SB
246

— FILE

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May 1, 1984

Alaska State Senate
Pouch V
Juneau, Alaska 99811

Attention: Senator Joe P. Josephson

Re: SB 246/343
An Act Revising the
Corporation Code

Dear Senator Josephson:

As a follow-up to the time limited hearing conducted by you as a subcommittee of one, in Anchorage on Saturday, April 21, 1984, I respectfully desire to (i) reiterate a number of requests members of the Alaska Bar Law Committee "Task Force" made at such time, and (ii) offer a number of random but pertinent observations on the subject matter.

(1) Opportunity to Respond to the April 21, 1984 Statement of ACRC Chairman. As you recall, the Task Force members present at the April 21, 1984 hearing were very disturbed by the contents, tone and thrust of John Abbott's (Chairman of the ACRC) comments regarding the Task Force and one or more of its members. You indicated we will receive copies of Mr. Abbott's complete remarks that he read from a prepared text, and be given an appropriate and full opportunity for a response. Incidentally, the Task Force had been telephonically informed by Mr. Butler of your office that the "hearing" on April 21, 1984 was to be an informal round table discussion intended to reconcile diverse views on the efficacy and wisdom of the proposed bill.

(1) Request for copies of Written Materials Submitted to Senate Judiciary Committee.

To enable the Task Force to properly assist the Legislature in evaluating the need for, and merits of the proposed bill, it is respectfully requested the Task Force be furnished copies of:

(a) all documents submitted to the Senate Judiciary Committee by or on behalf of, the Alaska

Code Revision Commission (ACRC)[1] before, on, or after April 21, 1984 pertaining to the subject bill;

(b) any [illegible] documents submitted to the Senate Judiciary [illegible]ttee on behalf of other persons or groups [illegible] than members of the Task Force) pertain[illegible] the subject bill.

(3) Need for Further Exploration and Study by Senate Judiciary Committee. The two hour hearing on April 21, 1984 held on fairly short and not particularly widespread notice to affected Alaskans did not, other than the discussion on Section 488 thereof pertaining to secondary liability of directors and officers, provide enough time, in my judgment, to facilitate a sufficient in depth critique of, or insight into the proposed bill. Hopefully, you will, before acting on the bill, be able to fully review the written comments I previously submitted to you, plus Professor Fessler's memorandum regarding "close" corporations also previously submitted by me to you and particularly pages 2-22 thereof (a copy of such memorandum is herein again enclosed for your convenience).

The difference(s) between the ACRC representatives and the Task Force is not merely an intra-mural dispute between zealous technicians. Rather it affects vital interests of many Alaskans including but not limited to the (i) level of legal costs for Alaskans, (ii) suitable flexibility in dealing with business and investment requirements, plus (iii) the special problems and needs of small or family businesses which, I daresay, constitute a significant percentage of Alaska corporations.

(4) Role of the ACRC. The ACRC in 1979, on its own initiative, commenced a study of our existing Alaska Business Corporation Act (AS 10.05),[2] essentially grounded on the American Bar Association Model Act. With the assistance of Professor Daniel Fessler of California as consultant, a comparative analysis of such statute with other state statutes and the ABA Model Act (before its comprehensive revision in 1983) was made. Largely through the efforts of Professor Fessler a bill

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1. including but not limited to individual Commission members, Professor Fessler and Brad Regan; we made a request on April 21, 1984 for various documents submitted to the Committee but have not received copies as yet.
2. Alaska Business Corporation Act (AS 10.05) originally enacted in 1957 and thereafter amended to include some but not all of the subsequent amendments to the ABA Model Act.

was drafted to completely replace the existing statute with a new Code, and after review by staff of the Legislative Affairs Agency readied for the introduction during the Second Session of the Twelfth Legislature in 1982.[3] A bill sponsored by the ACRC was introduced in March 1982 as SB 873.[4]

The ACRC has to date expended a significant amount of time and invested a very substantial sum of public funds on the project.[5] It is now apparent the Alaska Bar was not diligent in participating in or monitoring the progress of the ACRC Project. Setting all of that aside, what is important now is to proceed in good faith, ignoring any and all attempts to channel the discussions or inquiry into personalities, to focus our attention on what is of consequence--maintaining or procuring the best product for Alaska.

(5) Identifying the ACRC Bill as the "Fessler Code". Professor Fessler strongly objected to my identification or labelling of SB 246/HB 343 as the "Fessler Code". By such identifying label I was and am not implying the ACRC simply rubber-stamped Fessler's work and the policies embodied therein. It is my understanding ACRC members John Abbott and L. S. (Jerry) Kurtz worked closely with Professor Fessler. However, it appears to me after discussions with a number of individual ACRC members that the lion's share, of the comparisons, analysis and drafting were performed by Professor Fessler. The ultimate policy decisions that the full ACRC membership logically must have made (before submitting the proposed bill to the Alaska Legislature) were to a high degree based, I have to assume, on the underlying work of Professor Fessler.[6]

In deference to Professor Fessler's request, suffice to say, I will try henceforth simply to refer to SB 246/HB 343, as the ACRC Code rather than the Fessler Code.

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3. 1982 Annual Report of ACRC, dated February 1982 at page 3.
4. March 3, 1983 transmittal letter by Chairman Abbott to Senator Bill Ray as Chairman, Alaska Legislative Council.
5. An Anchorage newspaper account in February 1984 placed the sum expended at $240,000--likely such amount, if accurate, includes travel and out of pocket expenses of ACRC members, staff and consultant.
6. Professor Fessler in commenting on the Revised ABA Model Act asserted that the ABA Committee members (spread throughout the nation, including California, New York and Delaware) did not play any meaningful role in developing the ABA Revised Model Act--such is not my understanding.

(6) Technical Nature of Subject Matter Necessarily Requires Heavy Reliance on "Experts". The subject matter is one that our Alaskan legislators likely will require assistance or help on from one or more experts in this field. Lacking staff of your own with suitable experience and skills the logical inclination of an Alaskan legislator is to give significant weight to the recommendations of the ACRC. In turn, the ACRC has clearly relied heavily on the experience and skills of Professor Fessler plus ACRC members Abbott and Kurtz.

The Task Force, of the Alaska Business Law Committee, that reviewed the proposed ACRC Code has offered (admittedly rather belatedly) the experience and skills of ten (10) practicing Alaskan lawyers, and has further suggested the Legislature and the ACRC avail themselves of the experience and skills of the broad based nationwide group of practitioner and academicians involved in the development of the ABA Revised Model Act,[7] before acting on the proposed legislation.

(7) Disagreement Between Two Groups of Experts. The ACRC represented by Professor Fessler and ACRC lawyer members, John Abbott and L. S. Kurtz, contends the proposed ACRC Code (SB 246/HB 343) is a suitable product for Alaska. Ten lawyers who practice in the business law area in Alaska do not concur. If the mere weight of numbers in the opposing camps is insufficient to warrant a conclusion on your part, prudence suggests you procure a "second" or "third opinion" from other experienced practitioners and academicians.

No one currently in the arena has a monopoly on wisdom, scholarship or astute policy making. Given the likelihood any new Code will affect Alaskans for a long period of time, it is under the circumstances imperative to continue the inquiry or examination of the subject matter even if additional time and money must be expended in the process.

(8) A Personal View. My personal view is that the ABA Revised Model Act will, after an even handed, thorough examination, prove to be a much better platform to build a flexible, modern new Code for Alaska upon than SB 246/HB 343. Moreover, I emphatically disagree with the ACRC rejection, without any articulation in the commentary or other form of disclosure, of the special needs of the small or family business, as is appropriately provided for in the close corporation supplement to the

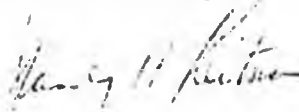
7. The Revised Model Act released in March 1983 including commentaries, is available for $15 per copy from the ABA office in Chicago.

ABA Revised Model Act (and in the laws of the fourteen (14) jurisdictions[8] named below) plus in the main body of the ABA Revised Model Code.[9]

(9) The Alleged Support of AFN Lawyers. The ACRC has indicated it has the support of an AFN lawyer group. Such support procured in early 1983 before the release of the ABA Revised Model Act in March 1983 and after, the AFN lawyers received a number of "trade-offs" for their support, is more apparent than real. I have, as previously asserted, recently talked to a number of lawyers who work for or with Native corporations. Their position as expressed to me is that (i) the ABA Revised Model Act should be carefully and comprehensively compared vis-a-vis the ACRC Code, and (ii) the ABA product appeared to be the preferred vehicle for a new Alaska Code.

(10) Summary. Let us look before we leap--there is simply no compelling need to enact the ACRC bill unless and until we are reasonably assured, after careful consideration of all relevant sources, it is the best alternative to our existing Alaska Business Corporation Act--suffice to say, I am not convinced SB 246/HB 343 should be enacted.

Respectfully,



Stanley H. Reitman

SHR:jf

Distribution list on following page

8. The following jurisdictions have adopted close corporation legislation in one or more forms: Alabama, Arizona, California, Delaware, Illinois, Kansas, Maryland, Maine, Michigan, Minnesota, New Jersey, Ohio, Pennsylvania and Texas.
9. For example, the comprehensive treatment in Section 6.27 of transfer restrictions and related buy-sell or shareholder agreements contractually negotiated.

cc: Senate Judiciary Committee
Bill Ray, Chairman
Richard I. Eliason
Fritz Pettyjohn
Robert M. Ziegler

Jalmar M. Kertulla, President of
Senate

Task Force
David Bendell, Esq.
Richard Block, Esq.
Julius Brecht, Esq.
Brian Brundin, Esq.
Mark Copeland, Esq.
Ken Eggers, Esq.
Bruce Frenzel, Esq.
Ray D. Gardner, Esq.
John Norman, Esq.
Richard Rosston, Esq.

ACRC
Chairman John Abbott, Esq.
L. S. Kurtz, Esq.
Judge Thomas B. Stewart

Paul Kelly, Esq., Chairman,
Business Law Section

—PAULA—

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JAMES B. FRIDERICI

April 19, 1984

MEMORANDUM

To: Senate Judiciary Committee:
✓Bill Ray, Chairman
Joe Josephson, Vice Chairman
Richard I. Eliason
Fritz Pettyjohn
Robert H. Ziegler
Senator Jalmar M. Kertulla, President of Senate

From: Stanley H. Reitman

Re: SB 246
An Act Revising the Corporate Code

It is my understanding Senator Josephson will conduct a subcommittee session in Anchorage on

Saturday, April 21, 1984
at 9:00 a.m.
1024 West Sixth Avenue

to consider SB 246, An Act Revising the Corporate Code--a bill sponsored by the Alaska Code Revision Commission largely utilizing the work product of Professor Dan Fessler from California.

To assist you in evaluating the subject bill, I am enclosing for your convenience, the following materials previously made available to Senator Josephson (including a self explanatory letter of Senator Josephson) regarding the prospective subcommittee hearing in Anchorage:

(1) March 12, 1984 letter of the undersigned to Senator Josephson, regarding (i) the background of Alaska's existing corporate statute, (ii) the Revised Model Act released in 1983 by the American Bar Association, (iii) close corporations, and (iv) the purported or alleged needs of Native

corporations for a revision of the existing statute, plus (v) other relevant comments — Exhibit A

(2) March 15, 1984 letter of Senator Josephson to the undersigned — Exhibit B

(3) March 30, 1984 letter of undersigned to Senator Josephson (accompanied by a position paper or memorandum by Professor Fessler to the Alaska Code Revision Commission dealing with the topic of close corporations) — Exhibit C

(4) March 30, 1984 transmittal letter of undersigned to Senator Josephson accompanied by the March 30, 1984 report to the (i) House Judiciary and (i) House Labor and Commerce Committees, by a Task Force[1] of Alaskan lawyers critiquing Professor Fessler's Code (SB 246, HB 343) — Exhibit D

As you will note, the Alaskan lawyer task force suggests (page 4 of letter of Richard Block, Task Group Chairman), action on the subject SB 246 (HB 343) be deferred until next session to:

(a) give the Legislature, Code Revision Commission, and the public a meaningful opportunity to fully consider the revised Model Act (of the American Bar Association);

(b) give all sectors of the business community an opportunity to consider and propose specific amendments;

(c) explain to the non-lawyer business community the Legislature's interest in revising the Code and seek an expression of support or concern from affected economic sectors.

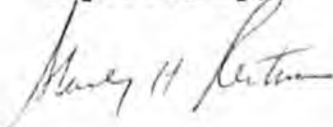
The Task Group is prepared to work with the Alaska Legislature, the Alaska Code Revision Commission and one or more economist(s), business leader(s), investor(s), jurist(s), academician(s) plus actual and potential enterpreneurs, to

1. David Bendell, Richard Block, Julius Brecht, Brian Brundin, Mark Copeland, Ken Eggers, Bruce Frenzel, Ray Gardner, John Norman, Stan Reitman, Richard Rosston.

carefully and comprehensively review the existing Alaska statute, the proposed Alaska Code Revision Commission/Fessler Code (SB 246), the American Bar Association Revised Model Act[2] and any and all other relevant sources to develop a modern, flexible and comprehensive new corporation code for Alaska.

Before we discard the existing statute, we should be sure we are adopting, consistent with Alaskan interests and needs, the very best code for Alaska.

Respectfully,



Stanley H. Reitman

2. Developed over a period of approximately four years (1979-1983) by a nationwide group of extremely able and prestigious practitioners and academicians with varied and extensive experience.

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JAMES B. FRIDERICI

March 12, 1984

Senator Joseph P. Josephson
Alaska Senate
Capitol, Room 508/510
Juneau, Alaska 99811

Re: Senate Bill 246
An Act Revising the
Corporation Code

Dear Senator Josephson:

As a follow-up to my telephone call to you on Friday, March 9, 1984 regarding SB 246, "An Act Revising The Corporation Code", here in summary form are the reasons I suggested the Judiciary Committee of the Senate should delay acting on this bill until at the minimum, the end of March 1984, to allow a group of lawyers (the Alaska Task Group) who are currently reviewing SB 246 and related HB 343, time to make a report to the legislative committees considering the subject corporation code bill.

(1) Goals.

I am sure the (i) Alaska Legislature, (ii) Alaska Code Review Commission (ACRC), (iii) Alaska judiciary, (iv) Alaska Bar, and (v) Alaska public, will readily agree that we want the best available legislative product for Alaska. If the existing statute is ripe to be updated and overhauled (and I concur in such conclusion), let's get the best code we can--irrespective of who gets the credit, plaudits or gold stars--consistent, of course, with related objectives of predictability, flexibility and cost.

(2) Background of Alaska's Existing Statute/Model Business Corporation Act.

Alaska's existing corporation code is essentially the Model Business Corporation Act (MBCA) as it existed in or about 1953, with a number but by no means all of subsequent amendments or embellishments thereto.

EXHIBIT A

Some of the most able and prestigious practitioners and academicians throughout the nation, developed the MBCA. The Act containing a number of optional and alternative provisions has since been revised from time to time, largely in piecemeal fashion. A volume of official forms for the MBCA prepared under the auspices of the Committee on Continuing Legal Education of the American Law Institute has also proven to be helpful to practitioners and the public.

In 1960 under the guidance of the American Bar Foundation and the ABA Committee, the MBCA Annotated[1] was published. At such time the MBCA had been used as the basis for the new business corporation acts of:

Wisconsin	1951	Virginia	1956
Oregon	1953	North Dakota	1957
D.C.	1954	Alaska	1957
Texas	1955	Colorado	1958
		Iowa	1959

By 1970, the editors of MBCA Annotated (then in its Second Edition) noted that twenty-one (21) states (including Alaska and Oregon) had by such time utilized the MBCA as the basis for their acts and another nine (9) states had employed significant portions thereof.

In 1969 the Model Act itself was revised because of the then accumulated amendments. In or about 1979, a further and comprehensive (the first in roughly 30 years) revision project was undertaken by the ABA Committee, culminating in the release of an exposure draft (with comments) in March 1983. Attached hereto as Appendix 1 is the "Introduction" to the ABA Revised MBCA. The May 1983 issue of the Business Lawyer[2] called attention to and reported on such ABA revision project.

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1. contains a comprehensive analysis of the business corporation acts of all states, annotations thereto and comparisons to the MBCA, together with commentary and bibliographical notes.
2. product of the Section of Corporation, Banking and Business Law of the American Bar Association.

In telephone conversations with Messrs. Hamilton[3] and Goldstein,[4] the authors of Appendix 1, here is the anticipated timetable for the finalization of the ABA revision project:

(i) April 1984 - the Revised MBCA will be approved on or about April 7, 1984, with a few anticipated minor changes from the March 1983 exposure draft;

(ii) June 1984 - the revision will go to the printer for publication by the end of June 1984.

Accompanying the Revision will be two (2) optional supplements intended to complement and augment the Revision, in two vital areas:

(a) close corporations - see Appendix 2 for report of the ABA Committee;

(b) professional corporations (forming part of the March 1983 exposure draft).

Although Alaska has not kept up to date with all of the amendments to the MBCA since 1953, the Alaska statute (i) has nevertheless been reasonably effective and (ii) it has been comforting to "outside" investors, lenders and business concerns to be advised that we have the basic MBCA in Alaska.

(3) The Two Projects--ACRC and ABA.

In 1979, the ACRC began a major project--revision of Title 10 - Corporations and Associations[5] - utilizing to a fair degree an outside consultant.[6] A draft of a new corporate code for Alaska was completed in November 1980 and embodied into a bill introduced in the Twelfth Legislature and again in the current Thirteenth Legislature (SB 246).

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3. Professor of Business Law at the University of Texas School of Law.
4. Chairman of the Committee on Corporate Laws.
5. 1981 Annual Report of ACRC.
6. Professor Daniel Fessler from California.

The unofficial position of two members of the ACRC, as enunciated in a meeting with four (4) members of the bar group studying SB 246, is that it is simply too late for the Revised MBCA to be considered. Such position is wrong--why should Alaska not have an opportunity to have the very latest and best thinking, draftsmanship, experience and policy embodied in its new code. Anything less is a disservice to Alaska.

(4) Close Corporations.

A number of jurisdictions including California and Delaware have in recent years enacted comprehensive close corporation provisions intended to accommodate the needs and expectations of entities where membership and management is substantially identical and the owner/managers view each other as partners in an incorporated partnership setting.[7] Some states have blended their close corporation provisions throughout the business code--other states employ a separate compilation of integrated sections to accomplish their objective.

The close corporation patterns allow deviation from statutory norms that to a fair degree have been historically directed at the large publicly owned enterprises, including among other provisions:

(a) greater informality on the part of shareholders and directors;

(b) downgrading the importance of the board of directors in its management of the business of the corporation, or even eliminating the need for a board altogether;

(c) greater or lesser than normal quorum or voting requirements for shareholder or director powers;

(d) enforcement of non-judicial dissolution by the holders of fewer than 2/3 of the shareholders or whatever the prescribed statutory norm is;

(e) restrictions on disposition of shares;

(f) buy-sell compacts among shareholders.

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7. For example--(i) the family corporation and (ii) the corporation with a minimal number of shareholders all or part of whom are active in management.

Some or all of the foregoing provisions have historically been utilized by sophisticated practitioners in shareholder agreements (and sometimes in by-laws and articles of incorporation) with or without express statutory or judicial blessing.

The enclosed draft of the Close Corporation Supplement (the incorporators need not utilize it) is also worthy of careful consideration by the Alaska legislature before any new code is enacted, given the significant number of small closely held corporations in Alaska. Note for example the codification in the Supplement of customary practices used by experienced practitioners to achieve the objectives and expectations of investors in close corporations, plus these other features (not intended to be exhaustive):

(a) reduction in amount of legal drafting that will have to be done in routine incorporations of close corporations;

(b) set of statutory or standardized transfer restrictions (if you want them);

(c) standardized buy-sell agreements (if you want them);

(d) election not to have a board of directors;

(e) power in the shareholders, akin to that of a general partner in Uniform Partnership Act, to dissolve the corporation.

(5) <u>The Purported Needs of Alaska Native Claims Settlement Act (ANCSA) Corporations and Alleged Current Problems with Existing Statute</u>.

In a letter[8] to Senator Ray on May 3, 1983, plus public testimony by representatives of the ACRC on February 24, 1984 in Anchorage, and in a number of informal conversations

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8. Transmittal letter under signature of the chairman of the ACRC accompanying a draft of the subject bill.

with two members of the ARRC, the support of an Alaska Federation of Natives (AFN) Subcommittee (apparently created to consider the subject bill) for the new ACRC code, has been vigorously asserted. Moreover, we are told, various native corporations have found the existing Alaska statute inadequate for their current needs and clearly inadequate for the forthcoming 1991 events embodied in the existing ANCSA statute.

I have within the past week personally talked with a number of lawyers who work every day on legal matters of one or more ANSCA entities, and the message I got from them is this in essence:

(a) they have not perceived any significant overwhelming problems in, or created by, the existing Alaska statute, as it pertains to native corporations or interests;

(b) the support given to the ACRC bill by the AFN Subcommittee was grounded on their being advised enactment was a relatively sure thing and on a number of trade-offs they received;

(c) the native lawyers further indicated a national act with the opportunity for development and evolution based on nationwide experiences can be very beneficial to all Alaskans including ANSCA and other Native corporations.

(6) The Inadequate Disclosure and Explanation of the History of the MBCA.

The ACRC in the May 3, 1983 transmittal letter under signature of its Chairman, to Senator Ray, in identifying and characterizing the current Alaska Statute, as taken "off the rack", "never intended for Alaska", and based on Oregon law, failed to accurately and fairly inform the reader of the background of the act, including the high degree of scholarship, craftsmanship and varied experience of lawyers and scholars throughout the nation, brought to bear on the original model act (as well as on subsequent amendments and the current ABA revision project).

The current ABA revision clearly exemplifies, once again, the benefit of bringing to bear on the subject matter the collective experience, scholarship, skills and wisdom of people from all over the country. Incidentally, the March 1983 ABA

Committee exposure draft including comments, is available from the ABA office in Chicago for $15 per copy including shipping costs.

(7) Summary.

(a) Alaska should have the best product obtainable--one that if at all possible is national in approach and scope (in part to encourage the free flow of business, commerce, investors and lenders between Alaska and other jurisdictions).

(b) There simply are no urgent or immediately foreseeable need(s), of either native or non-native corporations, or groups in Alaska, for the revision of our corporate code before carefully and fully considering the ABA revision together with the related close corporation and professional corporation supplements thereto.

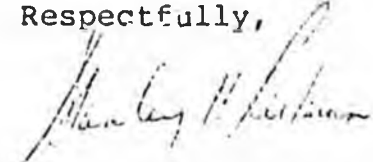
(c) The ACRC has the resources and the duty to review and carefully consider the proposed corporation code revision of the American Bar Association, before vigorously promoting its own product (the Fessler Code).

The Alaska Bar and more particularly, the members practicing in the corporate area, have clearly not been diligent over the years in helping to keep our Act up to date, or in appropriately responding to the ACRC revision project. Nonetheless, personal pride and dollars spent to date should not be determinative--what is vital is to get Alaska the best product obtainable.

If after a comprehensive, even handed evaluation of the ABA Revision of the MBCA is made by (i) Professor Fessler, (ii) the ACRC, (iii) the Alaska Bar, (iv) the AFN, and (v) other interested groups, and suitable comparisons vis-a-vis the current ACRC product (the Fessler Code) effected, it is entirely possible the Fessler Code will be deemed superior--if such is the case, I

am all for the Fessler Code; provided Section 488[9] thereof is eliminated. One last thought--nothing contained here is intended to downgrade the scholarship or craftsmanship of Professor Fessler,[10] substantially relied on by the ACRC, nor of the laudable motives of the ACRC. I am simply saying--before we leap, we should be reasonably sure we have the very best for Alaska.

Respectfully,



Stanley H. Reitman

SHR:jf

cc: Alaska Code Revision Commission
John W. Abbott, Chairman
L. S. Kurtz, Jr.
Judge Thomas B. Stewart
Alaska Bar Association
Paul D. Kelly

Postscript - After preparing this letter, I talked with Judge (Ret.) Thomas B. Stewart of Juneau, a member of the ACRC. Judge Stewart I believe is willing, albeit the effort by the Alaska Bar is very late in coming, for an evaluation of the ACRC Code vis-a-vis the ABA Revised MBCA to be made, but appeared concerned

9. Section 488 imposing secondary liability on corporate officers and directors is unfair to management people (officers and directors) who likely will be unwittingly trapped, will create litigation, overturns traditional principal/agent concepts and represents an overly broad complicating solution to the perceived problem of aggrieved corporate creditors allegedly frustrated by corporate manipulation(s).
10. After the February 24, 1984 hearing in Anchorage on the proposed Code, I had the opportunity to discuss on the telephone a number of the features thereof with Professor Fessler. He was most gracious in answering questions posed, and in correcting my misreading or inadequate reading of a number of specific provisions thereof. Professor Fessler appears more than willing to consider comments and suggestions directed toward his work product.

about the ability to complete such study by the end of March 1984--apparently to facilitate enactment in this session or legislature of a new code. My personal view is that a delay to the next legislature to get a better code for Alaska is neither unpalatable, nor fraught with danger, to affected Alaskans.

INTRODUCTION

THE 1983 REVISED MODEL BUSINESS CORPORATION ACT*

by

Elliott Goldstein** and Robert W. Hamilton***

The Committee on Corporate Laws has completed a major revision of the Model Business Corporation Act.**** The Committee is also in the process of overseeing the preparation of a third edition of the multivolume Model Business Corporation Act Annotated. The revised Model Act, in its final form, will also appear in these volumes.

