “shareholders’ agreements” might be exempt from qualification because they do not “materially and adversely affect any class of shareholders” but instead benefit some shareholders and adversely affect others with no adverse effect on the entire class.

During the discussion of the small offering exemption, this article hypothesized a “shareholders’ agreement” which retained the board of directors but shifted all power away from the board to a “Managing Shareholder” with an indefinite term. The Commissioner might take two possible views: (1) The agreement diminishes the effective voting power of all shares; or (2) the agreement diminishes the effective voting power of all shares except those of the “Managing Shareholder.” Under either approach, the execution of the agreement might be exempt from qualification.

If the Commissioner takes the first view, there is a material adverse effect on the entire class of shareholders, but not a disproportionate effect. Therefore, the hypothetical “shareholders’ agreement” would not be exempt under section 25103(e). However, the agreement might not create a second class of stock for purposes of the section 25102(h) small offering exemption. If, in addition, no “non-voting” stock is created, such an agreement might be outside the Commissioner’s jurisdiction if adopted on initial organization. Rule 260.103 exempts

[a]ny change in the rights, preferences, privileges, or restrictions of or on outstanding securities . . . if the transaction, had it involved the issuance of a new security containing the changed rights, preferences, privileges, or restrictions . . . would have been exempt from . . . section 25110 [requiring the qualification of issuer securities sales] by any

7.03. See also discussion of share transfer restrictions in text accompanying notes 157-58 supra.
280a. See authorities cited note 278b and accompanying text supra.
291. See authorities cited note 288 supra.
293. See text accompanying note 259 supra.
294. See notes 255-59 and accompanying text supra.
294a. Id.
294b. See authorities cited notes 260-62 and accompanying text supra.
of the subdivisions of section 25102 (including section 25102(h)).

Therefore, the vagueness of the Department’s standards for the small offering exemption creates additional uncertainty as to when the execution of a "shareholders' agreement" must be qualified. Because the Commissioner has given no guidelines as to when a "shareholders' agreement" creates "non-voting" stock disqualifying an issuer from the section 25102(h) exemption and has not given a clear indication of when a "shareholders' agreement" creates a disqualifying second class of stock, it is difficult to know when the execution of a "shareholders' agreement" is exempt under Rule 260.103.

Two possible views of the hypothetical "shareholders' agreement" were mentioned earlier. If the Commissioner takes the second approach, there is arguably no material adverse effect on a "class" of stock. Such an agreement would make a newly organized company ineligible for the small offering exemption but would not require qualification if adopted by the shareholders of an existing company. Under the second view, most "shareholders' agreements" would not adversely affect an entire class of securities and would therefore be exempt from qualification. Regardless of which position the Commissioner takes, the results are anomalous.

Unfortunately, there appears to be virtually no discussion of the meaning of "class" in section 25103(e). The Commissioner would probably take the view that two or more shareholders constitute a "class." Indeed, the Department may even be forced to maintain that the term "shareholder" means a "class" of shareholders. Other-

294c. Rule 260.103, 10 CAL. ADMIN. CODE § 260.103 (1978). See Release 55-C, supra note 244a, at 5; 1 H. MARSH & R. VOLK, supra note 63, § 7.05. Although the text of Rule 260.103 states that it is adopted pursuant to § 25103 of the Code (dealing with exemptions from qualification of recapitalizations and reorganizations), the language of the rule is not limited to recapitalizations and reorganizations and has a broad impact. The official note following the rule cites as authority § 25105, which gives the Commissioner broad general exemptive power (see note 304 infra); and Marsh and Volk state that the rule is adopted pursuant to § 25105 of the Code, 1 H. MARSH & R. VOLK, supra.

294d. See authorities cited note 262 and accompanying text supra.

294e. See notes 253-57 and accompanying text supra.

294f. See notes 255-59 and accompanying text supra.

294g. See text accompanying note 290 supra.

295. See, e.g., 1 H. MARSH & R. VOLK, supra note 63, § 703(3), which analyzes § 25103(e) but contains no discussion of the meaning of "class."

296. On January 6, 1972, the Commissioner gave an opinion that a set of articles and by-laws changes a corporation from professional to non-professional status was exempt under § 25103(e) "because since B is the sole shareholder . . ., they (the amendments) do not substantially or adversely affect
wise, there would be no need to qualify a “shareholders’ agreement” which materially and adversely affected the rights of only one shareholder of a two-shareholder corporation.

b. Conversion to or from Close Corporation Status as a Sale

When an existing corporation amends its articles to elect or terminate close corporation status, it either creates or eliminates the statutory share restrictions and rights discussed at the beginning of this article. Such conversions may therefore be a “sale” under section 25017(a). Under the Commissioner’s rules, section 25017(a) encompasses the addition to, or deletion from, the articles of incorporation of the provisions prescribed by section 158(a) for all close corporations.