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* This is an edited version of an article describing the revised 1983 Revised Model Business Corporation Act prepared for publication in the Business Lawyer.

** Member of the Georgia and District of Columbia bars. Mr. Goldstein practices law with Powell, Goldstein, Frazer and Murphy; he is the Chairman of the Committee on Corporate Laws.

*** Benno C. Schmidt Professor of Business Law, The University of Texas School of Law, Austin, Texas. Professor Hamilton is the Reporter for the Model Business Corporation Act Revision Project.

**** The 1983 revised Model Act includes two supplements, the Model Professional Corporation Supplement and the Model Statutory Close Corporation Supplement. The former was first adopted by the Committee on Corporate Laws in 1976; it has been revised as part of the Model Act project and is available for comment with the exposure draft. The Model Statutory Close Corporation Supplement was published in the November 1981 issue of the Business Lawyer for comment (37 BUS. LAW. 169), and adopted by the Committee in June 1982. Notice of adoption and of changes made in the comment draft appear in the March 1983 issue of the Business Lawyer. Because of its recent publication, the Close Corporation Supplement is not included in the exposure draft.

This article describes the 1983 revised Model Act, the reasons for its development at the present time, and the principal innovations that have been made in the Model Act since it was last published as a complete statute in 1971 in the Model Business Corporation Act Annotated (Second Edition).

1. Description of the revised Act

The 1983 revised Model Act is designed to be a convenient guide for revision of state business corporation statutes, reflecting current views as to the appropriate accommodation of the various commercial and social interests involved in modern business corporations. The Model Act is designed for use by both publicly held and by closely held corporations, and takes into account the rights and duties of their shareholders, investors, directors, and mangement, as well as the interests of the state.

The 1983 revised Model Act represents the first complete revision of the Model Act in over 30 years. The creation and review of this revised Act has been a major project that has largely occupied the attention of the Committee for the last three years. All sections and provisions of the Act were reviewed and analyzed in light of the experience with similar provisions in important commercial states. In addition, the suggestions of several corporation service companies were solicited. To improve the usefulness of the Act, Official Comments have been prepared for each section that describe the substantive decisions made in the drafting of the section and

often further explain the meaning and purpose of the section. The Official Comments also contain suggestions as to possible use of options provided in the Act. Statutory cross-references have also been added after each section.

2. Reasons for the development of a new Model Act

Several factors entered into the decision to develop a revised Model Act at this time. First, a new edition of the Model Business Corporation Act Annotated was under serious consideration. The Second Edition of these volumes had been published in 1971, and supplements had been published as separate volumes in 1973 and 1977; there was a need to further update these volumes, either by a revision and republication of the entire set or by publication of another supplement, in order to comply with the guidelines of the American Bar Association. However, publication of a third supplement would make the use of these volumes even more unwieldy, so that creation of a new third edition was an attractive alternative. Revisions of the Model Act could be readily coordinated with the development of a new edition of the Model Business Corporation Act Annotated.

Second, the Committee had received the report of a subcommittee appointed in 1979 to review portions of the Act that had not been studied in detail since the Model Act was first published in 1950. This study revealed numerous additional areas in which state experimentation had produced significant simplifications and innovations which were appropirate for inclusion in the Model Act.

This subcommittee also pointed out that the structure of the Model Act, based on the organization of the Illinois Business Corporation Act of 1933, was not entirely logical, and that a number of states had adopted useful reorganizations of their corporation statutes. The Committee decided that it would be desirable to reorganize and renumber all sections of the Model Act. The reorganization was designed to make reference to the Model Act easier, since sections would be grouped by subject matter. The new numbers also avoid confusion between the revised version and earlier versions of the Model Act.

Finally, a large number of amendments were considered and approved by the Committee over the years. The number of these amendments and the form in which some of them were presented made it increasingly difficult to determine the precise content of the Model Act. Further, as a result of these amendments, many variations in style and format had crept into the Model Act. It was decided that all provisions of the Act should be revised so that the language of the Act was internally consistent and uniform. The Committee adopted the stautory drafting principles set forth in Drafting Rules for Writing Uniform or Model Acts, promulgated by the National Conference of Commissioners on Uniform State Laws. The redrafting has resulted in a style and format consistent with the numerous uniform state laws that have been widely adopted in recent years but that is quite different from the style of earlier versions of the Model Act.

The Committee ultimately decided to undertake as a single project both the revision of the Model Act and the preparation of a third edition of the Model Business Corporation Act Annotated. Professor Robert W. Hamilton, a member of the Committee, was named as Reporter, and Seth S. Searcy III, of the Texas Bar, was named as Project Director. The original plan of revision contemplated that a number of the changes described in the preceding paragraphs would be incorporated along with the Committee-prepared substantive revisions approved since 1969. As the project progressed, however, further substantive changes in the Model Act, usually of a relatively minor character, were proposed and considered as part of the revision project, and included in the final revised Act. Thus, the revised Model Act, as now proposed for comment by the Committee on Corporate Laws, should be viewed in its entirety as a new and integrated statute.

3. Major substantive changes since 1969

There have been numerous statutory amendments to the Model Act since it was first published. Beginning in the 1970's, the number, pace, and importance of the amendments began to increase as the Committee addressed issues of central importance in the law of corporations. All post-1972 amendments were published in the Business Lawyer for comment and their subsequent adoptions were formally reported. These earlier, substantive amendments are the sou.ce of most of the provisions of the revised Model Act that may viewed as innovative when compared with the

traditional content of most current corporation statutes. Provisions of this nature include:

a. Financial provisions

Amendments adopted in 1980[1] eliminated the traditional concepts of par value, stated capital, and treasury shares and substituted a simpler, less confusing, and potentially less misleading treatment. The standards for determining the legality of distributions of all types--dividends, redemptions or repurchases of shares, and distributions of capital--have been made both simpler and uniform. The principal test is the familiar one that the corporation must be solvent in the equity sense after the distribution; in addition, a balance sheet test is retained that requires the assets of the corporation to exceed the sum of its liabilities and the preferential amounts due on liquidation to senior equity interests on the basis of accounting principles that are reasonable under the circumstances (but that are not necessarily generally accepted accounting principles). The Committee advised the National Conference of Commissioners on Uniform State Laws of inconsistency between these financial provisions and the Uniform Fraudulent Conveyance Act. The Commissioners are now considereing possible revision of the Uniform Fraudulent Conveyance Act to mae it consistent with the provisions of the Model Act.

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[1] Committee on Corporate Laws, Changes in the Model Business Corporation Act--Amendments to Financial Provisions, 34 BUS. LAW. 1867 (1979); adopted, 35 BUS. LAW. 1365 (1980).

The revised Model Act also permit promissory notes and promises of future services to serve as consideration for the issuance of shares, subject to a requirement that all such transactions be reported to the shareholders.

b. Standard of care for directors and officers

The Committee on Corporate Laws has devoted much attention to the appropriate articulation of the duty of care of directors and officers, particularly in making decisions with respect to large and complex businesses. Important changes in this area were made in 1975.[2] The revised Model Act contains an amended provision on this subject that seeks to coordinate and harmonize the business judgment rule and the revised Model Act, including provisions relating to conflict of interest. The Committee recognizes, however, that this is a developing field of law, and that continuing attention must be given this important area. It is the Committee's intention to reexamine these provisions after publication of this exposure draft.

c. Principles relating to derivative litigation

The Committee on Corporate Laws also considered at length the issues relating to the modern shareholder's derivative action in 1981[3] developed a provision dealing with derivative litigation that attempts to strike a reasonable

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[2] MODEL BUSINESS CORPORATION ACT ANNOTATED § 35 (Supp. 1977).

[3] Committee on Corporate Laws, Proposed Revisions of the Model Business Corporation Act Affecting Actions by Shareholders, 37 BUS. LAW. 261 (1981). This provision was substantially in final form when the Model Business Corporation Act Revision Project commenced and was formally adopted as part of that project.

balance between the competing considerations of discouraging litigation brought solely for its settlement value on the one hand and avoiding unreasonable roadblocks in the way of all such litigation on the other. The provision developed by the Committee eliminates the security-for-expenses requirement for small shareholders, but encourages the court to assess the costs of litigation against the plaintiff if the suit was commenced without reasonable cause. Several issues were not resolved in the drafting of this section, such as whether a directors' decision that suit is not in the best interests of the corporation should bar the suit, whether calculation of the attorneys' fees shold be specified, and whether there should be a maximum limit on directors' liability. Since this is also a developing field, it is the Committee's intention to address these and other issues after the publication of this exposure draft.

d. Indemnification

A third subject to which the Committee on Corporate Laws devoted much attention is indemnification of officers and directors. One the one hand, it is generally recognized that a broad right of indemnification is essential if directors, particularly outside directors, are to be encouraged to serve on boards. On the other hand, broad indemnification raises public policy issues. In 1979,[4] the Committee developed comprehensive

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[4] Committee on Corporate Laws, Changes in the Model Business Corporation Act Affecting Indemnification of Corporate Personnel, 34 BUS. LAW. 1595 (1979); adopted, 36 BUS. LAW. 99 (1980).

provisions seeking to strike an appropriate balance between these competing considerations. These provisions, somewhat simplified in language, form the basis of an entire subchapter of the 1983 revised Model Act. The provisions of this subchapter not only establish standards for permissive and mandatory indemnification of directors but also the machinery by which claims for indemnification may be considered by the corporation free of claims of conflict of interest.

e. Right of dissent and appraisal from fundamental transactions

Another subject that the Committee on Corporate Laws has considered at length is the right of a shareholder dissenting from a fundamental transaction to obtain cash payment for his shares. The traditional right of dissent and appraisal was criticized as providing a time-consuming and expensive procedure which did not in fact provide protection to shareholders. From the corporation's point of view, the procedure was considered deficient because a corporation could not always determine in advance the extent of its financial obligation to dissenting shareholders. In 1977,[5] the Committee on Corporate Laws evolved a unique solution to these competing considerations that now forms an entire chapter of the 1983 revised Model Business Corporation Act. This chapter requires potential dissenters to identify themselves before the vote is taken, requires the

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[5] Committee on Corporate Laws, Changes in the Model Business Corporation Act Affecting Dissenters' Rights, 32 BUS. LAW. 1855 (1977); adopted, 33 BUS. LAW. 2587 (1978).

corporation to pay its estimate of the fair value of the dissenters' shares to the shareholders promptly after the transaction is effectuated, and establishes a procedure to encourage a negotiated, rather than a judicial, determination of the fair value of the shares.

f. Compulsory share exchanges

In instances in which it is important that the separate corporate existence of an acquired corporation be preserved, a compulsory share exchange, effected by the same procedural requirement applicable to statutory mergers and sales of all or substantially all the corporate assets not in the ordinary course of business, is often the simplest and most direct means of effectuating the acquisition. A compulsory share exchange provision has been included in the Model Act since 1976.[6]

* * *

Most of the above revisions had been completed prior to the commencement of the project to revise the entire Model Act. When this major project began, the Committee also had underway projects considering various other facets of the law of corporations, including, among others, the conflict of interest rules applicable to directors with a personal interest in corporate transactions, the validity of supermajority provisions

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[6] MODEL BUSINESS CORPORATION ACT ANNOTATED § 72A (Supp. 1977).

for decisions submitted to shareholders,[7] and the broadening of the kinds of consideration which may be used in payment for shares to include promissory notes and promises of future services. These various projects were "folded into" the development of the 1983 revised Model Act and the substantive revisions were considered as part of that larger project.

Other significant changes were made during the course of the revision process. These changes include:

(1) All filing requirements were made uniform and consolidated in a single chapter rather than being spread throughout the Act.

(2) A provision was added codifying the law of share transfer restricitons.

(3) A provision was added addressing the power of a public corporation to accept votes based on irregular proxies.

(4) The section dealing with the amendment of bylaws was revised to reflect clearly the ultimate primacy of the shareholders in the adoption and amendment of bylaws. This provision is of importance primarily to closely held corporations.

(5) A section was added in the chapter on dissolution dealing with the difficult question of product liability and other postdissolution claims arising after assets have been distributed to shareholders in final liquidation.

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[7] Consult Committee on Corporate Laws, Changes in the Model Business Corporation Act--Amendment Respecting Increases in Proportion of Vote for Shareholders' Approval, 36 BUS. LAW. 1899 (1981).

(6) The section dealing with shareholder inspection of corporate records was revised in an effort to preserve the basic right of access while preventing abuse.

4. The Model Business Corporation Act Revision Project

The Model Business Corporation Act Revision Project has responsibility for developing not only the revised Model Act under the direction of the Committee on Corporate Laws but also the annotations that will comprise the Model Business Corporation Act Annotated (Third Edition). These volumes will include historical comments, statutory comparisons of the corporation law currently in effect in the 50 states, the District of Columbia, and Puerto Rico, and citations to leading cases, law review articles, and American Law Reporter annotations.

The Project was funded by the American Bar Foundation and the Section of Corporation, Banking and Business Law of the American Bar Association. The University of Texas Law School contributed office space and related services, and the University of Texas Law School Foundation provided financial and accounting services, to the Project. The assistance of these various organizations is gratefully acknowledged.

Professor Robert W. Hamilton, Benno C. Schmidt Professor of Business Law, served as Reporter for the Project. Seth S. Searcy III, Esq., of Austin, Texas, served as project director and principal statutory draftsman. Amy Lebowitz Greenspan, Esq., also of Austin, served as staff attorney with primary responsibility for preparation of the annotations.

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[1] Term as secretary expired June 1981.
[2] Term expired August 1981.
[3] Term expired August 1982.
[4] Resigned June 1982.

APPENDIX 2

Editor's Note: The Section's Committee on Corporate Laws developed, and from time to time proposes changes in, the Model Business Corporation Act. A report of that Committee on the proposed addition of a Supplement—The Statutory Close Corporation Supplement to the Model Business Corporation Act—appears below.

Proposed Statutory Close Corporation Supplement to the Model Business Corporation Act

A Report of COMMITTEE ON CORPORATE LAWS

The Committee on Corporate Laws has approved a Statutory Close Corporation Supplement to the Model Business Corporation Act on second reading, and invites comments from interested persons. Comments should be addressed to the Chairman of the Committee, Elliott Goldstein, Esq., 1100 Citizens and Southern National Bank Building, Atlanta, Georgia 30303.

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INTRODUCTORY COMMENT

A. Background

The need for special statutory provisions to accommodate closely held corporations has been recognized for many years. Pioneer legislation to assist close corporations in this country was enacted in New York in 1948. North Carolina enacted several special close corporation provisions in 1955 as did South Carolina in 1962. Florida enacted the first complete close corporation statute in 1963. This statute was repealed in 1975 but most of the major provisions were incorporated into the Florida General Corporation Act. Maryland and Delaware enacted comprehensive close corporation provisions in 1967. In the past decade a number of additional states including Arizona, California, Illinois, Kansas, Maine, Michigan, New Jersey, Pennsylvania, and Texas have passed close corporation legislation.

These statutes basically follow two patterns: (1) a separate chapter of the state business corporation act (these statutes are commonly called integrated close corporation statutes) and (2) close corporation provisions that are spread throughout the business code. Most of the integrated statutes are to a large degree modeled on the Delaware provisions (Illinois, Kansas, Pennsylvania, and to a lesser extent Texas). The Arizona and Maryland integrated statutes are distinctive and contain a number of innovative features.

The 1969 Amendments to the Model Business Corporation Act (MBCA) included a number of liberalizing provisions for close corporations. These provisions, which are included as part of the regular statutory provisions in the MBCA, are summarized in a special comment to paragraph 2 of section 35 of the Model Business Corporation Act Annotated (2d ed. 1969). The Statutory Close Corporation Supplement builds on this prior close corporation legislation and assumes that most of the basic provisions included in such legislation are enacted in the state adopting the Supplement. If a state does not have provisions that authorize supermajority voting requirements, shareholder voting agreements, voting trusts, and transfer restrictions, that fully protect class voting rights for the election of directors and for approval of fundamental structural changes, and that contain dissenters' rights similar to MBCA sections 80-81, it should enact such provisions at the time the Supplement is adopted. These types of provisions can enhance flexibility in shareholder

relationships irrespective of the decision to operate as a statutory close corporation.

The main purpose of the Supplement is to provide model legislation for those states that wish to enact special provisions that incorporate the best available ideas on the special needs of close corporation shareholders and that at the same time provide basic statutory protection to the shareholders even in situations where they are not represented by experienced corporate counsel.

A corporation elects to become a statutory close corporation governed by the Supplement. The shareholders can choose not to be a statutory close corporation and, if the election is in effect, to terminate the election at any time. It is possible in most states, through the use of sophisticated contracts among the shareholders and special provisions in the articles of incorporation and bylaws, to reach the same legal results as can be achieved under the Supplement. However, investors in closely held corporations and their attorneys may want to elect to be a statutory close corporation because the Supplement is easy to use and provides more certainty and at the same time more flexibility and less drafting than is normally the case under the various general business corporation and professional corporation statutes.

B. Guiding Principles

There are four interrelated principles that were utilized in drafting the Close Corporation Supplement: (1) the need for a flexible, useful statutory framework; (2) the desirability of having adequate basic protection against oppression of minority shareholders; (3) the desirability of codifying some of the customary practices used by experienced practitioners to achieve the objectives and expectations of investors in close corporations; and (4) the necessity of integrating the special close corporation statutory provisions in the Supplement with all other statutory provisions governing business corporations.

1. A FLEXIBLE AND USEFUL STATUTE

The need for a statutory framework that allows the shareholders of a closely held corporation maximum flexibility to vary the normal corporate rules in order to meet their particular business and personal needs is the basic justification for a separate close corporation statute. Maximum flexibility is one of the linchpins of the Statutory Close Corporation Supplement. The clearest examples of this flexibility are section 10, which authorizes a statutory close corporation to operate without a board of directors and section 11, which allows the shareholders to achieve by private contractual agreement among themselves the same basic operational framework that is permissible among general partners in a partnership. Under section 11, even if the corporation has a board of directors, the shareholders can assume some or all of the normal management responsibilities. Furthermore, the directors are not bound by traditional operating rules. For example, director proxies and

weighted voting by directors are authorized. In addition many of the statutory rules in the Supplement can be varied. For example, section 4, which sets out standard stock transfer restrictions applicable to the shares of a closely held corporation governed by the Supplement, provides that the statutory restrictions can be modified or excluded entirely by appropriate notations in the corporation's articles.

One of the chief criticisms leveled at the existing integrated close corporation statutes is that they are so cumbersome lawyers are afraid to use them. To a large extent, the statutory framework for close corporations will inevitably be somewhat complex because the provisions must be drafted around the existing corporate statutes and case law. Nevertheless, the Statutory Close Corporation Supplement has been designed to minimize complexity and to maximize its usefulness in practice. This is accomplished in several ways.

First, the Supplement is elective. It does not apply unless the shareholders voluntarily elect to be governed by its provisions. The possibility of requiring every corporation meeting a certain definition to be governed by the Supplement was rejected as unworkable. Under most traditionally accepted criteria, close corporations encompass every type of corporation except a publicly held corporation. At any given moment in time there are literally thousands of close corporations that fall all along a spectrum of one-owner mom-and-pop operations to gigantic subsidiaries of major public corporations. There really is no "typical" close corporation. Additionally, the needs of an enterprise change as it matures and grows. To force every conceivable type of close corporation to conform to a special statutory framework could well produce more problems than it would solve for many of them and might force a close corporation into the same kind of legal straitjacket that has motivated the development of special statutes for close corporations. Furthermore, voluntary election is a hallmark of business law. A business elects to become a corporation. Shareholders elect to be taxed under subchapter S.

Second, the Supplement is designed to minimize the formalities necessary to establish and maintain a statutory close corporation. Any corporation, except an existing corporation having more than fifty shareholders at the time of election, is eligible for the election. The only requirement, other than the usual formalities necessary to incorporate, is the necessity of including the phrase "a statutory close corporation" in the articles of incorporation. Once articles of incorporation designating the corporation as a statutory close corporation are filed, the corporation continues to be governed by the Supplement unless the shareholders elect to terminate its statutory close corporation status. Additional requirements such as limiting the maximum number of shareholders and prohibiting public stock offerings, although included in most of the existing state close corporation statutes, were rejected on the grounds that they create the undesirable possibility of inadvertent terminations of close corporation status and unnecessarily complicate the statutory framework. As a practical matter it is doubtful that a corporation

that has a substantial number of shareholders or that has made a public offering will want to remain as a statutory close corporation, but if it does, there is no strong public policy reason why it should not be able to do so.

Third, several provisions in the Supplement are designed to reduce the amount of legal drafting that will have to be done in routine incorporations of close corporations. The standard share transfer restrictions, which automatically apply unless notice of a different set of restrictions is given, the standard notice required on all shares of stock, and the ability to incorporate by reference section 14 which, if elected, gives the estate or heirs the right to require the corporation to purchase the shares of a deceased shareholder, are examples of provisions which have the potential to simplify the process of setting up a closely held corporation. A specially designed standard articles of incorporation form for statutory close corporations, which will include the statutory provisions discussed above as well as a complete list with statutory references of all optional provisions that may be included in the articles of incorporation, further enhances the usefulness of the Supplement. The format for the proposed articles is attached as an appendix to these comments. In addition, the corporation need not have a formal set of by-laws if the requirements in section 12 are satisfied; and under section 13 an annual meeting of shareholders does not need to be held except upon shareholder demand.

Fourth, the flexibility in the Supplement to utilize or to vary the statutory rules in order to meet the special needs of the shareholders increases its usefulness. In addition to the ability to vary the standard transfer restrictions in section 4, previously discussed, the section 14 buy-out provision can, if elected, be readily modified to meet the particular needs of the shareholders. Moreover, section 15 authorizes a provision in the articles of incorporation giving one or more shareholders the option to dissolve the corporation and section 16 provides a wide range of remedies to resolve serious disputes among the shareholders.

Finally, there are no hidden or onerous requirements that might prevent a closely held corporation from wanting to elect to be governed by the Supplement. A statutory close corporation operating under the Supplement can, if it chooses, operate pursuant to the same rules as are applicable to regular corporations. For example, there are no special documents, such as special financial reports or directors' reports, that must be filed or submitted to shareholders. Except for the buy-out provision in section 14, which is elective, and the elimination of any need to have grounds for compelling dissolution of the corporation in order to qualify for relief from oppressive action in section 16, the Supplement essentially follows the basic format of existing state integrated close corporation statutes. Even the innovative features are derived from existing case law and practices adopted by practitioners representing closely held corporations.

2. BASIC PROTECTION AGAINST OPPRESSION

In the absence of special legal protection, the rights of minority shareholders are essentially subject to the goodwill of the majority shareholders. While it is possible to draft private contractual arrangements to protect the interests of minority shareholders against oppression, the enforceability of many of these agreements is doubtful in many states. Even where protective provisions have been given statutory sanction, gaps exist and the protection is often less than adequate. For example, many state statutes limit the maximum period of shareholder voting agreements and shareholder-management agreements to ten years. As a practical matter, the need for proper protection may be greater *after* ten years than before that time. If the corporation has been reasonably successful this is likely to be the time when growing pains will create serious tensions between the shareholders. As a consequence it might prove impossible to obtain the necessary consent to a renewal of the agreement.

The real strength in the existing close corporation statutes is the protection they provide for private contractual arrangements among the shareholders. Minority shareholders who are not represented by skillful draftsmen, however, may well find themselves without adequate protection of their rights in the absence of being able to prove fraud by the majority or grounds entitling them to force an involuntary dissolution of the corporation. Dissolution is a radical remedy which will not normally be granted if the corporation is financially viable, and even where this legal obstacle has been overcome by statute, the scope and type of relief that a court can grant is often unclear.

Finally, even though several state close corporation statutes have provided expanded protection for minority shareholders, these statutes have not adequately dealt with the problems of oppression *by* the minority which can easily develop when minority shareholders have a veto power over action desired by the majority. If the minority misuses its powers, the majority needs an adequate remedy to resolve the deadlock.

The Supplement attempts to remedy these deficiencies in several ways. It contains many provisions, most of which have already been mentioned, that guarantee the enforceability of any private contractual arrangement between the shareholders without artificial time limitations. Moreover, under section 16 minority shareholders can petition a court for relief from oppression, fraud, and unfairly prejudicial conduct; and in addition, the holders of a majority of the corporation's shares can file an action for relief from a deadlock caused by minority tyranny. The court is authorized to grant any kind of relief it deems proper, including, as a last resort, liquidation of the corporation, to resolve the dispute leading to the suit. Contrary to existing statutes, however, grounds for involuntary liquidation are not a prerequisite to relief. To prevent abuse of these remedial provisions, the court is empowered to award attorneys' fees and expenses against parties who have acted vexatiously or in bad faith.

3. CODIFICATION OF CUSTOMARY PRACTICES

The Supplement also contains provisions which incorporate basic contractual rights that experienced practitioners draft for close corporation shareholder clients. These provisions provide a minimum amount of automatic protection to the investors' normal expectations. For example, shareholders in closely held corporations usually want to limit the transfer of shares in some reasonable fashion. The share transfer restrictions in section 4 prohibit transfer to outsiders without the consent of the remaining shareholders, but at the same time allow intra-shareholder and intra-family transfers, and transfers to persons making bona fide offers in the event the remaining shareholders elect not to cause the corporation to purchase the offered shares. Thus basic protection of the shareholders' normal expectations is automatically provided. At the same time a potential market is available for the shareholder who wishes to liquidate his investment and can locate an eligible transferee. In this connection there have been a significant number of cases where courts have found share restrictions to be defectively drafted.[1] While the statutory transfer restrictions in section 4 will not fit every situation, they are designed to meet the needs of most close corporations which consist of a limited number of shareholders, many or all of whom are active in the management of the business. Furthermore, the provisions are easy to modify. Therefore use of the section 4 format with any necessary amendments should reduce the amount of potential litigation involving the construction and coverage of share transfer restrictions.

If elected, the shareholder purchase option in section 14 provides additional basic protection to shareholders by providing liquidity for the shares of a deceased shareholder. The illiquidity of stock in a closely held corporation is a serious problem and is a common cause of disputes and litigation between shareholders. Buy-out contracts are often used to alleviate this problem. Expanding the buy-out scheme in section 14 to cover situations other than death is allowable. Furthermore, the statutory provisions in section 14 can be easily modified by stating the modifications in the articles of incorporation.

4. INTEGRATION WITH THE GENERAL BUSINESS CORPORATION ACT

The concept of a self-contained close corporation statute was considered but rejected. Except for a limited number of special needs, a close corporation is like any other type of corporation and the attempt to produce a complete separate statute would result in needless duplication and produce a variety of other problems, for example, the necessity of amending the close corporation statute every time the state's general business corporation act is amended.

The Statutory Close Corporation Supplement is designed to function essentially like the integration between the Uniform Partnership Act and the Uniform Limited Partnership Act. The basic provision implementing this

1. *See, e.g.*, H. O'Neal, Close Corporations § 7.18 (2d ed. 1971).

integration is section 2, which provides that the state's general business corporation act, or in the case of a professional corporation, the state's professional corporation act, will apply except to the extent such acts are inconsistent with the provisions in the Supplement. In addition, section 3 deals with the procedure for election by an existing corporation to become a statutory close corporation subject to the Supplement and sections 8 and 9 set out the procedure for termination of the election.

Although it is integrated with the state's general business corporation and professional corporation acts, the Supplement is a separate statute in the sense that only corporations that elect statutory close corporation status can qualify to be governed by its provisions. This exclusiveness makes it possible to include in the Supplement only those special provisions that will apply to a certain category of corporations.

There is, however, a great deal of flexibility under state corporation statutes following the Model Business Corporation Act to provide many of the same types of protective arrangements that are available to close corporations governed by the Supplement. One prominent example is the use of shareholder voting agreements and voting trusts pursuant to statutes similar to section 34 of the MBCA. See the special comment to paragraph 2 of section 35 of the MBCA for a summary of these provisions. Closely held corporations that do not elect to become a statutory close corporation can still utilize these and other provisions designed to allow flexibility in operating a corporation. Many of these provisions are also useful to shareholders of corporations that are not closely held.

SECTION 1. SHORT TITLE

This Act shall be known and may be cited as the "[Model] Statutory Close Corporation Act."

Comment: None.

SECTION 2. APPLICATION OF [GENERAL] BUSINESS CORPORATION ACT AND [ ] PROFESSIONAL CORPORATION ACT

(a) To the extent not inconsistent with the provisions of this Act, the [general] business corporation act shall apply to all statutory close corporations.

(b) This Act shall apply to a professional corporation organized under the [ ] professional corporation act whose articles of incorporation contain the provision required in section 3(a), except insofar as the [ ] Professional Corporation Act contains inconsistent provisions.

(c) This Act shall not be deemed to repeal or modify any statute or rule of law which is or would be applicable to any corporation which is organized under the [general] business corporation act or the professional corporation act that does not elect to become a statutory close corporation pursuant to section 3.

Comment: An explanation of the interplay between the state's general business corporation and professional corporation acts and the Supplement is found in the general introductory comment.[2]

Subsection (c), which is derived from section 356 of the Delaware Corporation Law, makes it clear that enactment of the Supplement will not affect the law applicable to corporations, including closely held corporations, that are not statutory close corporations.

SECTION 3. DEFINITION OF A STATUTORY CLOSE CORPORATION; ARTICLES OF INCORPORATION

(a) A statutory close corporation is a corporation whose articles of incorporation contain a statement that the corporation is a statutory close corporation.

(b) Any corporation organized under the [general] business corporation act and having fewer than 50 shareholders may become a statutory close corporation by amending its articles of incorporation to include the statement required by subsection (a). The amendment shall be adopted in accordance with the requirements of [sections 59 and 60 of the MBCA-Procedures to amend the articles of incorporation], except that it shall be approved by the affirmative vote of the holders of at least two-thirds of the shares of each class of shares of the corporation whether or not otherwise entitled to vote. If the amendment is approved by the requisite vote, any shareholder who voted against the amendment shall be entitled to receive the fair value of his shares upon compliance with the provisions of [sections 80 and 81 of the MBCA—Rights of dissenting shareholders].

Comment: 1. With the exception of a corporation having more than fifty shareholders at the time it wishes to become a statutory close corporation, all corporations are potentially eligible to make the election. The election is made by including in the articles of incorporation a statement that the corporation is a statutory close corporation. As is explained in the general introductory comment, additional restrictions on eligibility commonly found in existing close corporation statutes do not seem to serve any purpose except to complicate the statutory framework.

The danger that a large corporation with numerous shareholders might attempt to elect close corporation status in order to operate without a board of directors, although highly unlikely to occur, is the basis for precluding existing corporations with more than fifty shareholders from being eligible to elect close corporation status. A new corporation that wishes to elect statutory close corporation status at the time of its initial incorporation is eligible, however, regardless of the number of subscribers. Likewise a new or existing corporation that becomes a statutory close corporation at a time it has fewer than fifty

2. *See* comment to section 8 and section 9 for a discussion of the applicability of these acts when the corporation terminates its status as a statutory close corporation.

shareholders can continue to operate as a statutory close corporation even though it subsequently has more than fifty shareholders. The potential for abuse by evasion of the normal rules governing corporations is not considered to be sufficiently great in these situations to justify a shareholder numbers limitation. Such a limitation inevitably creates legal uncertainty and the possibility of an unknowing change in status.

Consideration was given to requiring a statutory close corporation to use a special designation such as "A Statutory Close corporation" or "S.C.C." on all letterheads and documents, to distinguish it from a regular corporation. Special designations are used in all European corporate statutes to distinguish between public and private companies. This practice has not been used in the past in the United States except with respect to professional corporations, which under section 2 will still be subject to such requirements even though the corporation elects to be governed by the Supplement. The only real purpose served by such a designation is to provide special notice to creditors and shareholders. The usual name of a corporation gives a creditor notice of the company's limited liability. A creditor is on notice to look at the company's financial records to decide whether shareholder guarantees of credit will be required and can obtain a copy of the articles or any other document he needs. Shareholders have notice of the corporation's special status because of the required legend on the share certificates.[3]

2. The articles of incorporation is the basic document that contains all the essential information about a corporation. The articles also give notice to prospective shareholders or creditors of any special or unusual contractual arrangements among the shareholders.

The only required difference between the form of articles for a statutory close corporation and a regular corporation is the designation of the enterprise as a statutory close corporation. While it would be possible for statutory close corporations to use the standard articles of incorporation form, it is preferable to have a special format similar to that set out in the appendix. This format takes into account the provisions respecting share transfer restrictions (sections 4 and 14), the possibility that the corporation will not have a board of directors (section 10) and the other optional provisions that can be utilized by statutory close corporations. The recommended format also includes the statutory language of some of the more critical provisions in the Supplement as well as a complete list with statutory references of all the optional provisions that can be included in the articles. This additional material is included on the assumption that it will simplify the proper drafting of articles and reduce the number of inadvertent omissions.

3. Some states, for example Texas, require unanimous consent by all shareholders for an existing corporation to become a statutory close corporation.[4] Most states, however, follow the Delaware statute which requires two-thirds vote of all outstanding shares.[5] A compromise between the two positions is to require a two-thirds vote of each class of shareholders but to allow those shareholders opposed to the election to exercise dissenters' rights. This is the position adopted by the Supplement.

4. A state having a comprehensive close corporation statute enacted prior to adoption of the Supplement will want to adopt a statutory provision allowing existing close corporations to qualify automatically for close corporation status by filing amended articles of incorporation complying with section 3.[6]

3. *See* section 5, *infra*.

SECTION 4. SHARE TRANSFER RESTRICTIONS

(a) Except as otherwise provided in the articles of incorporation, no interest in shares of a statutory close corporation may be transferred, by operation of law or otherwise, whether voluntary or involuntary.

(b) The provisions of this section shall not apply to a transfer:

(1) to the corporation or to any other holder of the same class of shares;

(2) to members of the holder's immediate family, or to a trust, all of whose beneficiaries are members of the holder's immediate family. A holder's immediate family shall include only his spouse, parents, lineal descendants (including any adopted children and stepchildren) and spouse of any lineal descendants, and brothers and sisters;

(3) which has been consented to in writing by all of the holders of the corporation's common shares having voting rights;

(4) to an executor or administrator upon the death of a shareholder or to a trustee or receiver as the result of a bankruptcy, insolvency, dissolution, or similar proceeding brought by or against a shareholder;

(5) by merger, consolidation, or share exchange that becomes effective pursuant to [section 76 of the MBCA] or a share exchange of existing shares for other shares of a different class or series in the corporation;

(6) by a pledge as collateral for a loan that does not grant the pledgee any voting rights possessed by the pledgor;

(7) made after termination of the corporation's status as a statutory close corporation.

(c) Any person desiring to transfer shares in a transaction not exempt under subsection (b) shall obtain an offer from a third party who meets the requirements in paragraphs (1) and (2) of this subsection to purchase such shares for cash and shall deliver written notice of the third party offer to the corporation's registered office in this State stating the number and kind of

4. Texas Bus. Corp. Act art. 2.301(E) (West).
5. Del. Code Ann., tit. 8 § 344.
6. *See* section 22 *infra*.

shares, the offering price, the other terms of the offer, and the name and address of the third party offeror. No transfer shall be made to a third party unless:

(1) the third party is eligible to become a qualified shareholder under the provisions of any federal or state tax statute that the corporation has elected to be subject to and the third party shall agree in writing not to take any action to terminate the election without the approval of the remaining shareholders;

(2) the transfer to the third party will not result in the imposition of the personal holding company tax or any similar state or federal penalty tax on the corporation.

(d) The notice specified in subsection (c) shall constitute an offer to sell the shares to the corporation on the terms of the third party offer. Within 20 days after the corporation receives the notice, the President shall call a special meeting of shareholders, which shall be held not more than 40 days after the call, for the purpose of determining whether to purchase all (but not less than all) of the offered shares. Approval of action to purchase shall be by affirmative vote of the holders of a majority of the shares entitled to vote excluding the offered shares. With the consent of all the shareholders entitled to vote for the approval, the corporation may allocate some or all of the shares to one or more shareholders or to other persons, but if the corporation has more than one class of shares, the remaining holders of the class of shares being offered for sale shall have a first option to purchase the shares that are not purchased by the corporation in proportion to their shareholdings or in such proportion as shall be agreeable to those desiring to participate in the purchase.

(e) Written notice of the acceptance of the shareholder's offer shall be delivered or sent to the offering shareholder at the address specified in his notice to the corporation, or in the absence of any specification, at his last known address as reflected in the records of the corporation, within 75 days after receipt of the shareholder's offer. Notice sent by U.S. mail shall be timely if it is deposited in the mail prior to midnight of the 75th day following the day the offer from the shareholder was received by the corporation. If the notice contains terms of purchase different from those contained in the shareholder's notice, the different terms shall be deemed a counter offer and unless the shareholder wishing to transfer his stock accepts in writing the counter offer, or the shareholder and the purchaser(s) otherwise resolve by written agreement the differences between the offer and counter offer within 15 days of receipt by the shareholder of the notice of acceptance, the notice containing the counter offer shall be ineffective as an acceptance.

(f) If a contract to sell is created under subsection (e), the shareholder shall make delivery of all the certificates for the stock so sold, duly endorsed, within 20 days of receipt of the notice of acceptance, or in the case of uncertificated securities, shall within the 20 day period send or deliver to the corporation the required instruction requesting that the transfer be made. Breach of any of the terms of the contract shall entitle the non-breaching party to any remedy at law or equity allowed for breach of a contract, including, without limitation, specific performance.

(g) If the offer to sell is not accepted pursuant to subsections (d) and (e), the shareholder shall be entitled to transfer to the third party offeror all (but not less than all) of the offered shares within 120 days after delivery of the shareholder's notice specified in subsection (d) in accordance with the terms specified in the shareholder's notice.

Comment: 1. This section sets out a standardized set of transfer restrictions which automatically apply unless the articles of incorporation otherwise provide. The share transfer restriction provisions set out in this section are designed to accomplish two purposes: first, to provide restrictions that fit the needs of the "typical" close corporation; and second, to facilitate alteration in order to fit the special needs of the shareholders in a particular corporation. This section is not exclusive. The shareholders can modify its provisions or opt out of the section entirely. See Comment 3. If a decision is made to opt out, the shareholders can utilize any type of share restrictions that are lawful under the state's general business corporation statute or case law.

2. The definition of "transfer" in subsection (a) is intended to cover every possible type of transaction that can create an interest in corporate stock, including without limitation, purchase, sale, discount, negotiation, gift, trust, legacy, inheritance, pledge, mortgage, lien, creation of a security interest, hypothecation, bankruptcy, or pursuant to court order.

Intra-shareholder and intra-family transfers are exempted on the assumption that most "typical" close corporation shareholders would want these transfers to be exempt. Transfers to executors, administrators, trustees, or receivers that result from death, bankruptcy, liquidation, or dissolution of a shareholder are also exempt from the statutory restriction. In addition transfers that are in effect merely internal recapitalizations and transfers having the approval of all the shareholders are exempt when no voting rights are given to the pledgee. Transactions in which the stock is pledged or hypothecated are also exempt when no voting rights are given to the pledgee. In all these situations, however, further attempted transfers by the transferees are subject to the statutory restrictions, unless the subsequent transfer qualifies under one of the exemptions. For example, although a pledge of stock as collateral for a loan is an exempt transaction, a subsequent sale of the pledged stock by the pledgee in a foreclosure proceeding could only be made in accordance with the provisions of subsections (c) through (g) unless the transfer is exempt under subsection (b).

A final type of exempt transfer is one which is made after the corporation ceases to be a statutory close corporation. The automatic extinction of the transfer restrictions at termination is justified on the assumption that in most

cases the shareholders will want the restrictions to be ineffective after termination. The right to receive the fair value of his shares by voting against the termination (see section 8) is considered to be a reasonable remedy for those shareholders opposed to the termination on any grounds. Alternative methods for continuing the restrictions after termination of statutory close corporation status are explained in the comment to section 8.

3. The statutory format can be excluded or modified simply by stating in the articles that it will not apply or by specifying in the articles the changes from the statutory model. See paragraph 7 of the proposed articles of incorporation for a statutory close corporation in the appendix to these comments. For example, if the shareholders wanted all pledges to be subject to the transfer restrictions but otherwise found the statutory restrictions acceptable, the attorney drafting the articles of incorporation could effectuate this modification simply by providing in paragraph 7 of the articles: "Subsection (b) (6) is nonapplicable." The net effect is that all shareholders have some automatic basic protection against unwanted transfers plus maximum flexibility to alter or replace the statutory scheme.

4. With respect to a proposed transfer to a third party, the primary thrust of this section is to encourage the parties to reach an agreement one way or the other in a reasonably short period of time. The fifteen-day interval between the last day for holding a shareholders' meeting to consider the third party offer and the cut off date for the notice of acceptance is designed to allow time for the corporation and the other shareholders to contact potential third party purchasers or shareholders not present at the meeting where the decision to purchase stock was taken and to make any necessary arrangements to finance the purchase.

5. If the proposed transfer is not an exempt transaction, the only guaranteed right a shareholder has to sell his shares under this section is to obtain a third party cash offer from a person or entity that meets the requirements in paragraphs (1) and (2) of subsection (c). The mere offer by a shareholder to sell his shares to the corporation at a price he designates will not trigger the first refusal option and other rights in subsections (d)-(g). Any broader rights guaranteeing a market for the shares by the corporation or other shareholder can be provided by way of a buy-out agreement.[7]

Paragraphs (1) and (2) of subsection (c) are designed to protect the corporation and other shareholders against serious adverse tax consequences that might result from having the third party offeror as a shareholder.

Subsection (c) also requires that any third party offer submitted to the corporation be stated in terms of cash per share. An offer based on other consideration, such as stock in another corporation, is not a qualifying offer, and unless the shareholder can convince the third party to make the offer in terms of cash, the shareholder will have no right to have his stock transferred

7. *See* comments to section 14 *infra*.

to the third party should the corporation refuse to consent to the transfer or to purchase the offered shares. The decision to exclude non-cash offers is based on the conclusion that most third party offers are made on a cash basis and the mechanics of dealing with non-cash offers would unduly complicate the statutory framework. If the possibility of non-cash offers is considered to be significant, the problem can be dealt with by including appropriate language in the articles of incorporation as an amendment to the statutory restrictions. Since the corporation will not be able to match in specie the non-cash portion of the third party offer, some mechanism, such as arbitration, should be set out to resolve any disputes over the adequacy of any offer made by the corporation to purchase the offered stock.

6. If no agreement to purchase the offering shareholders' stock is consummated, the shares can only be transferred to the third party if the transfer is made within 120 days of the date the shareholder notifies the corporation of the third party offer. Additionally, the transaction must be consummated on the terms set forth in the notice of the offer. For example, a sale for less than the total price specified in the notice or an installment purchase when a cash sale is specified in the notice would not be valid. If the transfer is not consummated, or is invalid, then the offering shareholder cannot thereafter dispose of his shares except in compliance with the provisions of this section. Thus the shareholder would be free to make a transfer that was exempt under subsection (b) or to obtain another qualifying third party offer at any time in the future. If the transfer to the third party is consummated, the shares acquired by the third party would be subject to the transfer restrictions in this section, unless the transferee has no notice or knowledge of the restriction.[8]

SECTION 5. NOTICE OF STATUTORY CLOSE CORPORATION STATUS ON ISSUED SHARES

The following legend shall be noted conspicuously on each share certificate issued by a statutory close corporation:

> The rights of shareholders in a statutory close corporation may differ materially from the rights of shareholders in other corporations. Copies of the articles of incorporation and bylaws, shareholders' agreements, or other documents, which may restrict transfers and affect voting and other rights, may be obtained by a shareholder on written request to the corporation.

This notice shall satisfy all requirements of this Act and the [general] business corporation act that notice of restrictions be given. Within a reasonable time after the issuance or transfer of uncertificated shares, the corporation shall send to the registered owner thereof a written notice containing the information required to be set forth on certificates by this section. All persons claiming

8. *See* sections 5 and 6 *infra*.

an interest in shares of a statutory close corporation complying with the notice requirement of this section shall be bound by the documents referred to in the notice. All persons claiming an interest in shares of a statutory close corporation not complying with the requirement of this section shall be bound by any documents of which they, or any person through whom they claim, have knowledge or notice.

Comment: The purpose of this section is to put shareholders in a statutory close corporation on notice that the shares are subject to transfer restrictions and that their rights may be different from those of shareholders in regular corporations. Such notice is essential to bind third parties who are not signatories to the original agreements establishing the rights of the shareholders *inter sese*.

The notice is also drafted to satisfy the notice requirements in cases where a statutory close corporation has uncertificated securities. Under the 1977 Revisions to Article 8 of the Uniform Commercial Code, the notice required by this section would appear in what is called a transaction statement.[9]

SECTION 6. TRANSFER OF SHARES IN BREACH OF TRANSFER RESTRICTIONS

Any attempted transfer of shares in a statutory close corporation in violation of any transfer restriction binding on the transferee shall be ineffective. Any attempted transfer of shares in a statutory close corporation in violation of any transfer restriction not binding on the transferee shall give the corporation the option, exercisable by notice and payment within 30 days after presentation of the shares for registration in the name of the transferee, to purchase the shares from the transferee for the same price and terms.

Comment: This section provides additional protection for the effectiveness of the transfer restrictions appliable to the shares of a statutory close corporation. If the required notice of the restrictions has not been given[10] and the transferee does not have actual notice of the restrictions, then the corporation is given a thirty-day option to purchase the stock. If the corporation exercises its option, the proposed transferee may pursue a breach of warranty claim against the transferor or any other appropriate remedy.[11]

This section also gives the corporation an option to purchase shares attempted to be transferred in violation of a transfer restriction that has been found to be void by order of a court.

SECTION 7. MERGERS, CONSOLIDATIONS, SHARE EXCHANGES, AND SALE OF ASSETS

(a) Approval of any plan of merger, consolidation, or exchange of shares:

9. *See* UCC 8-204 and 8-408 (1978 Text).
10. *See* section 5 *supra*.
11. Del. Code Ann. tit. 8 § 347.

(1) that if effected will terminate the status of the corporation as a statutory close corporation shall require the affirmative vote of the holders of at least two-thirds of the outstanding shares of each class of shares of the statutory close corporation, whether or not otherwise entitled to vote thereon.

(2) under which the new or surviving corporation shall be a statutory close corporation shall require the affirmative vote of the holders of at least two-thirds of the outstanding shares of each class of shares of the corporation that is not a statutory close corporation, whether or not otherwise entitled to vote thereon.

(b) A sale, lease, exchange, or other disposition of all, or substantially all, the property and assets, with or without the good will, of a statutory close corporation, if not made in the usual and regular course of its business, shall require the affirmative vote of the holders of at least two-thirds of the outstanding shares of each class of shares of the corporation, whether or not otherwise entitled to vote thereon.

Comment: Section 8 provides that a minimum two-thirds vote of every class of shares whether or not otherwise entitled to vote is required to terminate close corporation status. This section imposes the same voting requirement in transactions that have the effect of terminating a corporation's status as a statutory close corporation.

In addition, under subsection (a) (2), the shareholders of a corporation that will end up as a statutory close corporation in a merger, consolidation, or share exchange will have to approve the transaction by the same minimum two-thirds vote. This is consistent with section 3(b) which requires a two-thirds vote for approval of an amendment by an existing corporation to become a statutory close corporation.

The exceptions to shareholder approval of mergers, consolidations, and share exchanges for subsidiary mergers and some other types of transactions[12] do not apply to statutory close corporations in situations covered by subsection (a) on the grounds that a shareholder vote should be required in all circumstances where statutory close corporation status is elected or terminated.

Shareholders of a statutory close corporation who vote against the merger, consolidation, share exchange, or sale of all or substantially all the assets not in the regular course of business should be able to obtain the fair value of their shares under the state's dissenters' rights statute.

SECTION 8. TERMINATION OF STATUTORY CLOSE CORPORATION STATUS

(a) A statutory close corporation shall cease to be subject to the provisions of this Act upon the effectiveness of articles of amendment deleting from its articles of incorporation the statement that it is a statutory close corporation,

12. *See* MBCA, §§ 73(d), 75.

and if the corporation has elected pursuant to section 10 not to have a board of directors, deleting the statement in the articles to that effect and specifying the number, names, and addresses of its directors. The amendment shall be adopted and shall become effective in accordance with sections [59-65 of the MBCA] except that it shall be approved by the affirmative vote of the holders of at least two-thirds of the shares of each class of shares of the corporation, whether or not otherwise entitled to vote thereon.

(b) If the amendment to terminate the corporation's status as a statutory close corporation is approved by the requisite vote, any shareholder who votes against the amendment shall be entitled to receive the fair value of his shares upon compliance with the provisions of [sections 80-81 of the MBCA — Rights of dissenting shareholders].

Comment: 1. Sections 8 and 9 deal with issues that arise when a corporation no longer wants to continue operating as a statutory close corporation. Termination is accomplished by shareholder approval of a resolution amending the articles of incorporation to eliminate the special designation required in section 3. The amendment to terminate statutory close corporation status must be approved by the same vote (two-thirds) as is necessary to elect close corporation status (unless the articles specify a higher vote); and shareholders opposed to the termination have the right to cash out by exercising rights as dissenting shareholders. This is consistent with the provisions in section 3(b) for election by an existing corporation to become a statutory close corporation.

2. Whenever a corporation that is operating without a board of directors wants to terminate its status as a statutory close corporation, it must, in addition to amending the articles to delete reference to the fact that it is a statutory close corporation, amend the provision in the articles that states the corporation shall have no board and state in the articles the number, name, and address of each of the directors.

3. Unless other changes in the rights and obligations of the shareholders are agreed upon, the effect of a termination is twofold: (1) the corporation automatically becomes subject to the state's general business corporation statute, or professional corporation act if the corporation was organized as a professional corporation; and (2) except for transfer restrictions under section 4[13] and authority to operate without a board of directors, any existing rights of the shareholders established by agreement[14] between the shareholders or with the corporation and any rights granted to the shareholders in the articles of incorporation that are legal under the provisions of the general business or professional corporation acts continue to be effective.

4. If the shareholders want transfer restrictions applicable under section 4 to continue after termination of statutory close corporation status, they can

13. *See* section 4(b)(7) *supra*.
14. *Cf.* UCC § 1-201(3).

accomplish this by means of a private agreement. An alternative method to have the section 4 transfer restrictions apply after termination is to provide in the articles that section 4(b) (7) shall not be applicable. This would eliminate the need to draft a complete set of transfer restrictions. To be binding on third parties, however, all new shares issued after the termination is effective will have to contain a notice meeting the requirements of the state's general business corporation act and other applicable law.[15] The notice required on the shares of statutory close corporations[16] will no longer be appropriate, although it will be effective notice with respect to all stock outstanding at the time of termination.