The February and September 1977 proposed regulations included a rule which would have exempted certain changes in rights accompanying the termination or election of close corporation status. That rule has not been adopted in light of the likely passage of A.B. 2510, which exempts from qualification any change in shareholder rights resulting from the addition or deletion of the articles provisions required of close corporations. In other words, the pending bill would exempt any change in shareholder rights resulting solely from the election or the voluntary or involuntary termination of close corporation status.


Under the Commissioner’s rules relating to close corporations, “shareholders’ agreements” are defined as “charter documents” and treated much the same as articles provisions are presently treated. A “shareholders’ agreement” any class of shareholders.” Dep't of Corporations, State of California, Commissioner's Opinion Op. L. 206, at 3 (Jan. 6, 1972) (emphasis added) (on file with the San Diego Law Review). Whatever the underlying rationale, the stated basis of the opinion appears to be that a single shareholder is not a “class” of shareholders for the purpose of § 25103(e).

297. See Release 55-C, supra note 244a, at 3; Release 50-C, supra note 253, at 3-4.
299. See notes 8-9 and accompanying text supra.
301. Release 55-C, supra note 244a, at 5.
303. A.B. 2510 would also exempt the termination of a “shareholders’ agreement” pursuant to § 300(b). See text accompanying notes 278-278c supra.
(a) must be disclosed in permit applications; 
(b) creates a second class of stock making the corporation ineligible for the section 25102(h) exemption if the agreement alters shareholder rights in a non-uniform manner; 
(c) under certain circumstances might create "non-voting" stock disqualifying an issuer from the section 25102(h) exemption; and 
(d) is itself a "sale" of securities under section 25017(a) if the agreement changes the rights of shareholders, unless an exemption under section 25103(e) or Rule 260.103 is available.

Pooling agreements, voting trusts, and other such arrangements are not treated as section 25017(a) "sales," but the Commissioner has warned that they may create a second class of stock making the corporation ineligible for the section 25102(h) exemption. Furthermore, the Department now requires that such voting agreements be disclosed on the form notifying the Commissioner of the use of the exemption. Unfortunately, the Department has provided no rules on pooling agreements or other such arrangements to guide the attorney who must sign the opinion that the section 25102(h) exemption is available.

Under a rule adopted by the Commissioner, changes in shareholder rights resulting from the election or termination of close corporation status would be treated as a section 25017(a) "sale"; but pending legislation (A.B. 2510) would grant a statutory exemption to any changes in shareholder rights resulting solely from conversion to or from close corporation status.

In light of the new rules, it is unwise to insert voting provisions in a "shareholders' agreement." The best device for reallocating control is a voting trust with five or fewer beneficiaries. The next best alternative would be a section 706(a) pooling agreement. In light of both federal tax law and the California Sevices Law, whenever possible a corporation should issue stock in proportion to the economic participation desired (without any reallocation of distributions) and, if necessary, use a voting trust or pooling agreement to differentiate the pattern of control from that of economic ownership. This approach should avoid problems under section 25017(a) and minimize (although not eliminate) problems under section 25102(h).
5. Recommended Changes in the Securities Rules and Statutes Which Affect the Close Corporation

As just noted, there are a number of anomalies and ambiguities in the securities rules the Commissioner has adopted in an attempt to reconcile the Securities Law with the close corporation provisions of the new General Corporation Law. There are three approaches to solving some of these problems: (a) distinguishing between the reallocation of voting power and of corporate distributions; (b) creating a California private offering exemption by statute or through the Commissioner’s exempting authority under section 25105; and (c) providing across-the-board exemptions (by statute or rule) from sections 25102(h) and 25017(a) for “shareholders’ agreements” and other contracts among close corporation shareholders.

a. **Distinguishing Between Reallocation of Voting Power and of Corporate Distributions**

As mentioned earlier, a corporation electing Subchapter S status is permitted only one class of stock. The federal courts, the Internal Revenue Service, and, to some extent, the Internal Revenue Code have adopted the position that reallocations of voting power through voting trusts and pooling agreements do not create a second class of stock.

The Corporations Commissioner could adopt rules which take a similar approach. Pooling agreements, voting trusts, irrevocable proxies, and voting provisions of “shareholders’ agreements” would not be considered changes in shareholder rights for the purposes of section 25017(a) and would not affect the availability of the section 25102(h) small offering exemption.