5. Assuming the state's general business corporation act is similar to the MBCA and that its professional corporation act is similar to the Professional Corporation Supplement to the MBCA, most of the special control distribution arrangements among the shareholders and the optional provisions that can be included in the articles will continue to be effective in spite of the termination pursuant to section 9. For example, if section 14 is elected, the buy-out purchase option at the death of a shareholder will continue to apply, unless the articles are amended to terminate such rights.[17] Some types of provisions will not, however, be valid after termination. One that will probably be invalid under most state general business corporation acts is a provision in the articles that gives one or more minority shareholders the right to force a dissolution of the corporation as authorized in section 15 of the Supplement. At the time of termination, all relevant documents relating to the corporation and the shareholders should be carefully reviewed, and where necessary revised. The Supplement does give some automatic protection by providing in section 9(b) that the special control and contractual arrangements automatically continue to be effective unless they are invalid under other applicable statutes or case law.

SECTION 9. EFFECT OF TERMINATION OF STATUTORY CLOSE CORPORATION STATUS

(a) Any corporation that terminates its status as a statutory close corporation shall thereafter be subject to all the provisions of the [general] business corporation act, or if it was organized under the [ ] professional corporation act, to that act.

(b) The termination of statutory close corporation status shall not affect the rights of any shareholder or the corporation under any agreement or under the corporation's articles of incorporation except to the extent that any provision in any such agreement or in the articles of incorporation is invalid under the [general] business corporation act or any other laws of this state or as otherwise provided in this Act.

15. *See, e.g.*, UCC § 8-204.
16. *See* section 5 *supra*.
17. *See* comment 2 to section 14 *infra*.

(c) If at the time the corporation's statutory close corporation status terminates it has no bylaws, it shall forthwith adopt bylaws pursuant to [MBCA section 27].

Comment: Refer to the comment to section 8.

SECTION 10. ELECTION NOT TO HAVE A BOARD OF DIRECTORS

(a) A statutory close corporation may operate without a board of directors if the articles of incorporation contain a statement to that effect. While this statement is effective:

(1) All corporate powers shall be exercised by or under authority of, and the business and affairs of the corporation shall be managed under the direction of, the shareholders of the corporation, and all powers and duties conferred or imposed upon the board of directors by the [general] business corporation act shall be exercised or performed by the shareholders.

(2) No liability that would otherwise be imposed on the directors shall be imposed on a shareholder by virtue of any act or failure to act unless the shareholder was entitled to vote on the action.

(3) Any requirement that an instrument filed with any governmental agency contain a statement that a specified action has been taken by the board of directors shall be satisfied by a statement that the corporation is a statutory close corporation having no board of directors and that the action was duly approved by the shareholders.

(4) The shareholders by resolution may appoint one or more shareholders to sign any documents as "Designated Directors."

(5) Unless the articles of incorporation otherwise provide, any action requiring director approval or both director and shareholder approval shall be sufficiently authorized by shareholder approval and any action otherwise requiring a vote of a majority or greater percentage of the board of directors shall require the affirmative vote of the holders of a majority, or such greater percentage, of the shares entitled to vote thereon.

(b) An amendment to the articles of incorporation to include the provisions authorized by subsection (a) shall be approved by the holders of all the shares of the corporation whether or not otherwise entitled to vote thereon, or all the subscribers to such shares, or the incorporators, as the case may be. An amendment to the articles of incorporation to delete the election shall be approved by the affirmative vote of the holders of at least two-thirds of each class of the shares of the corporation whether or not otherwise entitled to vote thereon.

Comment: 1. This section allows a statutory close corporation to elect not to have a board of directors by including a statement to that effect in the articles of incorporation. It also sets out the legal effects of this election. It is derived essentially from the Maryland Close Corporation Statute.[18]

2. The shareholders of a statutory close corporation operating without a board of directors will have the legal liability imposed by law on directors for managing the business and affairs of the corporation. They will also have to undertake the usual obligations imposed on directors, such as the responsibility for calling meetings to initiate or to approve action required by statute to be done by directors. Of course, it will not be necessary to call for an organizational meeting of directors, nor to hold any other directors' meetings. The statutory requirements will be fulfilled by shareholders' meetings.

3. One difference in this section from the Maryland provision and those of other states that have followed the Maryland model is subsection (5) which authorizes the use of "designated directors" to satisfy the insistence by a party dealing with the corporation that certain documents be signed or approved by "directors." Some banks and creditors have in the past refused to accept documents that do not meet their regulations for corporate formalities. This subsection is designed to allow an admittedly artificial but practical method of getting around this objection. The designated directors have the same liability as they would have had in the transaction had they not been designated directors. In other words they do not expose themselves to extra liability just because they sign any documents as designated directors in order to accommodate third parties.

4. Subsection (5) provides that the shareholders will vote the same way they vote as shareholders when voting on action normally requiring director approval. This rule can be changed if the alteration is included in the articles of incorporation. For example, if the articles so state, it would be possible to have the shareholders vote on a one vote per person basis as is the normal rule for directors' votes rather than the one vote per share rule applicable to shareholders. The shareholder voting rule is utilized as the standard rule because it is the option most likely to be chosen. A weighted voting scheme to give one or more shareholders a veto power on approval of proposed action either generally or restricted to certain designated issues is also permissible. Where a corporation has different classes of stock with voting rights or the corporate statutes guarantee voting rights to all classes of shares on a particular issue, the requisite vote of the various classes of shares will still have to be obtained to validate the transaction. The vote under subsection (5) only satisfies any requirement for director approval of proposed action.

5. Since they are acting as directors, the shareholders will be eligible for indemnification to the same extent as directors would be under the state's general business corporation statute.

6. While unanimous approval is necessary to elect not to have a board of directors, the election can be terminated by a two-thirds vote of all shares.

18. Md. Corp. and Ass'ns Code Ann. § 4-302.

Operating without a board is such a radical departure from traditional corporate law that it ought not be undertaken unless all the shareholders agree since they will have additional liabilities as a result of the election. Terminating the election, however, has the effect of returning to a more traditional corporate format; and a two-thirds vote, which is the voting standard used in the Supplement for most fundamental structural changes, seems to be sufficient.

7. If a corporation without a board of directors terminates its status as a statutory close corporation, it must proceed forthwith to elect directors. The names and addresses of the board members must be listed in the articles of amendment terminating the election.[19]

SECTION 11. AGREEMENTS AMONG SHAREHOLDERS

(a) The shareholders of a statutory close corporation may by unanimous action enter into one or more written agreements to regulate the exercise of the corporate powers and the management of the business and affairs of the corporation or the relations among the shareholders of the corporation.

(b) Any agreement authorized by this section shall be valid and enforceable according to its terms notwithstanding the elimination of a board of directors, any restriction on the discretion or powers of the board of directors, or any proxy or weighted voting rights given to directors and notwithstanding that the effect of the agreement is to treat the corporation as if it were a partnership or that the arrangement of the relations among the shareholders or between the shareholders and the corporation would otherwise be appropriate only among partners.

(c) If the corporation has a board of directors, the effect of an agreement authorized by this section restricting the discretionary powers of the directors shall be to relieve the directors of, and to impose upon the person or persons in whom such discretion or powers are vested, the liability for acts or omissions imposed by law upon directors to the extent that the discretion or powers of the directors are controlled by the agreement.

(d) An election not to have a board of directors in an agreement authorized by this section shall not be valid unless the articles of incorporation contain a statement to that effect in accordance with section 10.

(e) An election granting one or more shareholders the right to have the corporation dissolved at will or upon the occurrence of any specified event or contingency shall not be valid unless a statement of this right is included in the articles of incorporation in accordance with section 15.

(f) A shareholder agreement authorized by this section shall not be amended except by the unanimous written consent of the shareholders unless otherwise provided in the agreement.

19. *See* section 8(a) *supra.*

(g) Any action permitted by this section to be taken by shareholders may be taken by the subscribers to shares of the corporation if no shares have been issued at the time of the agreement authorized by the section.

(h) This section shall not prohibit any other agreement among two or more shareholders not otherwise prohibited by law.

Comment: 1. This section authorizes the shareholders to have any agreement they wish regulating the business of the corporation and their relationship to one another. Examples of the types of provisions that can be included in such an agreement are:

> (1) the management of the business and the affairs of the corporation in whole or in part by or under the direction of all the shareholders of the corporation or by or under the direction of one or more shareholders or third parties selected by the shareholders;
>
> (2) the right of one or more shareholders to dissolve the corporation at will or upon the occurrence of a specified event or contingency;
>
> (3) the exercise or division of voting power by the shareholders and directors and the use of director as well as shareholder proxies;
>
> (4) the terms and conditions of the employment of any officer or employee by the corporation, regardless of the length of the period of employment;
>
> (5) the persons who shall be directors and officers of the corporation;
>
> (6) the payment of dividends or division of profits;
>
> (7) the arbitration of issues as to which the shareholders or directors are deadlocked, or arbitration of any issue of disagreement between a shareholder in his capacity as a shareholder, director, officer, or employee and the corporation, or the other shareholders.

The only prerequisites are that all the shareholders execute the agreement and that whenever the agreement specifies that the corporation will have no board of directors or that one or more shareholders will have a special right to dissolve the corporation, the articles of incorporation will include appropriate language indicating these facts.[20]

2. Such an agreement will be valid and enforceable even if it in effect results in the business being operated essentially as a partnership without a board of directors. See subsection (b). Close corporations where most or all the shareholders are executive employees of the corporation are often referred to as "incorporated partnerships." This section gives legal sanction to the special needs of the shareholders of such corporations. Section 17 reinforces this concept by providing that shareholder limited liability will be recognized in spite of any such agreement.

3. The Supplement does not deal with the effect of a shareholders' agreement on the tax status of the corporation. In some circumstances the

20. *See* sections 10 and 15 *infra.*

agreement might result in the taxation of the business as a partnership. This determination will have to be made by competent counsel representing the corporation.[21]

4. The requirement of unanimity for adoption and amendment is justified because of the unusual nature of an agreement that has the potential to alter radically the normal corporate structure.[22]

5. Subsection (g) preserves the right of shareholders to enter into any other type of shareholder voting agreement or voting trust or similar agreement that is authorized in the state's general business corporation or professional corporation statutes. Such statutes do not ordinarily require unanimous approval of all the shareholders but in general do not authorize as much flexibility, particularly with respect to restrictions on the normal powers of directors, as is possible under this section.

6. The shareholders of a statutory close corporation can choose to operate with or without a board of directors. Section 10 deals specifically with the requirements for making this election and the legal consequences of operating without directors. If the board is retained, any responsibilities required to be exercised by the directors can be delegated to one or more of the shareholders or to third parties selected by the shareholders. To the extent the shareholders are entitled to exercise the management rights required by statute to be exercised by directors or have delegated these rights to others, they also assume the same scope of liability as would otherwise be imposed on the directors for failure to exercise these rights in an appropriate fashion. The shareholders who are exercising director management responsibilities would, however, be eligible for director indemnification under the state's general business corporation statutes. See comment 5 to section 10. If the corporation has a board of directors, the directors would continue to be liable for any management rights they have the power to exercise.

7. This section is essentially derived from similar provisions in the Maryland and Texas Close Corporation Statutes.[23]

SECTION 12. BY-LAWS

Provisions otherwise required by law to be stated in corporate by-laws may be contained with equal effect in the articles of incorporation or a shareholders' agreement authorized by section 11.

Comment: The purpose of by-laws is to provide regulations for the management of a corporation. Business corporation statutes universally require that a corporation adopt by-laws. Very few, however, specify more than a few mandatory provisions that must be included in the by-laws. For example, under the MBCA, the only mandatory requirements are: (1) the time and place of shareholder meetings (section 28); (2) the number of directors

21. *See* Treas. Regs. §§ 301.7701-1 through -3 (1960).
22. *Id.*
23. *See* Md. Corp. and Ass'ns Code Ann. § 4-401 and Tex. Bus. Corp. Act art. 2.30-2 (West).

(section 36); (3) the notice to be given of directors' meetings (section 43); and (4) the time, method of election, and authority of the officers (section 50). Moreover, under section 54(h) any provision required or permitted to be in the by-laws can be placed in the articles of incorporation.

Since the type of shareholders' agreement contemplated by section 11 will include much of the information normally included in by-laws, requiring the adoption of by-laws will in many cases involve unnecessary duplication. This is particularly true in closely held corporations where most or all of the investors are active in the business. Such corporations normally operate on an informal basis. The highly structured formalities in typical by-laws, although necessary in larger corporations with numerous shareholders, can be cumbersome when imposed on closely held corporations.

This section gives a statutory close corporation the option of not adopting by-laws, provided that any information required by statute to be in by-laws is included either in a section 11 shareholders agreement or in the articles of incorporation. Although this represents a break with tradition, it is consistent with the "incorporated partnership" concept[24] and all the information legally required to be in by-laws will be readily accessible to the shareholders.

SECTION 13. ANNUAL MEETING

A statutory close corporation may establish in its articles of incorporation or by-laws, or in a shareholders' agreement authorized by section 11, a date at which an annual meeting of shareholders shall be held, if called, and if not so established, the date shall be the first business day after May 31st. Unless otherwise provided in the articles of incorporation, no annual meeting need be held unless a written request therefor is delivered to the corporation by any shareholder not less than 30 days before the date specified for the meeting.

Comment: This section, which is derived from the Maryland Close Corporation Statute[25] requires that a statutory close corporation establish a date for an annual shareholders meeting but provides that the meeting need not be held unless one is demanded. Under most state corporate statutes, the requirement of an annual meeting is mandatory.

SECTION 14. SHAREHOLDER SALE OPTION AT DEATH

(a) If the articles of incorporation of a statutory close corporation provide that this section shall apply to the corporation, the estate or heirs of any deceased shareholder shall have the right to require the corporation to elect either to purchase or cause the purchase of all, but not less than all, of the shares of the decedent pursuant to subsections (d) through (f), or to be dissolved.

24. *See* comment 2 to section 11.
25. Md. Corp. and Ass'ns Code Ann. § 4-402.

(b) A modification of the provisions in this section shall be valid if it is set forth or referred to in the articles of incorporation.

(c) An amendment to the articles of incorporation to provide that this section shall apply or to delete or modify the provisions of this section shall be approved by the holders of at least two-thirds of each class of shares of the corporation whether or not otherwise entitled to vote thereon, or if the corporation has no shareholders at the time of the amendment, by two-thirds of all of the subscribers or all of the incorporators, as the case may be. Any shareholder who votes against an amendment to delete or modify the provisions of this section shall, if the amendment terminates or substantially alters the existing rights of the shareholder pursuant to this section to have his shares purchased, be entitled to receive the fair value of his shares upon compliance with the provisions of [sections 80 and 81 of the MBCA—Rights of dissenting shareholders].

(d) A person exercising rights under this section shall, within six months after the death of the beneficial owner of shares, deliver a written notice to the corporation's registered office in this state specifying the number and class of all shares beneficially owned by the deceased shareholder and stating that an offer by the corporation to purchase such shares is being solicited pursuant to this section. Within 20 days after receipt of the notice, the president of the corporation shall call a special meeting of shareholders, which shall be held not more than 40 days after the call, for the purpose of determining whether to offer to purchase the shares. Approval of action to offer to purchase the shares shall be by affirmative vote of the holders of a majority of the shares entitled to vote, excluding the shares covered by the notice. With the consent of all the shareholders entitled to vote for the approval, the corporation may allocate some or all of the shares to one or more shareholders, or to other persons, but if the corporation has more than one class of shares, the remaining holders of the class of shares being offered for sale shall have first option to purchase the shares that are not purchased by the corporation in proportion to their shareholdings or such proportion as shall be agreeable to those desiring to purchase. Written notice of any offer to purchase approved by the shareholders, or that no offer to purchase was approved, shall be delivered or sent to the person exercising his rights under this section within 75 days after delivery of the notice soliciting the offer to purchase. Any offer to purchase shall be accompanied by copies of the corporation's balance sheets as of the end of, and profit and loss statements for, its preceding two accounting years and any available interim balance sheet and profit and loss statement.

(e) To the extent the price and other terms for purchasing shares of a transferring shareholder by the corporation or remaining shareholders are fixed or are to be determined pursuant to provisions in the articles of incorporation, the by-laws of the corporation, or by written agreement, those provisions shall be binding, except that in the event of a default in any payment due, subsection (h) shall apply and the person exercising his rights under this section shall have the right to petition for dissolution of the corporation. Any offer to purchase shall be accepted or rejected in writing within 15 days.

(f) If an offer to purchase is rejected, or if no offer to purchase is made, the person exercising rights under this section may commence an action in the [ ] court. The jurisdiction of the court shall be plenary and exclusive. The corporation shall be made a party defendant in such action and shall, at its expense, give notice of the commencement of the action to all of its shareholders and such other persons as the court may direct. The court shall proceed to determine the fair value of the shares of the person exercising rights under this section in accordance with section 16(d) of this Act and enter an order requiring the corporation to cause the purchase of the shares at fair value and on the other terms so determined or to give such person the right to have the corporation dissolved.

(g) Upon the petition of the corporation, the court may modify its decree to change the terms of payment if it finds that the changed financial or legal ability of the corporation or other purchasers of the shares to complete the purchase justifies a modification. Any person making a payment in order to prevent or cure any default by any purchaser shall be entitled to recover the excess payment from the defaulting person.

(h) If the corporation or other purchaser fails for any reason to make any payment specified in the court decree within 30 days after the due date for such payment, the court shall, upon the petition of the person to whom the payment is due and in the absence of good cause shown by the corporation, enter a decree dissolving the corporation.

(i)(1) If the fair value of the shares as determined by the court does not materially exceed the last offer made by the corporation prior to the commencement of an action brought pursuant to subsection (f) and the court finds that the failure of the person exercising rights under this section to accept the corporation's last offer was arbitrary, vexatious, or not otherwise in good faith, the court may assess all or a portion of the costs and expenses of the action against such person.

(2) If the fair value of the shares as determined by the court materially exceeds the amount of the last offer made by the corporation prior to the time a petition was filed pursuant to subsection (f) and the court finds that the corporation's last offer was arbitrary, vexatious, or was otherwise not made in good faith, the court may assess all or a portion of the costs and expenses of the action against the corporation.

(3) Expenses assessable under subsections (1) and (2) shall include reasonable compensation for and reasonable expenses of any appraisers appointed by the court, and the reasonable fees and expenses of counsel for and experts employed by any party.

(4) Except as provided in subsections (1) and (2), the legal costs of an action filed pursuant to subsection (f) shall be assessed on an equal basis

between the corporation and any party exercising rights under this section, and all other fees and expenses shall be borne by the party incurring the fees and expenses.

(j) Any shareholder may waive his and his estate's and heirs' rights under this section by a signed writing.

(k) This section shall not be construed to prohibit any other agreement not prohibited by law that provides for the purchase of shares of the corporation, nor shall it prevent a shareholder from enforcing any other remedy he may have.

Comment: 1. This section, which is operative only if the articles of incorporation specifically so provide, is designed to guarantee a buy-out at the death of a shareholder. By including appropriate language in the articles, the mandatory buy-out authorized by this section can be limited to the death of one or more specified shareholders, or to shareholders holding a particular class of stock. It can also be expanded to cover other contingencies, for example retired or disabled shareholders. In fact, the decision to have any kind of mandatory buy-out is optional. The procedure to implement the election is to specify in the articles of incorporation that section 14 applies and to state any variation in the statutory scheme.

This section is intended to work in tandem with the share transfer restrictions in section 4. The main conceptual difference between the two sections is that under the share transfer restrictions, there is no obligation to purchase whereas under this section, unless the corporation is willing to be dissolved, the shares must be purchased by the corporation or the other shareholders if the estate wants to sell.

The statutory scheme is limited to giving the estate or heirs of a deceased shareholder the right to compel a purchase of the decedent's shares since this is the situation most often covered in privately drafted contractual buy-outs. The problems caused by the illiquidity of close corporation stock are most acute in this situation because the estate frequently needs cash for estate taxes and other purposes. At the same time the remaining shareholders are often concerned about having the decedent's spouse and children involved in the management of the corporation. A significant amount of shareholder litigation involving close corporations involves disputes between the surviving shareholders and the successors in interest of a deceased shareholder. Having a guaranteed market for the decedent's stock reduces the likelihood that such disputes will arise. Life insurance can be used to fund part or all of the purchase obligation. In the absence of available cash, an installment arrangement will help to alleviate any financial strain on the corporation. The remaining shareholders can agree to purchase some or all of the shares or find a third party purchaser if it is undesirable for legal or financial reasons for the corporation to purchase all the offered shares.[26] Furthermore, if the parties do not have an existing agreement containing a binding price formula or other typical terms contained in such agreements and are unable to agree voluntarily on the price or other terms, a court action can be brought in which the judge has wide discretion to resolve the differences and to structure a buy-out plan that will not create an unrealistic financial drain on the corporation.

In summary, assuming some sort of mandatory buy-out in a particular situation is desirable, the major advantage of electing section 14 is that it provides basic protection in the event the shareholders have failed to enter into an appropriate private agreement, or have a buy-out agreement but have failed to agree upon a buy-out price formula, or have a formula but have neglected to provide other necessary terms such as interest rates or number of installments in the event deferred purchases are authorized or necessary. This section does not prohibit the shareholders from having an all inclusive private buy-out agreement drafted by competent counsel. An attorney may wish, however, to use the provisions of section 14 as the basis of the agreement, making such additions and modifications as are deemed necessary. This procedure could substantially reduce the amount of drafting the attorney will have to undertake.

2. Under subsections (b) and (c) the statutory provisions authorized in this section can be modified by a two-thirds vote of all the shares. Subsection (c) further provides that a shareholder who votes against a modification that terminates or substantially alters buy-out rights he previously had under this section will have dissenters' rights to obtain the fair value of his shares. Dissenters' rights are also granted to dissenting shareholders at the time close corporation status is elected or terminated.[27]

3. Subsection (d) sets out the mechanics of exercising the buy-out option. The procedures are similar to those in section 4 relating to third party offers. Subsection (d) requires that the selling shareholder offer all of his shares for sale under the buy-out on the premise that a shareholder having a right to cash out of the corporation ought to divest himself of all stock interest in the business. If he wants to offer less than all his shares, he is still free to pursue his rights under the corporation's stock transfer restrictions.

4. The rationale behind a court suit to determine the fair value and other terms of the buy-out authorized in subsection (f) is explained in comment 1. The power of the court to allocate all costs and attorneys' fees associated with the suit should provide an adequate incentive for both sides to act in good faith. No court action will be necessary, however, where the buy-out price and other terms are established pursuant to a written agreement among the shareholders or provisions in the articles of incorporation or by-laws.

If a suit to determine the fair value is brought, the court has wide discretion to include in its order any conditions it feels are justified on the basis of the financial and other needs of both the selling shareholder(s) and the purchaser.

26. *See also* comment 6 *infra*.

27. *See* sections 3, 7, and 8 *supra*.

The court, for example, could authorize an installment sale. The order would include a provision for interest and could require collateral to secure the unpaid installments.

5. If stock is not purchased or the purchasers default, the shareholder has the right to file for dissolution of the corporation. The court, however, could deny the petition for good cause shown This guarantees that there will be a hearing on the matter and the corporation will have one last opportunity to avoid dissolution. The basic idea behind the concept of mandatory dissolution in the event the offered stock is not purchased is to provide a strong motivation for the corporation and the remaining shareholders either to purchase the stock themselves or to find someone else who will do so. Presumably, the corporation and other shareholders would refuse to purchase if the corporation's financial prospects were bleak. If this is the case, then dissolution may be the appropriate solution. Under other provisions of this section there is sufficient time for the other shareholders to come up with a purchasing group and a court has the power to authorize an installment purchase and any other terms that are necessary in order to enable the purchasing group to finance the purchase without bankrupting the corporation or other purchasers.

6. The ability of a corporation to redeem its shares is subject to legal limitations which vary from state to state. Some states apply the same limitations that apply to dividends. Others, however, apply a different test. A wide variety of insolvency and surplus tests, sometimes in combination, exist. Where corporate indebtedness is incurred in connection with a redemption, it is unclear in many states whether the applicable test must be met at the time the transaction is entered into, at the time payments are made, or at both times. The priority ranking of redemption-related corporate debt is also unclear in many states.

Redemptions also involve complex tax considerations. Some redemptions, principally those that satisfy the requirements of sections 302 and 303 of the Internal Revenue Code, can qualify for taxation at capital gains rates. If not, they will be taxed as dividends under section 301.

This section is designed to provide maximum flexibility for the affected parties to negotiate a purchase scheme that will take into account these complicating factors. For example, under subsection (c), a portion or all of the purchase of the decedent's shares can, with shareholder approval, be allocated to the remaining shareholders or third parties. This provides the framework for allowing the interested parties to allocate the stock in a manner which minimizes the corporate law and tax problems discussed above. If a mutually acceptable allocation cannot be agreed upon, the selling shareholder can, pursuant to subsection (f), reject the offer made by the corporation and file a petition requesting the court to resolve the differences. In framing its decree, the court has the duty to take these problems into account. In addition, subsection (g) specifically authorizes the court to modify its decree on the basis of legal as well as financial constraints.

Flexibility to deal with other tax problems is also built into this section. If certain conditions are met, it is possible to defer the payment of the estate tax on the deceased shareholder's estate for up to 15 years under section 6166 and ten years under section 6166A and to pay an interest rate on the deferred tax at a rate considerably lower than the normal rate applicable to late payments. A redemption keyed into maximum use of these provisions can in appropriate cases be quite advantageous to both the estate of the deceased shareholder and the corporation. Nothing in this section would prohibit the estate of the deceased shareholder and the corporation from working out such a plan with the aid of competent tax and corporate counsel.

An additional tax problem involves the weight in a tax valuation case that will be accorded the price set for shares in a buy-out agreement. If the buy-out price formula meets certain criteria, it will be deemed controlling for estate tax purposes. Competent tax counsel should be consulted to determine what adjustments, if any, will be necessary to achieve this result under a section 14 buy-out agreement.

SECTION 15. SHAREHOLDER OPTION TO DISSOLVE THE CORPORATION

(a) The articles of incorporation of a statutory close corporation may grant to any shareholder, or to the holders of any specified number or percentage of shares of any class or classes, an option to have the corporation dissolved at will or upon the occurrence of any specified event or contingency. Whenever any such option to dissolve is exercised, the shareholders exercising the option shall give written notice thereof to all other shareholders. After the expiration of 30 days following the sending of the notice, the dissolution of the corporation shall proceed as if the required number of shareholders having voting power had consented in writing to dissolution of the corporation as provided in section [82 of the MBCA] of the [general] business corporation act.

(b) Unless the articles of incorporation otherwise provide, an amendment to the articles of incorporation to include, modify, or delete a provision authorized by subsection (a) shall be approved by the holders of all the outstanding shares, whether or not otherwise entitled to vote thereon, or all of the subscribers or all of the incorporators, as the case may be.

Comment: The purpose of this section is to give shareholders in a statutory close corporation, if the shareholders so elect, basically the same power to dissolve the business as general partners have under the Uniform Partnership Act. The section only applies if notice of its applicability is included in the corporation's original or amended articles of incorporation. The right can be given to a single shareholder or any group of shareholders and can be exercised for any reason or restricted to certain designated circumstances. Any rights under this section are in addition to any other rights a shareholder might have under the state's general business corporation or professional corporation acts or this Supplement to dissolve the corporation.

Similar provisions have been adopted in several states having close corporation legislation.[28]

The possible impact of a provision authorized by this section on the tax status of the corporation under the tax classification regulations[29] should be reviewed with the corporation's tax adviser.

SECTION 16. POWER OF COURT TO GRANT RELIEF IN CERTAIN CIRCUMSTANCES

(a) Any shareholder of record, the beneficial owner of shares held by a nominee, or the holder of voting trust certificates of a statutory close corporation may file a petition in the [ ] court for relief on the grounds that:

(1) The directors or those in control of the corporation have or will have acted in a manner that is illegal, oppressive, fraudulent, or unfairly prejudicial to the petitioner, whether in his capacity as a shareholder, director, officer, or employee of the corporation; or

(2) The directors or those in control of the corporation are so divided respecting the management of the corporation's affairs that the votes required for action cannot be obtained and the shareholders are unable to break the deadlock, with the consequence either that the corporation is suffering or will suffer irreparable injury or that the business and affairs of the corporation can no longer be conducted to the advantage of the shareholders generally; or

(3) Conditions exist that would be grounds for involuntary dissolution of the corporation.

(b) The jurisdiction of the court shall be plenary and exclusive. If the court finds that one or more of the conditions specified in subsection (a) exist, it shall grant such relief as in its discretion it deems appropriate, including, without limitation, orders granting one or more of the following types of relief:

(1) Cancelling, altering, or enjoining any resolution or other act of the corporation;

(2) Directing or prohibiting any act of the corporation or of shareholders, directors, officers, or other persons party to the action;

(3) Cancelling or altering any provision contained in the articles of incorporation or by-laws of the corporation;

(4) Removing from office any director or officer, or ordering that a person be appointed a director or officer;

(5) Requiring an accounting with respect to any matters in dispute;

(6) Appointing a custodian to manage the business and affairs of the corporation;

28. *See, e.g.*, Del. Code Ann., tit. 8 § 355.
29. Treas. Regs. §§ 301.7701-1 through 3.

(7) Appointing a provisional director who shall have all the rights, powers, and duties of a duly elected director and shall serve for the term and under the conditions established by the court;

(8) Ordering the payment of dividends;

(9) If the court finds that the relief specified in paragraphs (1) through (8) is or would be inadequate or inappropriate, ordering that the corporation be liquidated and dissolved unless either the corporation or one or more of the remaining shareholders has purchased all of the shares of another shareholder at their fair value by a designated date, with the fair value and terms of the purchase to be determined as provided by subsection (d). In the event the share purchase is not consummated and the corporation is dissolved and liquidated, any shareholder whose shares were to be purchased shall have the same rights and priorities in the assets of the corporation as would have been the case had no purchase been ordered by the court.

(10) Ordering liquidation and dissolution, but only if grounds exist for ordering involuntary dissolution if the corporation were not a statutory close corporation, or if all other relief ordered by the court has failed to resolve the matters in dispute.

In determining whether to enter a judgment under paragraphs (9) or (10), the court shall take into consideration the financial condition of the corporation but shall not refuse to order liquidation solely on the grounds that the corporation has earned surplus or current operating profits.

(11) Awarding damages to any aggrieved party in addition to or in lieu of any other relief granted.

(c) If the court determines that any party to a proceeding brought under this section has acted arbitrarily, vexatiously, or otherwise not in good faith, it may award reasonable expenses, including attorneys' fees and the costs of any appraisers or other experts, to one or more of the other parties.

(d) If the court orders relief pursuant to subsection (b)(9), the court shall:

(1) Proceed to determine the fair value of the shares to be purchased, considering the going concern value of the corporation, any agreement among some or all of the shareholders fixing a price or specifying a formula for determining the value of the corporation's shares for any purpose, the recommendations of any appraisers appointed by the court, any legal constraints on the ability of the corporation to acquire the shares to be purchased, and other relevant evidence.

(2) Enter a decree specifying the identity of the purchaser and the terms of the purchase found to be proper under the circumstances, including such provisions as are deemed proper concerning payment of the purchase price in two or more installments, payment of interest on the installments, subordination of the obligation to the rights of other creditors of the corporation, security for the deferred purchase price, and a covenant not to compete or other restriction on the selling shareholder.

(3) Order that the selling shareholder shall, concurrently with the payment of the purchase price, or in the event of an installment purchase, concurrently with the payment of the initial payment called for in the order, make delivery of all his shares and from that date have no rights or claims against the corporation or its directors, officers, or shareholders by reason of his having been a director, officer, or shareholder of the corporation, except the right to receive the unpaid balance of the amount awarded him under this section and any amounts due under any agreement with the corporation or the remaining shareholders that are not terminated by the court's orders.

(4) Order that if the purchase is not completed in accordance with the court's decree, the corporation shall be liquidated.

(e) Except as otherwise provided in subsections (f) and (g), the rights of a shareholder to file a proceeding under this section are in addition to and not in lieu of any other rights or remedies the shareholder may have.

(f) No shareholder shall be eligible to file an action under this section until he shall have exhausted any non-judicial remedy for resolution of the issues in dispute to which the shareholder has agreed in writing.

(g) If a shareholder has the right to dissent from any proposed action and to receive the fair value of his shares under any provision of this Act or the [general] business corporation act, any action under this section brought in respect to the proposed action shall be filed prior to the time limitation for a dissenting shareholder to file with the corporation notice of intention to dissent and to demand fair compensation specified in section [ ] of the [general] business corporation act.

Comment: 1. This section is derived from similar provisions in California, Michigan, Minnesota, New Jersey, and South Carolina, which in turn are derived from section 210 of the 1948 English Companies Act.[30] There are two major differences between these other statutes and this provision: (1) the existing statutes specifically or by implication require that a shareholder have grounds to force a dissolution of the corporation whereas this provision does not tie the relief to either a dissolution suit or the establishment of grounds for dissolution; and (2) the range of relief available to the court is spelled out in greater detail.

The primary danger in tying relief for oppression and related conduct to dissolution is that dissolution is such a radical remedy that courts have traditionally refused to issue a dissolution order if the corporation was solvent except in extreme cases of fraudulent conduct. Moreover, even though authority may exist to grant relief other than dissolution, some courts have been reluctant to grant any relief unless the fact situation itself justifies dissolution. This approach makes the grounds for relief much too narrow to protect in an adequate fashion the rights of minority shareholders. At the same time the threat of dissolution gives minority shareholders a powerful weapon to hold over the head of the corporation. Under the Supplement dissolution is one type of relief that can be ordered by the court, but it is appropriate only as a last resort after other possibilities of resolving the dispute have failed. If a shareholder genuinely wants the corporation to be liquidated, he is entitled to bring an action for dissolution under the state's general business corporation act, assuming he can qualify to bring the proceeding, or under a right to dissolve pursuant to section 15.

30. *See* Cal. Corp. Code § 1800 (West); Mich. Comp. Laws Ann. § 450.1825 (1978); Minn. Stat. Ann. § 301.49(3); N.J. Stat. Ann. § 14A:12-7; S.C. Code Ann. § 33-21-150 (1976).

While this section probably will be invoked most frequently by minority shareholders, subsection (a)(2) can be used by the holders of the majority of shares to seek relief from deadlocks created by veto rights given minority shareholders that seriously threaten the corporation's continued viability. Moreover, even in a suit filed by minority shareholders, the court has the power to order the petitioning shareholders to sell their stock to the corporation or the remaining shareholders, even if this is not one of the types of relief requested.

Relief under this section is circumscribed to minimize the danger of abuse by shareholders. No relief of any kind can be ordered unless the court affirmatively finds that one or more of the specific conditions listed in subsection (a)—fraud, oppression, unfairly prejudicial conduct, deadlock, or grounds for involuntary dissolution—exist. The petitioners have the burden of proof on this issue. Moreover, the power of the court to award expenses and attorney fees to either side should effectively discourage harassment suits. Furthermore, if the complaining shareholder has agreed to arbitrate the dispute in question or to resolve such dispute in any other non-judicial manner, these remedies must, pursuant to subsection (f), be exhausted before a suit under this section can be properly filed.[31]

2. *Subsection (a).* Only shareholders of record, beneficial owners of shares held by a nominee, or the holders of voting trust certificates can bring an action under this section. This parallels the limitations imposed on shareholder derivative actions under revised section 49 of the MBCA. Relief will be granted if any of the three categories of circumstances specified exist.

Paragraph (1) is designed primarily to provide relief from oppression and related conduct that adversely affects a minority shareholder in any capacity he has with the corporation. Attempted squeeze-outs in close corporations often involve removing a shareholder from his various offices or diminishing his compensation. The paragraph makes it clear that relief is not restricted to situations having an adverse effect on the value of the shareholder's stock interest.

No attempt is made to define oppression, fraud, or unfairly prejudicial conduct. These are of necessity elastic terms whose meaning varies with the

31. *See also* comment 4.

circumstances presented in a particular case, and it is felt that existing case law provides sufficient guidelines for courts and litigants.[32]

An action to enjoin a proposed act by the corporation can also be brought if the proposed act would result in fraud or oppression or would be unfairly prejudicial to the rights of the petitioner. Subsection (g), however, prohibits a section 16 suit in a situation where the shareholder has dissenters' rights unless the suit is filed before the time limit for the notice of intent to dissent. See comment 4 for further explanation of subsection (g).

Paragraph (2) is designed to allow relief when the corporation is deadlocked. As was pointed out in comment 1, majority shareholders can claim relief under this subsection. Relief can be granted even though the corporation's financial condition is not threatened with irreparable injury if the court finds that the interest of all the shareholders is being damaged by the deadlock.

Paragraph (3) allows a shareholder to obtain relief under this section whenever grounds for involuntary dissolution exist. The advantage of filing the action under this section is the greater range of relief that is available. The petitioning shareholder may not want the corporation dissolved, even though technically adequate grounds for dissolution exist.

3. *Subsections (b)-(d).* The purpose of listing the types of relief available is to overcome the reluctance some courts have shown in the past to ordering anything other than dissolution or possibly a buy-out, in the absence of any alternative relief being specified in the operative statute.[33] A court needs broad discretion in order to fashion the most appropriate remedy to resolve the dispute. What will work in one case may not work in another. Detailed standards are not provided on the grounds that such standards might overly encourage suits and also unduly restrict the court's discretion. Existing cases applying principles of equity, will, of course, be precedents that will operate to limit a judge's discretion.

Although most close corporation statutes contain special provisions similar to paragraphs (6) and (7) of subsection (b) authorizing the appointment of custodians and provisional directors, the number of actual cases where such appointments will be the most appropriate remedy are probably quite small. Having an outsider run the company or act as a tie-breaker in a deadlock situation may exacerbate rather than alleviate the internal dissension.

A mandated buy-out is a radical remedy, particularly if the shareholder ordered to sell his shares does not want to sell. This is the reason why subsection (b) (9) authorizes a share purchase order only when other relief short of liquidation will not, in the judge's opinion, resolve the dispute. If a buy-out ordered by the court is not consummated, however, an order dissolving the corporation is authorized. This places pressure on the remaining shareholders to obey the order but gives them the option of liquidation if they think the order is too onerous.

If the court orders a buy-out, it must also determine the fair value and other terms of the buy-out in accordance with subsection (d). The fair value would be determined under principles developed in dissenters' rights and other valuation cases. The court is authorized to require the selling shareholder to enter into a covenant not to compete and also to authorize an installment sale in order to protect the business and to minimize the financial strain on the purchasers.[34]

The designated purchasers have a choice: they can consummate the purchase or the corporation will be liquidated. The remaining shareholders would presumably elect to have the corporation liquidated if its economic prospects are bleak. Leaving the choice to the remaining shareholders is fairer than mandating a liquidation without any opportunity to buy-out the complaining shareholder and fairer than mandating a buy-out without the option of voluntary dissolution (unless the remaining shareholders hold sufficient voting shares to approve a dissolution).

If the remaining shareholders agree to comply with the court ordered buy-out, the sale basically operates as a release of all claims the selling shareholder has against the corporation, or its directors, officers, or shareholders. The selling shareholder would still have the right to pursue any contractual claim he might have against the corporation, for example a claim for breach of a long term employment contract, to the extent such claims are not dealt with in the court's order. Normally, however, the order would include relief for these contractual claims. The selling shareholder would also retain the right to collect any unpaid balance due on the purchase price, including the right to realize on any collateral given as security for the unpaid balance. Quite frequently the shares being sold in the buy-out will be the security. If there is a default, the former shareholder has the choice of foreclosing on the note and becoming a shareholder or filing to have the corporation liquidated under subsection (b) (10).

Should the remaining shareholders elect not to consummate the purchase and the corporation is liquidated, the selling shareholder has the same priority in liquidation as would have been the case if no buy-out had been ordered. In other words, the selling shareholder will not have the status of a creditor by reason of the buy-out order.

The court would have the power to modify its final order at any time upon the petition of any party. One circumstance where modification would be appropriate is where financial or legal constraints prevent the purchasers from fulfilling the terms of a mandated buy-out.[35]

32. *See e.g.*, Annot., 56 A.L.R.3d 358 (1974).

*33. *See, e.g.*, Greensberg v. Goldmine Plantation, Inc., 360 So.2d 884 (La. Ct. App. 1978); Harkey v. Mobley, 552 S.W.2d 79 (Mo. Ct. App. 1977); and White v. Perkins, 213 Va. 129, 189 S.E. 2d 315 (1972).

34. *See also* comment 6 to section 14, *supra*.

35. *See also* comment 6 to section 14, *supra*.

The purpose of subsection (c), which gives the court power to allocate costs and attorney fees, is explained in comment 1 of this section.

4. *Subsections (e)-(g).* Subsection (e) makes it clear that the remedies available under this section are cumulative and in addition to any other remedies the petitioner might have, except as otherwise provided in subsections (f) and (g).

Under subsection (f), any nonjudicial remedies which the petitioning shareholder has agreed to use must be exhausted before a suit under this section can be brought. Arbitration clauses covering a wide variety of intracorporate disputes are commonly included in shareholder agreements. If a dispute is covered by any arbitration agreement, the shareholder must submit the claim to arbitration prior to filing any suit under this section and the right to file under this section after the arbitration proceeding would depend on the preclusive effect of the arbitration under state law.

The requirement in subsection (g) that a shareholder who has dissenters' rights with respect to a transaction file a suit challenging the transaction under this section prior to the limitation period for claiming dissenters' rights is designed to prevent a shareholder who has foregone his dissenters' rights from having the option to file a suit under this section to prevent a proposed transaction from being consummated. If the complaining shareholder has not taken timely action to perfect his dissenters' rights, he would be relegated to whatever other rights might be available under state or federal law. If the shareholder does file a timely action under this section, the court must first determine whether relief under this section is warranted. If the court finds that a share purchase is the appropriate remedy, the proceeding should be treated as a fair value proceeding in a dissenters' rights case and consolidated with any other similar dissenters' rights proceedings involving the same transaction.

SECTION 17. LIMITED LIABILITY

The failure of a statutory close corporation to observe usual corporate formalities or requirements relating to the exercise of its corporate powers or the management of its business and affairs shall not be grounds for imposing personal liability on the shareholders for obligations of the corporation.

Comment: The purpose of this section is to prevent a court from holding the shareholders in a statutory close corporation individually liable for the debts and torts of the business because the corporation does not follow the classical model of a corporation. Pursuant to sections 10, 11, and 15, a statutory close corporation can in effect function like a partnership. Nevertheless, legally the business is still a corporation.

This section would not prevent a court from piercing the corporate veil of a statutory close corporation if the circumstances would justify imposing personal liability on the shareholders had the corporation not been a statutory close corporation. It merely prevents a court from piercing the corporate veil because it is a statutory close corporation.

The section is derived from the California close corporation provisions.[36]

SECTION 18. EXECUTION OF DOCUMENTS IN MORE THAN ONE CAPACITY

Any individual who holds more than one office in a statutory close corporation may execute, acknowledge, or verify in more than one capacity any instrument required to be executed, acknowledged, or verified by the holders of two or more offices, notwithstanding any contrary provision of law.

Comment: This section, which is derived from the Maryland close corporation provisions, is designed to facilitate the authentication of documents in a statutory close corporation. Many small corporations only have one shareholder or one officer.[37]

SECTION 19. EFFECT OF INVALIDITY OF PART OF THIS ACT

If any provision of this Act or its application to any person or circumstances is held invalid, the invalidity shall not affect other provisions or applications of the Act which can be given effect without the invalid provision or application, and to this end the provisions of this Act are severable.

Comment: None.

SECTION 20. REPEALS

(a) The following acts and parts of act are repealed:

(b) The repeal of a prior act or portion thereof by this Act shall not affect any right accrued or established, or any liability or penalty incurred under the provisions of such act prior to the repeal thereof.

Comment: Refer to the comment to Model Business Corporation Act section 150.

SECTION 21. EFFECTIVE DATE

This Act shall become effective at midnight on [ ] and shall apply to statutory close corporations filing articles of incorporation meeting the requirements of section 3 after that date and time.

Comment: None.

SECTION 22. TRANSITIONAL PROVISION

[A provision will need to be enacted by states that repeal an integrated close corporation statute adopted prior to the Close Corporation Supplement. This

36. Cal. Corp. Code § 300(e) (West).

37. *See* Md. Corp. and Ass'ns Code Ann. § 4-102.

Provision should provide a set period of time during which corporations qualifying under the repealed statute can elect to opt in or out of the new Act, the procedure for making the election, and the effect of the election on any existing agreements among the shareholders.]

APPENDIX

ARTICLES OF INCORPORATION FOR A STATUTORY CLOSE CORPORATION[1]

(File This Form In Duplicate Original. If The Space Provided In This Form Is Insufficient, Please Attach Additional Sheets Containing A Reference To The Appropriate Paragraph In This Form.)

1. The name of the proposed corporation is .... This corporation is a Statutory Close Corporation.
2. The initial registered office of the corporation is .... located in the city of .... state and zip code ...., county of ...., registered agent at such address is .... If different from the street address, the mailing address at the registered office is ....
3. The period of duration of the corporation shall be perpetual unless otherwise specified (................ years).
4. The general nature of business for which the corporation is organized is (please note that it is not necessary to set forth in this clause any of the powers enumerated in section [ ] of the [general] business corporation act):
5. The corporation is authorized to issue shares of stock as follows:

Class of Shares	Authorized No. of Each Class	Par Value[2]
....	....	....
....	....	....
....	....	....
....	....	....
....	....	....

If shares are divided into two or more classes or if any class of shares is divided into series within a class, the relative rights, preferences, and limitations of the shares of each class, or of each series within a class, are as follows:

6. The total authorized capital stock is ....
7. Unless specified otherwise below, the transfer of shares of stock of the corporation shall be subject to the restrictions set out in [section 4 of the Statutory Close Corporation Supplement], which are printed on page of

1. Additional special forms will have to be devised for existing corporations electing close corporation status and for amended articles of statutory close corporations. Items 1 and 6–9 plus the note at the end of the form and the statutory materials printed on the basic articles of incorporation form should be included in these forms.
2. States that have adopted provisions similar to the new MBCA financial provisions will not have to provide the column for par value. *See* 34 Bus. Law. 1867 (1979).

this form. ☐ Stock transfer restrictions other than those in [section 4 of the Close Corporation Supplement] are in effect. If the applicable stock transfer restrictions are not set forth in these articles, a copy will be on file in the corporation's registered office.

8. The corporation ☐ shall
☐ shall not
have a board of directors. If corporation has a board of directors, specify the names and addresses of the persons who are to serve as the initial directors of the corporation.

Name	Address
....	....
....	....
....	....
....	....
....	....

9. The optional provisions which the incorporators elect to include in the articles of incorporation are (a complete list of the available options with statutory references is printed on page of this form):

1.
2.
3.

10. The name and address of each incorporator is:

Name	Street & Box No.	City	County	State
......	....	....	....	......
......	....	....	....	......
......	....	....	....	......
......	....	....	....	......

*11. The corporation shall not begin business until there has been paid into the corporation in return for shares of stock the minimum amount specified in section [ ] of the [general] business corporation act, which is $............... [of which at least $............... is in cash].

*12. [Each of the undersigned, being all the incorporators of this corporation, hereby certifies that he has read the foregoing document, understands the meaning and purport of the statements therein contained and the same are true to the best of his information and belief.]

*Provisions required to be part of the articles by the general business corporation statutes of some states.

Sworn to and signed by the above named incorporators this .... day ...., 19 .

Signature	Type or print name
....	....
....	....
....	....

NOTE: All share certificates (and where the corporation has uncertificated shares, the initial transaction statements) issued by a statutory close corporation must contain the following notice:

THE RIGHTS OF SHAREHOLDERS IN A STATUTORY CLOSE CORPORATION MAY DIFFER MATERIALLY FROM THE RIGHTS OF SHAREHOLDERS IN OTHER CORPORATIONS. COPIES OF THE ARTICLES OF INCORPORATION AND BY-LAWS, SHAREHOLDERS' AGREEMENT, OR OTHER DOCUMENTS, WHICH MAY RESTRICT TRANSFERS AND AFFECT VOTING AND OTHER RIGHTS, MAY BE OBTAINED BY A SHAREHOLDER ON WRITTEN REQUEST TO THE CORPORATION.

Editor's note. The section's Committee on Corporate Laws developed the Model Business Corporation Act, and from time to time proposes and effects changes in it. A report on the final approval of that committee of the addition of a new supplement—the Statutory Close Corporation Supplement to the Model Business Corporation Act—appears below.

Statutory Close Corporation Supplement to the Model Business Corporation Act

A Report of COMMITTEE ON CORPORATE LAWS

In the November 1981 issue of *The Business Lawyer*,* notice was given that the Committee on Corporate Laws had approved on second reading a proposed Statutory Close Corporation Supplement to the Model Business Corporation Act. The committee invited, received, and considered letters of comment on the proposed Supplement.

At its meeting on June 26, 1982, the Supplement and related comments were adopted by the committee upon third and final reading. The following changes in the text and comments as printed in *The Business Lawyer* (November 1981) were approved:

(1) The introductory comment was amended to include Alabama, Minnesota, and Ohio in the list of states that have recently adopted close corporation legislation; and to add language more clearly indicating that the Supplement is merely model legislation for states that decide it is advisable to have integrated special statutory provisions for close corporations. A list of situations where lawyers and their clients will likely consider a corporation electing to be governed by the Supplement advantageous was also included in this comment.

(2) Section 6, which gives a statutory close corporation a thirty-day option to purchase shares that are transferred in breach of transfer restrictions, was amended by adding after the word "transferee" in line 4 the following language: "either because the notice required by Section 5 has not been given or because the restriction prohibiting the transfer is held by court order to be unenforceable." As amended, section 6 states:

> Any attempted transfer of shares in a statutory close corporation in violation of any transfer restriction binding on the transferee shall be ineffective. Any attempted transfer of shares in a statutory close corporation in violation of any transfer restriction not binding on the transferee either because the notice required by Section 5 has not been given or because the restriction prohibiting the transfer is held by court order to be unenforceable, shall give the corporation the option, exercisable by notice

*See Report of Committee on Corporate Laws, *Proposed Statutory Close Corporation Supplement to the Model Business Corporation Act*, 37 Bus. Law. 269 (1981).

> and payment within 30 days after presentation of the shares for registration in the name of the transferee, to purchase the shares from the transferee for the same price and terms.