Even if the Commissioner rejects this approach, he should clarify his views on voting trusts, pooling agreements, and irrevocable proxies.

b. **Creating a California Private Offering Exemption**

The rules proposed by the Commissioner in February, 1977, contained a “discussion draft” of a proposed rule which would create a kind of private offering exemption under the California Securities Law. The proposal closely tracked section 25102(h) with both re-

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304. Section 25105 permits the Commissioner to exempt transactions from §§ 25110, 25120, and 25130 (the provisions requiring qualification) if he finds the qualification requirement “as not being comprehended within the purposes of this law” and “not necessary or appropriate in the public interest or for the protection of investors.”

305. Note 305 has been omitted.

306. Note 306 has been omitted.

strictive and liberalizing additions. The more restrictive provisions included a requirement that specific disclosures be made and that participating investors be limited to persons who might be assumed not to require the protection of the qualification provisions because of financial sophistication, future employment by the issuer in a management capacity, and other such factors. The liberalizing provision made an issuer eligible for the section 25102(h) exemption despite the existence of "shareholders' agreements," pooling agreements, and irrevocable proxies.

The September, 1977 version of the proposed rules did not include the proposed "private offering" exemption "due to the present lack of regulatory experience . . . and the lack of substantive comment," although the Commissioner said that the proposal might be reconsidered at a later date. The finally adopted regulations also did not include the exemption proposed in February, 1977. Admittedly, it is difficult to define those investors whose sophistication or connection with the issuer is sufficient to enable them to protect themselves. Nevertheless, the Commissioner should adopt or at least recommend an exemptive rule or statutory provision which defines a "private placement" and provides that, in such a situation, "shareholders' agreements" and other contracts among close corporation shareholders neither constitute section 25017(a) "sales" nor prevent the use of the small offering exemption. In drafting the rule or statutory amendment, the Commissioner could rely on the substantial federal experience in defining "private placement" or could conceivably adopt Securities and Exchange Commission Rule 146 verbatim.


c. Across-the-Board Exemptions from Sections 25102(h) and 25017(a) for "Shareholders' Agreements" and Other Contracts Among Shareholders of a Close Corporation

The Corporations Commissioner has acknowledged that the purpose of the close corporation provisions of the new General Corporation Law is to provide flexibility to close corporation investors. If the new devices created by the new law, such as the close corporation "shareholders' agreement" and the section 706(a) pooling agreement, precipitate qualification or must themselves be qualified, a great deal of flexibility will be lost. Through "shareholders' agreements," close corporation shareholders can deprive themselves of much of the protection provided by the General Corporation Law. There seems no reason why close corporation associates should not be able to deprive themselves of the protection of the Securities Law as well.


d. Paternalism Versus Non-Paternalism

The three above-mentioned approaches are not mutually exclusive. In fact, even if statutory close corporations were largely exempted from the Securities Code, there would remain the problem of non-close corporation pooling agreements, voting trusts, and irrevocable proxies, none of which would require or precipitate qualification under the first approach discussed above.


Rule 146 has recently been amended to require the filing of a form with the SEC in connection with the use of the rule. No report need be filed for any offering or offerings of the proceeds of which total, cumulatively, less than $50,000 during any 12-month period. SEC Release No. 33-5912 (Mar. 3, 1978), reprinted in SEC. REG. & L. REP. (BNA) H-1 (Mar. 8, 1978), FED. SEC. L. REP. (CCH) ¶ 81,524.

The SEC has also recently proposed significant amendments to Rule 146. SEC Release No. 33-5913 (Mar. 6, 1978), reprinted in [current] FED. SEC. L. REP. (CCH) ¶ 81,532. The proposed amendments are reproduced in 1 FED. SEC. L. REP. (CCH) ¶ 2709 (1978).

In addition to relying on the federal experience, the Commissioner could draw on his own experience in administering California Code §§ 25102(a) (exempting non-public issuer offers or offers of any security under certain conditions); 25102(e), (f) (g) (exempting non-public issuer offers or sales of debt securities, partnership interests, and collateral trusts); and 25104(a) (exempting non-public non-issuer offers or sales under certain conditions). See also 10 CAL. ADMIN. CODE §§ 260.102.1-2 (1978).

313. This article does not address the relatively minor problem of how to treat a close corporation with more than 10 shareholders for the purposes of § 25102(h) (but with 10 or fewer shareholders for the purposes of § 158). See generally note 250 and authorities cited note 252 supra.
The solution one chooses depends in large part on how paternalistic one feels the government should be. As administered by the Department of Corporations, the California Securities Law remains extremely paternalistic. Investors are protected from themselves by a bureaucratic standard of fairness. Furthermore, the enactment of the new law seems to have triggered securities rules which actually decrease flexibility. Until the new statute became effective at the beginning of 1977, contractual arrangements among shareholders had received benign neglect from the Department of Corporations. Indeed, utilizing broad-sweeping language, the Commissioner ruled in 1973 that a voting trust did not create a second class of stock for the purposes of section 25102(h). Now, the Commissioner has stated that pooling agreements and other such voting arrangements may make an issuer ineligible for the small offering exemption.