(3) Comment 2 to section 10 was amended to make it clear that whenever a statutory close corporation has no board of directors, the shareholders with voting shares have the authority to delegate management responsibilities to one or more persons. In this instance, the delegating shareholders will have the same legal liability as directors who have delegated responsibility to agents.

(4) Section 14(a), which, if operative, gives the estate of a deceased shareholder the option of requiring the corporation or other shareholders to purchase the decedent's shares, was amended by striking from line 2 the words "or heirs" and inserting after the word "the" and before the word "estate" the phrase "executor or administrator of the"; and inserting in line 3 after the word "shall" and before the word "have" the following: "subject to any directions in the deceased shareholder's last will and testament." As amended, section 14(a) states:

> If the articles of incorporation of a statutory close corporation provide that this section shall apply to the corporation, the executor or administrator of the estate of any deceased shareholder shall, subject to any directions in the deceased shareholder's last will and testament, have the right to require the corporation to elect either to purchase or cause the purchase of all, but not less than all, of the shares of the decedent pursuant to subsections (d) through (f), or to be dissolved.
>
> Comment 1 to section 14 was amended to reflect this change. Language specifying the four major types of buy-out schemes was also added to comment 1.

(5) A new comment 2, pointing out the risks involved in giving one or more shareholders a special dissolution right, was added to section 15.

(6) Section 16(a)(1) was amended to eliminate the possibility that a shareholder who was an employee but not an officer of a statutory close corporation could file a section 16 action based solely on alleged prejudicial action relating to his or her employment status with the corporation. As amended, section 16(a)(1) states:

> The directors or those in control of the corporation have or will have acted in a manner that is illegal, oppressive, fraudulent, or unfairly prejudicial to the petitioner, whether in his capacity as a shareholder, director, or officer of the corporation; or. . . .

RECEIVED MAR 2 0 1984

ALASKA STATE SENATE

JOE P. JOSEPHSON
DISTRICT G · ANCHORAGE
1526 F STREET
ANCHORAGE, ALASKA 99501
(907) 277-4419

COMMITTEES
HEALTH, EDUCATION & SOCIAL SERVICES (CHAIR)
JUDICIARY (VICE-CHAIR)
FINANCE
MAJORITY CAUCUS (CHAIR)

WHILE IN JUNEAU
POUCH V
JUNEAU, ALASKA 99811
(907) 465-4907
(907) 465-4525

March 16, 1984

Stanley H. Reitman, Esquire
Delaney, Wiles, Hayes, Reitman
and Brubaker, Inc.
1007 West Third Avenue
Suite 400
Anchorage, Alaska 99501-1990

Dear Stan:

Thank you for your informative letter of March 12. I noted that copies of the letter were sent to members of the Code Revision Commission, and I appreciate that as well.

I had the opportunity this week to chat with Mr. Abbott. I explained to him that you had indicated via telephone that the Task Group had asked for an opportunity to review SB 246 until the end of March, and that I wished to accommodate that request.

In fairness to everyone, I am requesting that the results of the Task Force work be in hand here by March 31 so that I can then report to the full Judiciary Committee. Of course, at that juncture, the Committee would certainly allow verbal testimony at a public hearing. Another alternative might be for me to conduct a subcommittee hearing in Anchorage, where much of the interest seems to be; if you, Jerry Kurtz, and John Abbott, agree to that procedure, I would be happy to ask Senator Ray to schedule a subcommittee session in Anchorage at the end of March or very early in April.

I look forward to hearing from you, John and Jerry again soon.

EXHIBIT B

With best wishes, I am

Sincerely,

Joe P. Josephson
State Senator

JPJ:rak

cc: John Abbott, Esq.
L. S. Kurtz, Jr., Esq.

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ROBERT L. EASTAUGH
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MARC D. BOND
J. MICHAEL MOXNESS
J. D. CELLARS
GREGORY J. MOTYKA
JAMES B. FRIDERICI

March 30, 1984

Senator Joseph P. Josephson
Alaska Senate
Capitol, Room 508/510
Juneau, Alaska 99811

Dear Senator Josephson:

It is my understanding you are currently considering conducting the subcommittee hearing described in your March 16, 1984 letter, on or about Saturday, April 7, 1984 in Anchorage.

To better understand the backdrop for Professor Fessler's "vigorous" position on Section 488 (Secondary Liability of Directors and Officers) as enunciated in his defense thereof in his afternoon rebuttal at the Joint House Committee public hearing in Anchorage, on February 24, 1984, and to secure an invaluable insight into the Fessler philosophy that permeates his work, on which the Alaska Code Revision Commission (ACRC) has heavily relied, the enclosed Memorandum or "position paper" of Professor Fessler to the Code Revision Commission (Appendix 1 hereto), and particularly pages 2 through 22 regarding statutory recognition of the "Close Corporation", is very instructive. I suggest such position paper and my March 12, 1984 letter to you, be made part of the record of the contemplated April 1984 subcommittee hearing and be carefully considered by the Senate Judiciary Committee.

Ostensibly dealing with the concept of close corporations (family corporations and entities with relatively few shareholders), Professor Fessler's "views" on the corporate form for business activities, figuratively leap out at you in the subject Memorandum. Clearly, Professor Fessler does not approve of the corporate vehicle because of its purported employment to

(1) avoid risk or personal liability, and
(2) mitigate federal income taxation.

EXHIBIT C

In pages 2-22 of Appendix 1 Professor Fessler makes a number of personal observations on:

(a) the alleged adverse economic impact of corporations acquiring scarce investment (non-debt) capital thereby driving up the cost (interest rates) to all competitors;

(b) corporate abuse of misguided federal tax policies;

(c) the unfortunate tilt of law school curricula toward undue emphasis on the corporation at the expense of other more worthwhile subjects;

(d) proliferation of corporations; and

(e) the unseemly rush by lawyers and the public to use the corporate form vis-a-vis (i) joint ventures, and (ii) general and limited partnerships.

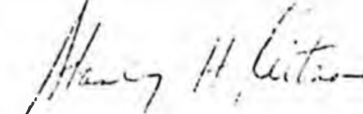
In analyzing close corporation legislation (found in the jurisdictions listed in the last two pages of Appendix 1) which Professor Fessler acknowledges is supported by "many of the most distinguished academicians and business practitioners", Professor Fessler's personal philosophy is vigorously asserted. Professor Fessler clearly views with disdain the "incorporated partnership", exemplified in the close corporation legislative approach employed in a number of jurisdictions (and as you know in the new ABA Revised Model Code).

Given the personal judgments of Professor Fessler, it was and is incumbent on the ACRC to make Professor Fessler's position(s) known to the reader and particularly our legislature, to enable them to more fully and intelligently appreciate the proposed ACRC bill. If Alaskans are to rely heavily on Professor Fessler, as the ACRC has admittedly done, we must with the assistance of one or more economist(s), business leader(s), investor(s), jurist(s), academician(s) plus actual and potential enterpreneur(s), carefully and comprehensively review his entire product and the underlying principles thereof.

Senator Joseph P. Josephson
March 30, 1984
Page -3-

By way of emphasis--Alaskans should have a meaningful opportunity to know more about Professor Fessler's value judgments--I am reasonably sure the majority of our legislators will not concur with them--nor I daresay will the Alaskan business community and Alaska practitioners, once they understand the Fessler Code's underpinnings and implications.

Very truly yours,



Stanley H. Reitman

SHR:jf

cc: Alaska Code Revision Commission
John W. Abbott, Chairman
L. J. Kurtz, Jr., Esq.
Judge Thomas B. Stewart
Alaska Bar Association
Paul D. Kelly, Esq.

TO: The Code Revision Commission, State of Alaska

FROM: Daniel Wm. Fessler, Corporations Code Project

RE: Compliance with Stage II of the Drafter's Obligation: Survey and Recommendations Respecting Statutory Recognition of the "Close Corporation"; and, the Selection of Financials for the New Corporations Code.

Pursuant to agreement with the Commission, Stage II of the drafter's responsibility has been the survey of existing law and the preparation of a memorandum setting forth the choices to be made respecting the fate of closely held business associations and the content of the basic statutory framework restraining the ability of incumbent corporate management to distribute assets under circumstances which threaten the security of creditors and the holders of preferred shares. For the sake of convenience the aspects of a corporations code dealing with the distribution of assets will be termed the "financials."

In meeting his obligations, the drafter has prepared the attached memorandum according to the following divisions:

Part I will deal with the statutory recognition of the close corporation, a creature currently unknown to Alaska law. It will begin with a series of arguments pro and con respecting the desirability of undertaking any statutory concessions to such an association. The second phase of this memorandum will survey the existing state of close corporate legislation in the jurisdictions which have thus far opted for recognition. The final aspect of the drafter's work on this topic has been presentation of a series of

decisions for the Commission to make should it decide upon any statutory concessions to the closely held firm.

Part II will survey three essentially competitive sets of "financials": (1) the balance sheet surplus test as used in New York and a handful of jurisdictions; (2) the earned surplus test employed in Model Act jurisdictions (and currently in use in the State of Alaska); and, (3) the ratio/assets surplus test adopted in the new California Corporations Code. As previously disclosed, the drafter will recommend the adoption of the California Code's financials as best suited to the needs of this jurisdiction.

PART I: THE STATUTORY TREATMENT OF CLOSELY HELD BUSINESS

A. The Social Implications of Incorporation:

Introduction: The revision of the business corporations code presents the State of Alaska with an opportunity to join an impressive array of jurisdictions providing "discrete statutory treatment of the close corporation." It is the purpose of this memorandum to trace in some detail the divergent paths selected by other jurisdictions in attempting to meet this challenge. Should a decision be taken to pursue this objective, the Commission must make several basic decisions for the guidance of the drafter. Yet before determining upon this course, the Commission may wish to consider the wisdom or folly implicit in the basic proposition: should this state modify its corporations code so as to accommodate the asserted special needs of a closely held

association? While the past two decades have witnessed legislative and judicial developments premised upon an affirmative answer, in the mind of the drafter the matter is open, and open to a negative response.

As a creature of the state, a "corporation" is the product of a social contract. Speaking in the most general of terms, the advantages conferred by incorporation include: access to non-debt capital; limited liability; favorable tax treatment; centralization of management; free transferability of interest; and, continuity of life. While these concepts will be explored in this memorandum, to list them is sufficient to prompt the question why society should either incur sacrifice or strain to bestow extraordinary advantage on any private enterprise. For more than a century the answer has been the assumption that incorporation fostered capital formation in the hands of dynamic management with the consequence that wealth was expanded within the society. This is the social contract: concessions and advantages will be allowed in the expectation that the corporate creature will provide employment, goods and services. Any creature which fails to attain these objectives disappoints correlative social expectations. A private project claiming the advantages of incorporation with a predetermined plan to disappoint these public expectations would be branded a fraud. Thus if it were widely suspected that self-styled "close corporations" would fail to attain the objectives defined for corporate accomplishment, one would have doubt as to the wisdom of

tolerating their creation. If it could be established that the essence of the close corporation is a creature congenitally disabled from ever aspiring to the attainment of those objectives, doubts would be resolved against their creation.

In order to serve as the vehicle for capital formation, a corporation is permitted to divide its residual ownership interest into shares which are sold to investors with no obligation that they ever be repurchased. In an era of increasingly prohibitive interest rates, it would be difficult to over-stress the advantage conferred by access to non-debt capital. A further attraction of corporate stock purchase is the legal concession that the risks generated by the incorporated enterprise do not threaten the personal assets of the shareholders. Their liability, or "downside risk", is limited to the invested amount. Income generated by the corporate vehicle is exempted from the steeply progressive rates imposed on all other taxpayers. In combination, these factors encourage initial capital formation while nurturing the growth of capital by leaving a greater "after tax" proportion of earnings in the hands of the corporate vehicle. What is done with the assets so patently fostered? They are divorced from the personal ownership dominion of the investors and placed at the disposal of a centralized management. Unlike the partnership, where all partners have certain rights of participation,[1/] the shareholder is relegated to an

---

[1/] Subject to any agreement among the partners, §18(a) of the Uniform Partnership Act [hereafter cited as the "UPA"] provides: "all partners have equal rights in the management and conduct of the partnership business."

essentially passive posture while elected representatives (the directors) chart the major decisions and determine the officers who implement the corporate objectives. Should an individual shareholder become disenchanted with the direction set by the representatives of the majority, or for any other reason desire to liquidate his investment, the free transferability of shares facilitates both entry and exit from the corporation. Finally, the corporate entity is given an almost perpetual existence by a continuity of life which endures beyond the death or withdrawal of any or all of the original investors.

While the advantages of these features of corporate existence are obvious, there are undeniable disadvantages thrust upon other members of society. If corporations may acquire non-debt capital, their competition for this scarce resource drives up the cost to all competitors. At the macro economic level this is reflected by the relationship between the stock and bond markets. A lively market in "equities" requires an increase in the rate of return on all borrowing if there is to be an effective competition for scarce dollars. More obvious is the disadvantage to a tort claimant who discovers that the injury has been worked by a corporate tortfeasor. If the assets of the corporate entity amount to only seventy cents on the dollar of the inflicted injury, the presence of a "victim" is more than a figure of speech. In the event of bankruptcy or insolvency, contract creditors absorb the losses inflicted by limited

liability. Finally, in the field of taxation, if it is assumed that the government must raise a certain quantum of revenue, then it follows that for every concession to the corporate sector some other sources must be found to make up the short fall. These are the burdens thrust upon some or all of the other members of a society which tolerates corporate enterprise within its midst. For those who elect to enter the family of investors there are disadvantages of a different kind. Parting with funds that need never be repaid and relegation to a passive role are the most obvious.

The point bears repeating: only so long as the benefits to society outweigh this package of burdens is there legitimacy in "incorporation." Private aspirations cannot command this judgment, for they are infected by selfish interest. It is the task of the legislature to strike the balance.

Having sketched in general terms the role of the corporation in modern society, we turn to the asserted need for statutory accommodation of the closely held concern. Although the matter is not free from difficulty in terms of technical implementation, the concept of a closely held corporation is not hard to formulate. Assume that a relatively small number of individuals desire to associate for the purpose of conducting a business. Assume further that they are motivated by family ties or bonds of friendship which inspire an initial confidence in the stability of their association,

but which suggest that they are mutually interested in limiting access to future members. This negative attitude toward the transferability of interest or freedom of admission will produce the conclusion that there will be little or no "market" for ownership rights in this closed entity. The term "closely held" tells the essence of the tale. Now let us assume that this small band of individuals desires incorporation. At first blush it appears a strange ambition. The profile of a corporation presupposes a surrender of individual dominion over property and the aggregation of the "invested assets" in the hands of a centralized management conducted by individuals who may have no proprietary interest in the business at all. The organization resembles a pyramid. There are many shareholders at the base electing a small number of individuals in whom is vested the power of management. These "directors" select the officers who carry into effect the business policies defined by the representative board. In so doing, the officers represent the corporate entity in dealings with all third parties.

The effort to unite individuals small in number and bound by unique qualities or ties with a deliberately impersonal entity, which is the corporation, is somewhat akin to fixing a horse collar upon a flea. The fit is not comfortable; the result is not functional. There are at least two solutions to this problem: radically modify the nature of the corporation; or, desist from the effort. The Commission should be prepared to consider both.

The attraction of "incorporation": Whatever the ultimate opinion as to their merits, it cannot be denied that incorporation is desired by many "closely held" business ventures and that this is encouraged by many attorneys. The professional encouragement is deserving of brief comment.

In the mid-1950's two developments gained momentum in law school curricula which have, by accident or design, influenced much human activity. First, the attraction of "corporations" as a legal discipline was enhanced by an era of rapid economic expansion and popular interest in "high finance" and the role of the federal Securities and Exchange Commission. The expanded scope of this material demanded greater classroom time and it was inevitable that something had to give in order to facilitate this expansion. The candidate for "giving" was the law of agency and partnership. Once the forte of every lawyer's second year of schooling, this material was gradually pushed out of the curriculum. Today, it is formally studied in a handful of law schools, and then generally in upper division courses with small enrollments. The popular and heavily enrolled "business associations or organizations" courses concentrate single-mindedly on the corporation. In such a climate, the advice to incorporate is less the product of wisdom than the result of ignorance of alternatives. Joint ventures and general and limited partnerships have an ancient history and function in the marketplace, but are increasingly neglected. With these advantages unknown and unweighed,

many lawyers will incorporate anything that shows signs of life. . . except the nuclear family. . . but including themselves.

Proponents of close corporations legislation justify their bid on several grounds. They number among their ranks many of the most distinguished academicians and business practitioners.[2/] Their arguments have been found convincing by legislatures in numerous jurisdictions.[3/]

2/ Israels, The Close Corporation and the Law, 33 Cornell L.Q. 488 (1948); Delaney, The Corporate Director: Can His Hands Be Tied in Advance?, 50 Colum. L.Rev. 52 (1950); Hornstein, Stockholders' Agreements in the Closely Held Corporation, 59 Yale L.J. 1040 (1950); Cary, How Illinois Corporations May Enjoy Partnership Advantages, 48 Nw.U.L.Rev. 427 (1953); see also 1953 Symposium on the subject which includes Hornstein, Judicial Tolerance of the Incorporated Partnership, 18 Law & Contemp.Prob. 435 (1953); O'Neal, Giving Shareholders Power to Veto Corporate Decisions: Use of Special Charter and By-Law Provisions, ibid. at 451; Gower, The English Private Company, ibid. at 535, and others contained in the same volume; O'Neal, Molding the Corporate Form to Particular Business Situations: Optional Charter Clauses, 10 Vand.L.Rev. 1 (1956); O'Neal, Developments in the Regulation of the Close Corporation, 50 Corn.L.Q. 641 (1965); Bradley, Toward a More Perfect Close Corporation--The Need for More and Improved Legislation, 54 Geo.L.J. 1145 (1966).

For a heavily documented assertion of most of the pro-concession arguments in the specific context of Alaska's potential interest in close corporation, see Comment, Close Corporations in Alaska, 7 UCLA Alaska L.Rev. 123 (1977). The student author concludes that there is sufficient flexibility under the current general corporations act to accommodate most of the "special needs" of the closely held concern.

3/ To date legislative concessions may be found in Arizona California, Delaware, Florida, Illinois, Kansas, Maine, Maryland, Michigan, New Jersey, New York, North Carolina, Pennsylvania, South Carolina and Texas. This legislation is examined in the second phase of this memorandum.

Commentaries on this legislation may be found in the following articles: Stevens, Close Corporations and the

A popular leader with the proponents of legislative accommodation is the argument that citizens should be indulged in their desire for freedom of choice. A complementary contention is that the benefits of incorporation should not be limited to "big guys", but should be available to the more humble aggregations of citizens.

It is asserted that certain business activity may not transpire unless incorporation is permitted. Ventures featuring a high degree of risk may not be pursued unless society is willing to hold the participants able to "cut their losses" by retreating behind the shield of limited liability.

Tax concessions essentially federal in nature suggest that state governments protect their citizens by facilitating broad access to incorporation. To fail to take this step is to irresponsibly condemn the citizens of Alaska to a higher federal tax bill than would otherwise be necessary.

Professor Edwin J. Bradley, a respected advocate of legislative accommodation, combines the classical claims and

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New York Corporation Law of 1961, 11 Buffalo L.Rev. 481 (1962); Hetherington, Trands in Legislation for Close Corporations: A Comparison of the Wisconsin Business Corporation Law of 1951 and the New York Business Corporation Law of 1961, 1963 Wis.L.Rev. 92; Hall, The New Maryland Close Corporation Law, 27 Md.L.Rev. 341 (1967); Bradley, A Comparative Evaluation of the Delaware and Maryland Close Corporation Statutes, 1968 Duke L.J. 425; Bradley, A Comparative Assessment of the California Close Corporation Provisions and Proposal for Protecting Individual Participants, 9 Loyola L.Rev. 865 (1976).

A noted legislative failure is discussed in Dickson, The Florida Close Corporation Act: An Experiment That Failed, 21 Miami L.Rev. 842 (1967).

boldly recasts them in a "planning" argument:[4/]

> The preeminent purpose of close corporation legislation is to free planning from senseless legal obstacles. The strong legislative trend is opposed to hobbling the close corporation by a set of rigidified prescriptions pertaining to how a corporation ought to be set up and operated. The foremost expectation from a particular close corporation legislative reform is the declaration of a pervasive principle of freedom of contractual planning so that the participants may adopt whatever arrangements they decide are useful and conducive to the success of their venture. That principle should apply to every facet of the close corporation's affairs. The point should be made with the utmost clarity that the price for limited liability and the corporate entity privilege is not a planning straightjacket.

The invocation of the attractive term "planning" recalls another plea. The "bailout" argument notes that already many business ventures have incorporated and are encountering great frustration with centralized management, observance of the fiduciary responsibilities of directors, the transferability of ownership with the threat of uninvited strangers at the table, and other "rigid corporate norms." Following this litany of horribles comes the suggestion that the brittle nature of the "law" is at fault and should amend its ways while seeking the pardon of enterprisers for causing them needless trouble.

Finally, it is claimed that if the legislature refuses to provide a rational and comprehensive approach, there is danger that <u>litigation</u> will produce a fragmented and chaotic response to the asserted need. In its extreme form this

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4/ Bradley, supra note 3, 9 Loyola L.Rev. at 866.

argument suggests that change is inevitable and that the state's only choice is to regulate the pace and quality of that change.

Arguments against statutory accommodation of the closely held entity. The burden of dialogue with proponents of statutory "reform" includes response to the propositions just reviewed, plus the assertion of certain counter-thrusts.

The argument that citizens should be indulged in freedom of choice as among business vehicles is easily met. There is no entitlement to status if the choice requires concessions and sacrifice from non-participating citizens. When this is the consequence, the request is not made as of "right", but is a matter of grace to be settled upon an assessment of advantage and disadvantage to the society. If closely held entities cannot play the role of "corporations", they are not entitled to the status.

In the sense that it is an accurate prediction, there is merit in the claim that certain business activity may not transpire unless incorporation is permitted. It is untrue that incorporation is indispensable to the attainment of non-debt capital. General and limited partnerships afford this advantage. Yet they do not afford the same measure of risk avoidance.[5/] If the risk inherent in the

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[5/] In the social contract offered by the limited partnership an enterpriser may insulate assets beyond those invested in the business, provided such an investor retreats to an essentially passive role in the conduct of the firm and there has been compliance with the formal steps for creation of the firm, including the participation of one or more "general partners" who assume full entrepreneural risks. See §§1 and 7 of the ULPA.

venture is so great that none of the participants is willing to accept the full liability consequences, it should not automatically be concluded that the road to that result should be paved by a concession of limited liability. An alternative deserving of careful consideration is that such activity ought not be encouraged at all.

Another response is that the concept of "limited liability" enjoyed by enterprisers operating as a closely held corporation may be an illusion of security. Here we must distinguish between tort and contract claimants.

If the plaintiff is a tort victim and the assets of the corporate entity prove insufficient to remedy the wrong, there is strong possibility that a court will "pierce the corporate veil" and expose to recovery the personal assets of some (the active participants), if not all, of the investors. California leads a list of jurisdictions in adopting the late Professor Ballentine's theory of adequate capitalization as a price tag for limited liability in a tort setting. It does not appear that Alaska has taken a position on this question, but it is predicted that it would reach a result in substantial harmony with the views of Ballentine.

Respecting the contract claimant, there is probably greater security that the corporate barrier will hold as an effective shield when an aggrieved creditor exhausts the assets of the corporation before obtaining satisfaction. This difference turns on the fact that, unlike the tort

victim, the contract claimant can be charged with having taken the calculated risk at the formation of the bargain to accept the liability of the corporate entity as opposed to asking for the further guarantees of the individual enterprisers. The "you made your bed now lie in it" rationale runs as a theme through those cases which refuse to disregard limited liability at the behest of contract plaintiffs.

Yet even in the realm of contract litigation there is an assumption that the corporation will have been capitalized and operated in such a manner as to give the entity a "fighting chance" to remain responsible to creditors. Thus if the enterprisers are guilty of using the corporation in high risk areas of their activities while exploiting the low risk aspects of what is, in retrospect, a single business in a non-corporate vehicle, this "heads we win, tails creditors lose" attitude will prove the undoing of the party claiming limited liability. By the same token, if the enterprise is begun with insufficient assets placed at risk in the form of investment while the balance of necessary funds is characterized as "loans" by the shareholders, a court is likely to order "reclassification" of these spurious creditor claims so as to subordinate them to those of outside creditors.

The point is distressing: if plaintiff is well represented by counsel there is no certain protection for investors in a closely held corporate entity. But there is a social cost. While the assets of enterprisers are

presumably at stake in the case of a partnership or sole proprietorship, they must be the object of litigation in the instance that the identical business has been organized as a corporation. The unpalatable consequence is the emergence of two classes of "victims": those who can afford and obtain the services of competent counsel (who may eventually overturn the claim of limited liability); and, those who must live without recompense because somebody took out corporate papers.

The planning plea of Professor Bradley contains some of the best and worst aspects of the pro-concession arguments. To his credit, Professor Bradley recognizes that attainment of corporate entity status is a "privilege." Yet he holds the view that the classical structure of corporate organization is a "straight-jacket" imposing "senseless legal obstacles" to the business planner. But, if there is wisdom in the view that a "corporation" has been created to serve a utilitarian purpose to society, its prescribed structure is no more deserving of pejorative characterization than would girders in a bridge or the beams in a ceiling. Again, if the classical profile is rationalized from the nature of the corporate mission, the mandatory prescription is not "senseless." The lack of sense arises from the aspirations of Professor Brdaley's "participants" to adopt a form of association ill suited to their purposes. An analogy may press the point. Should five individuals desire to use an automobile to "drive" to Hawaii, the ensuing disappointment

of their "plans" and potential loss of life and property cannot be laid at the doorstep of the design limitations of the vehicle. The frustration and loss is traceable to the senseless selection of the mode of transportation. To select an automobile over a boat for purposes of water transportation because of a fixed preference for styling or an asserted familiarity with a steering wheel must be frankly discouraged.

A similar tone must be adopted in rejecting the pleas of those who have followed the ill-founded advice (or proceeded without the benefit of counsel) to incorporate and now find the "straight-jacket" uncomfortable. Before we react with the concession of limited liability or "entity" status to pseudomorphs, society has a right to examine the likely direction of the participants. If they are found to be hell bent for an arrangement classically regulated within the context of a partnership or limited partnership, then is it not both "sensible" and pragmatic to redirect their attention to business vehicles suited for these needs? 6/

6/ The cries of the bailout advocates go beyond deploring the rigidity of the classical corporation structure to reveal problems peculiar to the "close" nature of the close corporation. Implicit in the following statement by Professor Bradley is broad recognition of trouble arising within the closely knit group of "participants". It is clear that problems inherent in the fallen nature of human-kind have not been cured by the wand of incorporation.

> In addressing the problem of unfairness and oppression in the close corporation, legislation will have to first define the close corporation in a manner which does not make that status merely optional. In addition, care must be taken to make sure that the substantive provisions

Also deserving of attention are the "costs" implicit in some of the "rescue legislation." When the impass of disagreement produces paralysis through the operation of shareholder agreements rejecting centralized management

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> do not affirmatively assist the majority in effecting an unfair situation for minority shareholders. Finally, the statute should formulate a set of minimum rights which each participant is entitled to, however, only presumptively and subject to the agreement of the parties. An equal voice in management and an equal share of profits would deserve the highest priority for inclusion in a catalogue of minimum rights, as would the right to information about the business. Other rights may be similarly deduced from the innate features of the close corporation relationship. The objective is to protect individual participants against exclusion from management, employment, salaries, dividends or other forms of corporate freeze-out, unless it is clear that what is happening is according to a compact unanimously arrived at. Legislation should nourish the principle that the close corporation is a cooperative undertaking for the mutual benefit of all of the parties involved.

Bradley, A Comparative Assessment of the California Close Corporation Provisions and Proposal for Protecting Individual Participants, 9 Loyola L.Rev. 865, 867 (1976).

It is respectfully submitted that what Professor Bradley is calling for is re-invention of the Uniform Partnership Act. The questions of an equal voice in the management and an equal share of profits, which Professor Bradley urges receive the highest priority, are assured by §§18(e) and 24 of the UPA (subject to agreement among the partners, every partner has equal rights in the management and conduct of the partnership business, and these are "property rights"); and §26 (defining a partner's interest in the partnership as his share of the profits and surplus). The fiduciary quality of the relationship inter se is the hallmark of the partnership at all stages of its life: formation, operation, and dissolution. See §21(1) of the UPA.

Of an importance rivaling the apt text of these provisions is the spirit of the partnership, which is well understood within the marketplace. In the event of violation, there is ample judicial precedent for application of the tested formulas of the UPA.

in favor of unanimity requirements, some commentators, some courts, and some legislatures have reacted by making such a corporation a ward of the state. No examination of entries in a citator for the milestone case of Galler v. Galler, 32 Ill.2d 16, 203 N.E.2d 577 (1965), can fail to excite depression at the continual attention demanded of the inferior Illinois judiciary in attempting to undo the schemes, plots, and ploys of two branches of a family bent upon war. If this case were multiplied even a hundred times, the burden upon all others awaiting a day in court would become obvious. In some jurisdictions special courts are proposed or have been created to act as receivers of glass jawed "plans" which ceased to be functional at the first breath of disagreement. Were such businesses partnerships, "dissolution" would have resolved the impass while ferreting out the villains. The businesses would likely have continued, but the enterprisers who had threatened their lives would be forced to lift their siege. Rather than return such business associations to the realm of the partnerships, proponents of concession urge the creation of state supported wards where non-functional close corporations may languish for an indefinite period. It is not unfair to greet these proposals with the question: "why"?

The argument respecting access to federal tax concessions is far more difficult to refute. As a consequence of historical accident, and notwithstanding strident efforts of the Internal Revenue Service to overcome it, qualification

for taxation at the significantly less onerous rates hinges upon the willingness of a state to grant a corporate charter. While Congress could change this result tomorrow, it shows no inclination to do so. As a result, even individuals may incorporate and, having obtained a charter, see their income from enterprise activity taxed at rates which do not exceed 46%. A non-incorporated taxpayer earning the same income could be subjected to taxation which runs as high as 70% (on every dollar in net income over $108,300). Certain tax reform, such as the maximum 50% tax bracket for income produced by the rendition of "personal service", has gone some distance in removing this irrational result. Notwithstanding, if a closely held enterprise operates as a partnership or limited partnership, the net business income is taxed to the owners in proportion to their interests in the firm, even though it is not distributed but retained for eventual expansion of the business. By contrast, the same business income which is not distributed by a corporation is taxed to the corporate entity at the lesser rates and there is no tax liability to the individual enterprisers. If any portion of this "after tax" corporate income is taken by the investors as a return on their capital (dividends), it is taxed a second time at the rates applicable to their personal income. Both legal and accounting practices thrive on these non-self-evident truths.

Corporate tax concessions obviously facilitate capital formation. Should the privilege be abused and the business earnings simply accumulated, using the corporate entity as

a tax minimizing piggy bank, there are unpleasant consequences. Yet no other business vehicle is afforded the chance for such accumulation.

Finally, the argument that the choice is between ordered change orchestrated by legislation or chaos produced by litigation contains elements of sound warning.[7/] Yet one need not surrender to the cries of this Cassandra. While the approach has not been tested, a legislature could provide in the corporations code that it had expressly considered the question of discrete treatment for closely held associations and found the social costs opposed to such a result. Such a declaration could not destroy the power of the courts to create common law, but common sense as well as comity suggest that a court so warned would not rush to embrace a consciously avoided result.

Passing from a refutation of the arguments in favor of statutory concession, one must consider the further premises of the negative position.

7/ Acceding to the demands for discrete statutory treatment does not create immunity from what may be viewed as common law meddling. A common feature of many of the legislative responses has been the attempt to define the close corporation in terms of a maximum number of shareholders. If the entity is organized with shareholders not exceeding this maximum, there is permission to claim the concessions implicit in the scheme. Such an arbitrary numerical limitation renders inevitable the case in which a court is plied with the argument that this particular entity has but "one more" shareholder and yet is deserving of a fate far closer to that of the _de jure_ close corporation than the alternative statutory scheme which will be characterized as functionally appropriate to General Motors.

The most crucial argument directly assaults the essence of the modification scheme. From the earliest efforts in New York to the more radical legislation in Arizona, closely held corporation provisions increasingly transgress the fundamental assumptions upon which the concept of a "corporation" is founded and experienced. The board is either stripped of all meaningful power or eliminated in favor of non-centralized management; voting rights are locked into agreements which destroy the concept of majority rule; free transferability of interest is denied by restrictions upon sale or inheritance of stock; and, continuity of life is threatened by permitting disagreement (or even lack of unanimity) to become the source of paralysis and then using this pretext for dissolution of the entity.[8] The road to this result is open and well traveled. Questions remain as to the utility of the journey.

A negative answer is suggested by a brief recollection of the role of the corporation. The accumulation of investment capital placed in the hands of centralized management

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8/ As has been repeatedly stressed by commentators who have no declared hostility to the concept, accommodation of the closely held corporation is no guarantee that enterprisers gathered under that umbrella will live in amity. See note 6, supra. Indeed, enticing investors into an entity with a presumed continuity of life sets the stage for "gang up" and other exploitative combinations exerted against a minority. Unlike rightful dissolution for breach of a partnership agreement, the victim of this harm dealing or income starving combination requires the extraordinary intervention of litigation to obtain relief which is neither certain nor clear. Thus while the thrust of the anti-concession arguments has been disservice to the public implicit in fostering "close corporations", there may be significant danger to individual enterprisers as well.

is thought to produce wealth and thus a public good. Yet to "incorporate a partnership" and hamstring its function by dent of shareholder agreements or provisions of the art[illegible]les is to undermine the premise upon which the expectation of pu[illegible]antage is grounded. True, limited liability is cla[illegible]it the view has already been asserted that this was a c[illegible]on to, and not the object of, a working corporation. Tax advantages are garnered in an essentially irrational interplay of state and federal law. Yet if the creation of corporate rates is traced to a desire to foster accumulation of capital for efficient deployment by centralized management, then this policy, like the essence of the corporate concept, is mocked by the close corporation.

The case for the opposition comes down to this: the modification of the corporate entity in the attempted accommodation of the "close client" involves the compromise, if not the surrender, of fundamental goals and vital assumptions. It is a transaction fraught with cost and without discernible benefit to the public. For the state to countenance such a result would be strange. To facilitate that end seems senseless.

B. General Survey of Close Corporation Legislation

1. Preliminary

This section collects and classifies existing close corporation legislation. The fifteen statutes analyzed here represent the efforts of fifteen state legislatures to go beyond the mere elimination of the traditional requirement

of three directors or the statutory sanction of high vote or quorum requirements. Organization is by substantive coverage; topics such as definitional factors, management structure, share transfer restrictions and special dispute resolution procedures will each warrant separate treatment. In addition, a list of the states surveyed, along with a classification of types of statutes in existence, appears as Appendix A.

As in all law, history plays an important part in the development of close corporation legislation. New York was the first to grant special recognition to the close corporation. In 1946 it enacted a provision allowing close corporation shareholder agreements to override or "sterilize" the power of the board of directors. The New York statute has since served as a model for the statutes of New Jersey, Michigan, North Carolina, South Carolina, Maine, and Florida.

Delaware leads the historically later trend to give the close corporation more extensive treatment. Delaware's statute extends to areas of dispute resolution and share transferability. Both Pennsylvania and Kansas have practically adopted this statute as their own. Texas, however, adopted Delaware's model but greatly expanded it.

The remaining states--Illinois, Maryland, California and Arizona--all have attempted to break new ground with their close corporation statutes. All four borrow and incorporate features of both the New York and the Delaware models. The result in each case, however, is unique.

Overall, however, individual states' treatment of the close corporation breaks down into three rough groups. In

the first group are states which have enacted separate close corporation legislation as a package of new rights and liabilities for the close corporation. In the second group are states which have merely amended their general corporation law with scattered provisions specifically exempting close corporations from various provisions. The last group of states is, in essence, a subset of the second; these states only amend one section of their general corporation law. While Appendix A contains a detailed breakdown of these provisions, certain facts warrant special consideration at this stage. Of the fifteen states involved, seven have separate articles for treatment of the close corporation. The remaining eight states are evenly split between multiple scattered provisions and single exemptions.

Within this group of states, Florida is noteworthy because of its complete about-face treatment of the close corporation. In 1963, Florida was one of the first states to enact a separate close corporation statute. Twelve years later, it repealed this eight section statute. In its place, Florida carved an exception to its shareholder agreement section. Thus, an early leader in the separate treatment of close corporations has completely disowned its early progressive stance. No overt reason appears for this change, although one commentator suggested, before the change, that the prior law was administratively difficult to apply. Dickson, The Florida Close Corporation Act: An Experiment That Failed, 21 Univ. Miami L.Rev. 842 (1967).

The remainder of this section separately considers, in

detail, the substance of each of these states' close corporation legislation. Initially, the question of how to select those corporations that will receive special treatment is addressed. Next, the topics common to most close corporation statutes are addressed in the following order: management structure, share transfer restrictions, and special dispute resolution procedures.

2. General Survey: Definitional Factors

Irrespective of the scope of statutory attention close corporations are to receive, the problem remains of how to rationally segregate those entities warranting special attention from the larger class of public corporations. The type of special treatment the close corporation receives, along with the social policies behind such different treatment, govern the factors to be used to define a close corporation. While it may very well be that one knows a Close corporation when one sees one, it is a completely different matter to select criteria that will affect only those entities deserving of special treatment. The remainder of this sub-section will describe the defining factors currently in use. The concluding section will attempt to identify the policies behind each factor.

a. Definitions containing a numerical test

Delaware was the leader in providing a close corporation definition using the number of shareholders as a defining factor. Del. Code Ann., Tit. 8, §342 defines a close corporation as a corporation with the following three features:

1. No more than 30 shareholders, and
2. Restricted transferability of shares, and
3. No offering of stock constituting a "public offering" under the federal Securities Act of 1933.

Delaware also requires the certificate of incorporation to state that the corporation is a close corporation. Id. §343(a). Several states have patterned their statutes on the Delaware model. They include: Pennsylvania (1968), Kansas (1972) and Texas (1973, revised 1975). Texas tinkered with the details by increasing the permissible number of shareholders to 35 and by referring to public offerings under either Texas or federal law. Texas Bus. Corp. Act, Art. 2.30-1(A).

California and Maine both define a close corporation on a strictly numerical basis. Maine is more liberal, setting the ceiling at 20. California, on the other hand, sets 10 shareholders as its maximum.

Arizona enacted a separate close corporation article in 1976. It also defines a close corporation with respect to the number of shareholders; however, it also adds a temporal element. Ariz. Rev. Stat. §10-203(3) provides only that "[t]he number of original investors shall not exceed ten." This presumably leaves open the potential for a subsequent increase in the number of beneficial owners of the firm.

b. Definitions focusing on the marketability of shares

Six states define a close corporation in terms of the marketability of its stock. New York was the first to enact such a provision in 1946. New York BCL §620(c) provides an

exemption from certain general corporation provisions for firms whose shares are not "listed on a national securities exchange or regularly quoted in an over the counter market." New Jersey, Michigan, and South Carolina have all adopted similar language. Florida, under both its old and its new law, and North Carolina have adopted a variant of New York's language. Both of these states provide certain exemptions for corporations whose securities are "not generally traded on a national securities exchange." This definition has the approval of F. Hodge O'Neal, F. O'Neal, Close Corporations §1.02, at 4 (1971).

c. Definitions based on some form of shareholder election

In Maryland, shareholders may unanimously agree to be treated as a close corporation. No other restrictions exist. Illinois, on the other hand, also requires unanimous shareholder approval, but adds that the corporation must place in its articles of incorporation at least one of five statutory methods of restricting share transfer. These include requirements mandating that any shareholder secure corporation approval before selling any stock, requirements that any shareholder must first offer the stock to the corporation at a prearranged price, requirements that no shareholder sell the stock so as to vitiate the Subchapter S election, specific person or class restrictions based on reasonable criteria, or any other lawful requirements. Ill. §1203.

d. Judicial definitions

The most famous judicial attempt at defining a close

corporation occurred in Galler v. Galler, 203 N.E.2d 577 (1965). Faced with a shareholder agreement not valid under Illinois' version of the Model Act, the Illinois Supreme Court defined a close corporation as one in which:

> the stock is held in a few hands, or in a few families, and wherein it is not at all, or only rarely, dealt in by buying or selling. 203 N.E.2d at 583.

It then held that the corporation at the bar met this definition, and that it did not have to strictly comply with the statute governing agreements among shareholders.

The court, in defining close corporations, utilized a combination of both numerical limits and share transfer restrictions. Both requirements, however, were given an open texture; no firm upper limit was set on the permissible number of shareholders and no strict limitation on marketability was delineated.

While Galler has met with judicial approval, Darwin v. Belmont Indust., 199 N.W.2d 542, 544 (Mich.Ct.App.1972), some courts have seen fit to add to it. In Donahue v. Rodd Electrotype Co., 328 N.E.2d 505, 511 (1975), the Supreme Judicial Court of Massachusetts quoted Galler, but intentionally went beyond it. It required an entity to have the following before attaining the status of a close corporation: (1) a small number of shareholders, (2) no ready market for the corporate stock, and (3) substantial stockholder participation in the management of the corporation.

These judicial definitions merely synthesize the current

discordant statutory strains of thought. Massachusetts' addition of the substantial identity between shareholders and management is not new. Most close corporation statutes are written with this fact in mind. The differing factors used by various courts and legislatures point out the need to isolate the principle behind the selection of one defining factor over the other. That is the function of the next section.

e. Policies behind the choice of different factors

The basic problems faced by the close corporation are clear. Close corporations have a limited market for their shares. This hinders the easy change of investment vehicle. Also, the high uniformity between shareholders and management creates problems distinct to the close corporation. Finally, the ineffectiveness of traditional remedies for corporate strife is a prime concern. Definitions can be framed which alleviate any one of these problems. The difficulty, however, occurs when one attempts to mold a definition to cure all of these ills. This memo will not attempt this task. Instead, it will analyze the concerns and the factors best serving them. From this discussion, a reasoned choice can then be made.

i. Concern: Avoidance of the "locked-in" syndrome

The locked-in syndrome occurs when a minority shareholder cannot liquidate his interest in a corporation. Its cause is the existence of a limited market for the corporation's shares.

Many definitions have used this quality of limited marketability as a segregating factor in order to relax traditional corporate strictures which might work to oppress minority shareholders. Typically, as in New York, this definition is used to exempt close corporations from traditional sanctions against shareholder agreements which attempt to limit the power of the board of directors. In this way, minority shareholders will have more of a say in the future of their investment. Thus, the line of definition is drawn along the lines of the perceived evil; smaller corporations receive a break if their investment is not liquid.

ii. Pragmatic Realization: Substantial identity between the board and the owners

Many of the reasons for the ineffectiveness of traditional corporate practices in close corporations is the inapplicability of the traditional pyramidal model of corporate organization. The close identity between ownership and management is more prevalent as the total number of shareholders decreases. Thus, many states have used the number of shareholders as a defining criteria. This practice is grounded in the belief that by setting a low ceiling, the corporations in which there is an identity between ownership and management will receive the close corporation status the statute warrants.

It is important to note the friction between these ideas. On the one hand there is a concern for the immobile investor; by overriding the traditional ban on director sterilization agreements, it is thought that the lack of

liquidity can be made palatable. On the other hand, there is the deeper concern that the traditional corporate model will just not provide the answer for the myriad problems facing the closely held entity. This distinction is best illustrated by the gray zone; those corporations having some 50 to 100 shareholders but are not listed on any exchange nor is there a ready market for the corporation's stock. In these situations, it may very well be the case that the corporate pyramid may govern justly; it is also the case that each investor has a non-liquid investment. Thus, it can be seen that any attempted compromise between these two goals may be weighted in favor of the more favored class (i.e., immobile investors or small businesses) by tinkering with either the numerical limits or the definitions of marketability.

iii. Objective Classification: Increased certainty for planners

The use of numerical limits also fosters increased assurance of close corporation treatment. To receive close corporation status, all the corporation needs to do is stay within the prescribed number. Thus, planners may arrange the corporation's affairs with some certainty.

This certainty, however, is ephemeral. The numerical approach, as well as the marketability approach, can create situations where close corporation status may be lost for reasons external to the entity. The share may devolve to multiple heirs, thus placing the number of shareholders over

the permissible maximum, or the stock may be sold in amounts jeopardizing status under a marketability standard.

Maryland, Illinois and Arizona attempt to obviate this problem. All require shareholder approval to attain close corporation status. Maryland is the most permissive. Unanimous election is its only requirement. Illinois and Arizona, however, impose further restrictions. Illinois requires the imposition of some kind of share restriction provision. Arizona requires only that the initial number of investors be less than ten. Both of these schemes obviate the type of external bust-up noted above by making close corporation status, once granted, immune to anything except shareholder action.

v. External Considerations: Subchapter S election

Under IRC §1371, a corporation may elect to be taxed similarly to a partnership. Thus, a serious consideration for close corporation planners is the ability to meet section 1371's requirements. Chief among these is the ceiling on the maximum number of shareholders. The statute allows only fifteen. Illinois recognizes this and allows corporations to elect to make share transferability contingent on meeting Subchapter S's requirements.

f. Concluding Thoughts on Definitional Factors

The questions of how to select those corporations deserving of special treatment is, in many respects, the most baffling of all. While definitions using numbers or share restrictions or marketability have found factors common to the popular conception of the close corporation, each presents problems

for the corporate advisor. Thus, a slection between competing policies is required. In this respect, the starting point for the close corporation is the last step for the legislator; by molding the definition to serve express social policies, the ultimate purpose of a close corporation statute can be achieved.

3. Management Structure

One idea that pervades close corporation writing is that concessions must be made in close corporation statutes to the reality of the day-to-day existence of a small corporation. The management of a small corporation is said not to fit the pyramidal model of classic corporations law. Thus, to avoid judicial expansion of general corporation statutes, exceptions are made for the small corporation. These exceptions generally are found in provisions authorizing the nullification, or sterilization, of the traditional corporate management body, the board of directors. This sub-section thus explores how various states treat shareholder agreements which structure a close corporation in a way at variance with traditional models.

a. Shareholder's Agreements

New York's BCL §620(b) validates, in limited circumstances, provisions of the certificate of incorporation which either delegate or usurp the powers of the board of directors to the shareholders. Three conditions, however, must be met before the certificate's provision will be given effect. First, all outstanding shares must have authorized the provision. BCL §620(b)(1). Second, any subsequent transferees of the stock of such corporation must either know of, or consent to, the terms of such provision. BCL §620(b)(2). Finally, the

corporation cannot be listed on either a national stock exchange or on the over-the-counter market. BCL §620(c).

Thus, New York allows corporations whose stock is not publicly traded to deviate from the traditional form of corporate management. Strict conditions, however, are placed on this license. In addition to the above, the BCL requires all stock subject to such a certificate provision to contain a legend to that effect. BCL §620(g).

It should be noted that New York only validates such agreements when they are contained in the certificate of incorporation; no side agreements are recognized nor are by-law provisions to the same effect. In Beresovski v. Warzawski, 28 N.Y.2d 419, 217 N.E.2d 520, 322 N.Y.S.2d 673 (1971), however, the New York Court of Appeals specifically enforced a unanimous shareholder agreement to amend the certificate of incorporation of a close corporation. This decision could be used to validate by-laws or side agreements not mentioning certificate amendment on a pro tanto amendment theory or on some theory that specific performance would be the only way to achieve the parties' intent.

Florida §607.107, enacted in 1975, basically incorporates most of New York law. Florida differs, however, in that it specifically recognizes any unanimous shareholder agreement, regardless of whether it is contained in the articles of incorporation. Florida also adds that any transferee of shares of such a corporation takes subject to the agreement if he or she has notice of the agreement. Notice is con-

clusively presumed if the share certificate has a legend indicating the existence of the agreement. Fla. §607.107(3). Finally, Florida explicitly states that, to the extent that shareholders take over director's duties, they assume the risk of director liability. Fla. §607.107(4).

Maine §701 is similar to Florida's statute. It states that management may be by shareholders, and, if this option is taken, the shareholders shall be treated as directors for purposes of delineating duties, responsibilities, and liabilities. Maine, however, follows the lead of New York and requires such agreement to appear in the articles of incorporation.

Michigan §21.200(463) and New Jersey §14A:5-21 are, in substance, identical to New York's statute. Both require the agreement to be in the articles and both condition the provision's validity on unanimous agreement, notice to all transferees, and limited marketability of the corporation's shares. Both require all stock certificates to carry an appropriate legend. New Jersey explicitly states what both New York and Michigan imply; namely, that the board of directors may be completely eliminated. NJ §14A:5-21(2). Finally, both states impose director responsibility on shareholder managers.

North Carolina §55-73(b) begins with New York's basic premise: unanimous shareholder agreements concerning shareholder management should be given effect. It, however, expressly validates such agreements if they are contained in

by-laws or side agreements. Furthermore, North Carolina expressly states that agreements to manage the corporation "as if it were a partnership" are not invalid for that reason. This fact has been specifically recognized by North Carolina courts. See, e.g., Blount v. Taft, 29 N.C.App. 626, 255 S.E.2d 583 (1976).

South Carolina §33-11-220 is the final statute adopting the New York model. It recognizes the validity of unanimous by-laws or side agreements usurping the board of director's power, but only if the agreement is set forth, or referred to, in the articles of incorporation. S.C. §33-11-220(b)(b). Thus, the agreement's terms need not be divulged in the articles; only the agreement's existence. South Carolina also adopts the marketability restriction of New York, as well as the legend requirement. Finally, South Carolina places a 10-year limit on the existence of any such agreement and allows renewal only in the last year of the agreement's existence. S.C. §33-11-220(b)(3).

Delaware has set the trend for three states. Delaware §350 provides that agreements among any number of shareholders are not invalid because they interfere with or restrict the discretion or powers of the board of directors. Furthermore, §354 provides that such agreements may validly attempt to regulate the affairs of the corporation as if it were a partnership. Thus, Delaware eliminates the requirement of unanimity for shareholder agreements. Delaware does provide, however, for pure management by the shareholders in §351.

Section 351 allows the corporation to dispense with shareholder meetings to elect directors, and makes all stockholders directors. To take advantage of this section, there must be unanimous agreement of all shareholders, and the provision must be in the certificate of incorporation. Also, the existence of such a provision must be included in a legend on all stock certificates. The provisions of Kansas §§17-7210, 17-7211 and 17-7214 and Pennsylvania §§1381, 1382 and 1385 are similar. Kansas adds that all actions of corporations electing to be managed by the shareholders shall be taken by a vote of the shares, unless otherwise provided for in the articles of incorporation. Kansas §17-7211.