I have always found it remarkable that the state is so solicitous toward securities investors, who constitute only a small fraction of the population—and the most affluent part at that. For the overwhelming majority of Californians, the largest and most important purchases are automobiles and homes rather than securities (and certainly not securities requiring qualification by permit). Yet there is no Department of Home and Automobile Purchases to ensure that buyers avoid transactions which are unfair, unjust, or inequitable. Of course, the counterargument is that there is a much greater potential for unfairness in securities sales than in the sale of homes or cars; but I suspect that for every victim of securities fraud, there are a hundred people (mostly poor) who have been cheated in used car transactions.

The processing of securities permit applications imposes costs on both the taxpayer and the investor. The benefits of preventing all exploitation of corporate shareholders should be weighed against its costs. Because of the small number of shareholders, there seems little potential for abuse in the close corporation context. Because I feel there should be limits to what the government should do to protect its residents from their own folly, I strongly support a non-paternalistic approach toward the shareholders of statutory close corporations. Although some investors would undoubtedly make mistakes, all close corporation associates would be able to take advantage of the provisions of the new General Corporation Law without the necessity of obtaining the approval of the Corporations Commissioner.

314. See note 278 and accompanying text supra.
315. See authorities cited notes 268-69 and accompanying text supra.
316. See notes 283, 282, 285-87a, & 269 and accompanying text supra.
V. CONCLUSION

The new General Corporation Law makes two devices available to the statutory close corporation: the section 300(b) "shareholders' agreement" and the section 706(a) pooling agreement.

Corporations with a small number of shareholders often wish to allocate control separately from financial interest. To minimize federal tax and California Securities Law problems, a close corporation should use a pooling agreement (or voting trust with five or fewer beneficiaries) to accomplish this objective and should avoid the use of a "shareholders' agreement." Indeed, the insertion of voting provisions in a "shareholders' agreement" is a trap for the unwary. A pooling agreement (or a voting trust) does not make a corporation ineligible for Subchapter S and would not be treated as a section 25017(a) "sale" under the Corporations Commissioner's recently adopted rules. Lamentably, the Commissioner has taken the position that a pooling agreement or other such arrangement will sometimes disqualify a corporation from the section 25102(h) exemption, although the Department has thus far not proposed any guidelines in this area.

The voting trust is available to close and non-close corporation shareholders alike, but the common law validity of a non-close corporation pooling agreement is unclear. Of course, neither a voting trust nor a pooling agreement would create the procedural flexibility attainable through a "shareholders' agreement." A "shareholders' agreement" can reallocate corporate distributions, abridge board discretion, or even shift most power away from the board and the shareholders to a single "Managing Shareholder"

317. See summaries in text accompanying notes 80-81, 162, 234-35, & 303-04 supra. See also ORGANIZING, supra note 10, at 66-67.
318. See 1 F. O'NEAL, supra note 6, §§ 3.12-17, 5.02; W. PAINTER, PROBLEMS AND MATERIALS IN BUSINESS PLANNING 21 (1975).
319. Voting trusts with more than five beneficiaries must normally be qualified with the Department of Corporations. See notes 63 & 244 supra.
321. See text accompanying notes 45-80 supra.
322. For a discussion of the distinction between abridging board discretion...
who would run the corporation almost like a sole proprietorship, thereby minimizing procedural red tape and decreasing legal expenses. Although this latter advantage will not be greeted with enthusiasm by attorneys, they still have a fiduciary obligation to advise their clients of their options under the new statute.

Unfortunately, a reallocation of corporate distributions would disqualify a corporation from Subchapter S status and create other federal tax complications. Furthermore, under rules adopted by the California Corporations Commissioner, a "shareholders' agreement" may create non-voting stock or a second class of stock making the corporation ineligible for the section 25102(h) exemption. Moreover, any "shareholders' agreement" altering shareholder rights would require a permit unless exempt under section 25103(e) or Rule 260.103. The regulations adopted by the California Department of Corporations have greatly diminished the utility of the "shareholders' agreement." A company may even decide to forego close corporation status entirely in order to escape the risk of having all its unanimous shareholder contracts classed as statutory "shareholders' agreements." It is ironic that the new securities rules may often transform the "shareholders' agreement" from a blessing to be sought into a curse to be avoided.

and shifting power away from the board, see text accompanying notes 140-41 supra.
323. See 2 Forms, supra note 67, forms 8.81, .82. See also authorities cited note 141 and accompanying text supra.

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