Maryland §4-401 is one of the broadest statutes regulating shareholder agreements. It states that "[u]nder a unanimous stockholders' agreement, the stockholders of a close corporation may regulate any aspect of the affairs of the corporation or the relations of the stockholders . . ." It then goes on to list some permissible provisions. Section 4-401(d) provides that an equity court will specifically enforce the agreement's provisions. This represents the fullest extent of the codification of the maxim volenti non fit injuria and has been copied by at least two other states, Illinois (§1211) and Texas (Art. 2.30-2). All three states specifically sanction the operation of the corporation in partnership form.

Maryland also makes it explicitly clear that a close corporation may elect to have no board of directors by approving a charter amendment to that effect. Md. §4-301.

In addition to a broad blessing for shareholder agreements, Illinois adopts Delaware's provision on management by shareholders (Ill. §1212). Texas, on the other hand, adopts Maryland's more open approach (Tex. Art. 2.30-2(B)(1)) by leaving the decision to the shareholder's agreement.

California §300(b) states that a unanimous shareholder agreement, as defined in §186, shall not be invalid because it restricts the board of directors, or attempts to regulate the corporation as a partnership. Thus, California fits the mold of such states as New York and Delaware. California differs, however, from most states in that it specifically lists items that may not be altered by shareholder agreement. Section 300(c), for example, does not allow shareholder modification of statutory mandates on dividend restrictions, involuntary dissolution procedures, records and reporting requirements and inspection rights. Finally, California allows close corporations to have agreements among less than all the shareholders, but only to the extent allowed for all corporations. §300(a).

b. Arizona--The Creation of a New Business Form

Arizona has a different approach to the management of close corporations. All Arizona close corporations must name one or more managers in their articles of incorporation. Ariz. §10-203(2). These managers are responsible for the day-to-day operation of the corporation. Ariz. §10-205. The manager's actual authority may not be restricted except by the articles and, even if so restricted, is not effective

against a third party dealing in good faith with the corporation. Ariz. §10-205. Further, the manager serves at the pleasure of a majority of the investors. Thus, in Arizona investors in close corporations must delineate the corporation's management structure in the articles of incorporation. In addition, provisions for dispute resolution and share transfer restrictions must also appear in the articles. Ariz. §10-204.

c. <u>A Short Summary--Close Corporation Management</u>

Several issues run throughout the close corporation legislation affecting management structure. If a structure different from the classic corporate model is to be tolerated, the question of what formalities must be observed arises. New York pioneered this area by requiring a unanimous agreement to be contained in the articles of incorporation. Other states have sanctioned side agreements, and still others, notably Delaware, have allowed less than all the shareholders to alter the basic structure to some extent.

A further concern is the protection of potential purchasers of stock subject to such an agreement. To this end, states have required legends on the stock certificates indicating the existence of a shareholder agreement. In addition, many states provide that a transferee who takes with such notice is bound by the terms of the agreement as if he or she was an original party. Thus, the state seeks to protect both sides to a subsequent share transfer.

Finally, it should be noted that most statutes are phrased in the negative. Constructions such as "shall not be invalid

as between the parties" are very common. This drafting technique allows for flexibility and leaves open the possibility that the agreement may be held invalid for reasons other than director sterilization. Furthermore, the use of the phrase "as between the parties" also leaves open the possibility that third parties, such as creditors, may attack the agreement for creating a situation to their detriment. In any event, there is much diversity present, and a great wealth of experience to be drawn upon to frame a shareholder agreement section.

4. Control Over Non-Participants

Many states, in apparent recognition of the highly personal nature of the close corporation, allow shareholders to establish restrictions on the alienability of shares which are more extensive than are generally allowed. Indeed, many states include the existence of share restrictions in their definition of a close corporation.

Illinois §1203 is the most graphic example. Its sole criterion for close corporation status is the existence, in the articles of incorporation, of at least one of the following five types of share restrictions: a corporate right of first refusal, corporate consent to the proposed transfer, specific person or class restrictions (so long as they are not "manifestly unreasonable"), transfers that destroy a Subchapter S election, or any other lawful restriction. Illinois thus allows the corporation to employ myriad devices to control its membership, many of which are unavailable to public corporation shareholders.

Delaware §342(a)(2), as well as Pa. §1372A(2) and Kansas §17-7202(a)(2), also requires close corporations to have at least one type of share restriction. The scope of permissible restraints is limited, however, to those restraints available to all corporations.

Maryland §4-503 invalidates any attempted share transfer unless each shareholder consents in writing within 90 days of the actual transfer, or the transfer is to the corporation or a trust under provisions of a unanimous shareholder agreement. In addition, this final type of transfer must be for the benefit of stockholders or their immediate families.

Arizona §10-209A requires that, as a condition precedent to a valid share transfer, the corporations commission must receive notice of the transfer on a standardized form.

Finally, California §418 allows a close corporation to retain its status by invalidating all inter vivos transfers of stock which impermissibly enlarge the number of shareholders beyond ten. A precondition of this invalidation, however, is that all stock certificates carry a legend indicating the permissible shareholder maximum.

5. Dispute Resolution

Due to the intensely interpersonal nature of the close corporation, many states have attempted to provide for special remedies for deadlock and dissension that such closeness tends to foster. In general, these include greater access to involuntary dissolution and the availability of provisional and custodial directors.

Many states grant a close corporation shareholder the right to petition for dissolution. However, in states such as California and Illinois, the right to petition is conditioned on the existence of corporate deadlock or the failure of any agreed remedies, such as arbitration. In addition to the normal grounds for involuntary dissolution, both California §1800(b) and New Jersey §14A:12-7(1)(c) give corporations with few shareholders additional grounds to ask for dissolution. California provides that if a corporation has fewer than 35 shareholders, dissolution may be granted if it is "necessary for the protection of rights or interests of the complaining shareholder . . ." New Jersey allows dissolution, or the appointment of a provisional or custodial director, upon a showing of mismanagement, abuse of authority, fraudulent behavior, or oppressive or unfair conduct by the corporation's directors if the corporation has 25 or fewer shareholders.

Other states, such as Maryland §4-603, provide for a "buy out" of the disgruntled shareholder in lieu of dissolution. Finally, some states allow the articles to give specific individuals the ability to dissolve the corporation at will. Ill. §1213.

Many states provide for the appointment of provisional directors. Cal. §308; Del. §353; Kansas §17-7213; N.J. 14A:12-7(3); Pa. §1384; Tex. Art. 2.30-4. A provisional director is a temporary addition to the corporation's existing board. He or she serves to break a corporate deadlock. As soon as the problem is resolved, the tenure of the provisional

director ends. A custodial director, on the other hand, has much broader powers. Generally, a custodian may assume duties of a corporate officer and manage the day-to-day corporate business. He or she may disregard the board and run the corporation on independent judgment. The custodian answers only to the court. Five states have adopted this drastic remedy: Ariz. §10.214A (called a conservator--scope of powers set by court); Del. §352; Kansas §17-7212; N.J. 14A12-7(4); and Pa. §1383.

Delaware, Kansas, and Pennsylvania utilize the custodian remedy upon deadlock and when the corporation is managed by the shareholders or when the petitioning shareholder has a right to dissolve the corporation under the articles. New Jersey's custodian is available to any corporation, subject to court order. It is basically an equitable receiver. Arizona's conservator is court-appointed when it is found that deadlock threatens to impair the conduct of the business.

6. Changes in Basic Structure

All states that treat the close corporation separately make provision for the merger or transformation into a public corporation. The main issue here is the type of approval necessary to convert the corporation's status.

Most states require a two-thirds vote of the shareholders, unless the articles provide for a higher requirement. Del. §346; Cal. §§158(c) (conversion), 1111 (merger); Ill. §1207; Kansas §17-7206; Pa. §1376. Arizona §10-211 and Maryland §4-203 require, however, unanimous shareholder approval to change status.

C. Legislative Agenda for Statutory Concessions to the Close Corporation

Should the Commission decide that specific concessions to closely held entities are desirable, then several legislative choices need to be made. Initially, the Commission must decide upon the method for defining a "close corporation." The Commission must next determine the application of agency law to the close corporation. As yet, no jurisdiction has addressed this problem. Such silence is an invitation to litigation. Finally, the Commission must decide the substantive breadth of any proposed statute.

1. The definitional criteria: As indicated in the survey of close corporations statutes in other jurisdictions, there is a major split respecting the criteria to be used in defining the close corporation. Many states, including California and Delaware, have opted for a numerical ceiling as the defining factor. The numbers range from a low of ten shareholders in California to a high of thirty-five permitted under the recent Texas Act. A second group of states focus upon the marketability of the corporation's stock as a defining factor. Close corporation status is available to those entities whose shares are not listed on a "national exchange" (New York, New Jersey, and South Carolina) or whose shares are "not generally traded on public markets" (North Carolina). Adoption of this approach would open the concessions to virtually every corporation organized under the laws of Alaska. As a third option, the Commission could follow the example of Maryland and simply leave the election

of close corporate status to the incorporators with no definitional requirements.

Recommendations of the drafter: There is a sense in which the motivation for statutory concessions impinges upon the selection of definitional criteria. If the major social issue is the "locked in" syndrome deplored by Professor Bradley, the absence of public trading in the shares becomes a rational criteria. Before the Commission should take this step, it may wish to consider that the pragmatic consequence is the likely availability of these statutory concessions to every business in Alaska. The social costs detailed in the anti-concessions arguments would be high indeed.

The drafter suggests that the Commission opt for a numerical limitation as the definitional factor. Further, the drafter recommends that the number be set at 15. The attraction of this figure is coordination with the Subchapter S election which, ironically, permits the close corporation to be taxed as if it were a prtnership. In the view of the drafter, such a limitation has the further advantage of minimizing the social costs involved in the proliferation of these fragile entities. It also permits increased certainty for the counseling lawyer.

2. The impact upon the law of agency: It has come as a surprise to the drafter that none of the existing statutory concessions to closely held entities has dealt with the inevitable complications which will be encountered with the law of agency. A brief summary of the classical law will illustrate the potential problem.

If a business is conducted as a sole proprietorship, the proprietor may choose to deal with third parties through the use of agents. The creation of this principal/agent relationship is consensual and conscious. A third party dealing with an individual who purports to be an agent for a disclosed principal has a duty to determine the bona fides of this claim as well as the extent of the agent's authority. If the agent has exceeded the authority defined (expressly or by implication) by his principal, the principal escapes liability on the unauthorized transaction. However, if the principal is guilty of acts or omissions which would cause a third party to reasonably be deceived into believing in the authority of the agent, such a betrayed principal is liable to the innocent third party on a theory of apparent authority.

What happens if the third party deals with a business conducted by more than one individual in a partnership form? The Uniform Partnership Act decrees that every partner is an agent of the firm. Further, the act of every partner apparently carrying on business of the partnership in the usual way binds the firm even though it is done without the authority of the other partners. The only exception is for a third party who has actual knowledge of the partner's lack of authority. It will at once be seen that the risks of internal disagreement inherent in this association of enterprisers is, by operation of the partnership act, turned against the firm. It is deemed unreasonable to place third parties at peril that a particular partner is, in fact, acting without the concurrence of a majority of the firm.

What if the business is a corporation? Here the problem is crucial, for a corporation, unlike a general or limited partnership, is a distinct legal entity. Who may bind such a "principal"? In order to answer this question, the law relied upon the pyramid corporate structure. The Board of Directors is regarded as the principal in that it is to make the determinations upon which transactions are authorized. Yet corporate <u>officers</u> are deemed to be agents, for they have the routine contact with third parties. In general, the president of the corporation is deemed a plenary agent with certain powers of agency inherent in the occupation of that office. Notwithstanding, a third party on notice that she is dealing with a corporate officer stands at peril of determining the bona fides of that relationship and the sufficiency of the officer's real authority from the board to cover the contemplated transaction.

Comes now the "close corporation" with the touted functional identity between shareholders, directors and officers. How is the law of agency to divide the risk of the "faithless or imposter agent" as between the enterprisers and third parties?

<u>Recommendations of the drafter</u>: The oft asserted desire of proponents of the concession theory to "incorporate partnerships" suggests to the drafter that the provisions of the Uniform Partnership Act provide a useful key to the application of agency law. Further, the drafter would like to suggest that many problems can be prevented in the market-

place if the statute commands that in all transactions a close corporation be forced to identify its status by the use of ". . . A Close Corporation" or "C.C." as part of its name. To alert third parties as to the nature of the beast is to set the stage for inquiry and care which the law demands. If the close corporation is thus identified, the problem of unauthorized transactions should be minimized while concepts akin to the UPA §§3, 9, 12, 13 and 14 are recommended to apportion the unavoidable balance of the risk to the enterprisers who are gaining the privilege of close incorporation.

3. Substantive Breadth of Close Corporate Legislation: The nature and extent of the concessions given to close corporations determines the impact of the statute; in short, a close corporation statute may be judged by the exemptions it creates. Historically, states have made concessions in three areas: management structure, share transfer restrictions, and dispute resolution.

a. Management structure: Every state which has acted in this area to date has made concessions to the alleged need for relaxation of the pyramid model of corporate organization. The rationale is the asserted human identity of the persons otherwise forced to play the role of shareholders, directors, and officers. The typical exemptions are two: the statutes are amended to permit sterilization or elimination of the board (so that there is direct shareholder management) or the members of the board are subjected to control by shareholder agreements.

Whether the board is eliminated or subjected to control by shareholders, the heart of the "new order" is the role of the agreement. Several important legislative choices immediately arise. Must the agreement be the product of unanimous consent or may a majority faction of the shareholders act in this extraordinary manner? How "formal" ought the agreement be? Here the choices range from New York's requirement that the agreement be the product of unanimous consent and enshrined in the articles of incorporation. Other jurisdictions deviate from the New York approach by failing to require that the unanimous agreement be placed in the articles. They would honor the terms of a less formally expressed agreement. Delaware stands at the opposite extreme requiring neither unanimity nor formal expression in the articles. Thus, unless the shareholders of a Delaware close corporation elect to eliminate the board and run the company directly, they may control election to the board and the apportionment of offices by an agreement among a bare majority of the shareholders.

In favor of the Delaware approach is the minimized risk of paralysis which is the constant threat to any requirement of unanimous consent. The danger of the Delaware approach is setting the stage for a "gang up" on a locked-in majority.

Recommendation of the drafter: On balance, the drafter favors the New York requirement that the shareholder agreement be placed in the articles of incorporation. It is felt that this formalism will have both a strong cautionary impact upon

the parties as well as an evidentiary convenience should a court ever be called upon to intervene. As a price tag for this concession from the pyramid model, the drafter favors the language found in many statutes to the effect that the fiduciary duties of care and loyalty which the act imposed upon officers and directors devolve upon shareholders to the extent that, by terms of agreement or conduct, they have usurped these roles.

b. Stock transfer restrictions: By their nature, close corporations tend to be highly personal associations. Because of this, many participants desire to have firm control over the transfer of ownership rights. Most close corporate legislation contains concessions to this desire. Indeed, Delaware and Illinois require such restrictions as a precondition for close corporate status.

Recommendation of the drafter: Transfer restrictions such as those found in the California Corporations Code appear both reasonable in nature and functional in operation. Should the Commission take this path, these provisions are recommended.

c. Special dispute resolution procedures: A social cost of concessions to the close corporation is the high probability that such creatures will wind up in a "legal emergency room." Due to the highly personal nature of the close association and the frequent use of shareholder agreements requiring unanimous consent, the potential for corporate deadlock is transformed into a probability. The vexing fact is that small matters or even petty personal differences may

cause deadlock in what is otherwise a profitable concern. Increasingly, concession states are experimenting with remedial devices. New Jersey and California take a pessimistic view, reacting to the probable deadlock by relaxing the grounds under which a disgruntled faction may seek involuntary dissolution Both jurisdictions join Delaware and Texas in providing for appointment of a "provisional director" to resolve a single issue dispute. If the rift is deeper or more pervasive, New Jersey, Pennsylvania and Delaware provide for a custodial director; a modern day equivalent of an equitable receiver who, instead of liquidating the business, attempts to preserve it despite the battling owners.

The legislative decisions presented by this panoply of remedies involve cost/effectiveness balancing. Each successive remedy has the potential to increase litigation and to enmesh the time and attention of a court with the evolving problems of a going concern. Every other litigant on the docket of a trial court must suffer delay and inconvenience as the inevitable price for this exertion. Balanced against these costs are the interests of society in preservation of going concerns which function as employers, competitors and sources of goods and services in the marketplace.

Recommendation of the drafter: New Jersey has given its courts of general jurisdiction the full range of remedial devices to deal with the problem of deadlock for all corporations. Its only special concession is in giving small corporations more expansive grounds for dissolution. The

inherent disadvantages in such a step include increased litigation and increased potential for judicial interference in business matters. An alternative would involve extensive use of private arbitration. Arizona and Maryland have created great incentives to use this remedy. As a price tag for close corporate status, the act could require that the enterprisers agree to mandatory arbitration of any disputes arising under their agreement.

Appendix A

I. States with Separate Close Corporation Articles or Other Groupings

State	Statutory Provisions	Year of Enactment
1. Arizona	§§10-201 to 10-218	1976
2. Delaware	Tit. 8, §§ 341-56	1953
3. Florida	Repealed 1975	1963
4. Illinois*	Chap. 32, §§ 1201-16	1977
5. Kansas	§§ 17-7201 to 17-7216	1972
6. Maryland*	§§ 4-101 to 4-603	1967, revised 1975
7. Pennsylvania	Tit. 15, §§ 1371-86	1968
8. Texas*	BCL Art. 2.30-1 to 2.30-5	1973, revised 1975

II. States with Scattered Provisions Relating to Close Corporations (references are to provisions defining the close corporation)

State	Statutory Provision	Year of Enactment
1. California	Cal. Corp. Code § 158	1975
2. Maine	Tit. 13-A, § 102(5)	1973
3. Michigan	MSA § 21.200(101), (103)	1972
4. New Jersey*	Tit. 14A:5-21(3)(b)	1972

III. States Which Define the Close Corporation for One Specific Purpose

State	Statutory Provision	Year of Enactment
1. Florida	§ 607.107	1973 (shareholder agreements)
2. New York	BCL § 620(c)	1946 (shareholder management)
3. North Carolina*	§ 55-73	1955 (shareholder agreements)
4. South Carolina	§ 33-11-220	1962 (shareholder agreements)

IV. States Which Use the Number of Shareholders as a Defining Factor

State	Number Used	Other restrictions
1. Arizona	Initially, 10	Articles provision
2. California	10	Articles provision
3. Delaware	30	Articles provision No public offering of stock
4. Kansas	30	Articles provision No public offering of stock
5. Maine	20	
6. Pennsylvania	30	Articles provision No public offering of stock
7. Texas	35	Articles provision No public offering of stock Unanimous shareholder election

*Denotes Model Act State

Appendix A (cont.)

V. States Which Use the Marketability of the Corporation's Stock as a Defining Factor

State	General Language	Other Restrictions
1. Florida (both old and new)	"not generally traded on public markets"	
2. New Jersey	"not listed on nat'l sec. exch."	
3. New York	"not listed on nat'l sec. exch."	
4. North Carolina	"not generally traded on pub. mkts"	unanimous s/h election
5. South Carolina	"not listed on nat'l sec. exch."	unanimous s/h election

VI. States Which Use Shareholder Election as a Defining Factor

State	Other Restrictions
1. Maryland	None
2. Illinois	Must use one of five statutory means of transfer restriction
3. Arizona	Cannot have more than 10 initial stockholders
4. Texas	No more than 35 shareholders; no public offering of stock
5. North Carolina	Stock cannot be listed on nat'l sec. exch.
6. South Carolina	Stock cannot be listed on nat'l sec. exch.

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March 30, 1984

Senator Joseph P. Josephson
Alaska Senate
Capitol, Room 508/510
Juneau, Alaska 99811

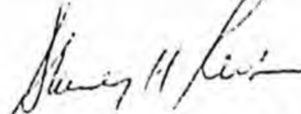
Re: SB 246
An Act Revising the
Corporate Code

Dear Senator Josephson:

Enclosed is a copy of the report dated March 30, 1984 made by the Task Force of the Business Law Section of the Alaska Bar Association to the Judiciary plus Labor and Commerce Committees of the Alaska House as agreed to during the course of the public hearing in Anchorage by such Committees on February 24, 1984.

This is the report described in my March 12, 1984 letter to you and your responsive March 16, 1984 communication.

Very truly yours,



Stanley H. Reitman

SHR:jf

cc: Alaska Code Revision Commission
John W. Abbott, Chairman
L. S. Kurtz, Jr., Esq.
Judge Thomas B. Stewart
Alaska Bar Association
Paul D. Kelly, Esq.

EXHIBIT D

RECEIVED MAR 3 0 1984

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March 30, 1984

Honorable Charlie Bussell
House Labor and Commerce Committee
Pouch V
Juneau, Alaska 99811

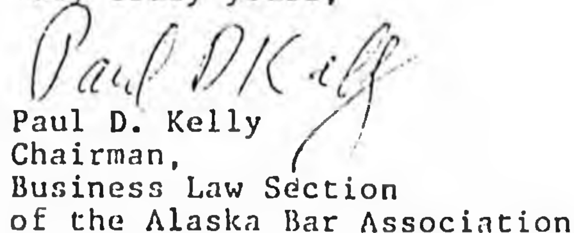
Re: Report of the Task Force of the Business Law Section of the Alaska Bar Association regarding HB 343 and SB 246, Corporate Code Revision.

Dear Representative Bussell:

Enclosed please find the report of the Task Group of the Business Law Section of the Alaska Bar Association. The report is the result of significant efforts by members of the task group who took time out of their busy practices to serve without compensation in providing their expertise on a subject of great importance to the Alaska business community. Each member on the task group has significant experience as a business law practioner.

Admittedly, the accompanying report is a brief review of a lengthy piece of legislation. The drafters have attempted to highlight certain areas of concern and hope that this report will aid the legislature. Listed below are the members who participated in the task group and their addresses and phone numbers. Please feel free to contact the group if we can be of any further assistance.

Very truly yours,



Paul D. Kelly
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Business Law Section
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PDK/pj
enclosure

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March 30, 1984

Honorable John J. Cowdery
House Labor and Commerce Committee
Pouch V
Juneau, Alaska 99811

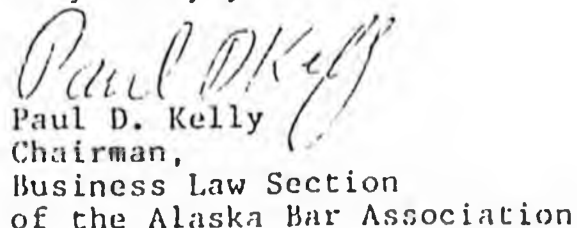
Re: Report of the Task Force of the Business Law Section of the Alaska Bar Association regarding HB 343 and SB 246, Corporate Code Revision.

Dear Representative Cowdery:

Enclosed please find the report of the Task Group of the Business Law Section of the Alaska Bar Association. The report is the result of significant efforts by members of the task group who took time out of their busy practices to serve without compensation in providing their expertise on a subject of great importance to the Alaska business community. Each member on the task group has significant experience as a business law practioner.

Admittedly, the accompanying report is a brief review of a lengthy piece of legislation. The drafters have attempted to highlight certain areas of concern and hope that this report will aid the legislature. Listed below are the members who participated in the task group and their addresses and phone numbers. Please feel free to contact the group if we can be of any further assistance.

Very truly yours,



Paul D. Kelly
Chairman,
Business Law Section
of the Alaska Bar Association

PDK/pj
enclosure

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ALASKA BAR ASSOCIATION

P.O. BOX 279, ANCHORAGE, ALASKA 99510, (907) 272-7469

BUSINESS LAW SECTION

March 30, 1984

Honorable Charlie Bussell
House Labor and Commerce Committee
Pouch V
Juneau, Alaska 99811

Re: Report of the Task Force of the Business Law Section of the Alaska Bar Association regarding HB 343 and SB 246, Corporate Code Revision.

Dear Sir:

Enclosed is a review by the Task Force of the Business Law Section of the Alaska Bar Association of Senate Bill 246 and House Bill 343, the Corporate Code Revision.

The Review represents a time-limited study of the bills and was performed for the limited purpose of bringing to your attention some of the possible legal and economic consequences to the business community and the Alaska public that could arise if the bill were adopted in its present form. We urge you, then to consider this only as such and not an exhaustive section by section analysis of proposed amendments or a scholarly attempt at opposition or rebuttal to the work product of the Code Revision Commission.

In our deliberations, we met, both in subcommittees and as a whole Task Force with John Abbott, Chairman of the Code Revision Commission. At some of those meetings, Jerry Kurtz, another member of the Commission, was also present. At these meetings there was candid exchanges of views on the bills. In addition, we were advised that Professor Dan Fessler was available to meet with us, although at a date too late to assist us with this report given the time constraints put on our work by your Committees.

Individual sections of the bills are commented upon in the attached review, but considering the bills as a whole, we would make the following observations:

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Individual sections of the bills are commented upon in the attached review, but considering the bills as a whole, we would make the following observations:

1. Any major revision of a comprehensive body of law, such as the Corporate Code should include as one of its objectives, making the practice of law and business operations under the Code easier and more explicit.

We believe the proposed bill goes a long way to make the law more explicit than our current Code in many aspects, but not necessarily easier under which to practice or conduct business. For an Alaskan practioner, far more work needs to be done in carefully drafting Articles, By-laws and other documents than is currently the case. While it may be the intent to encourage the preventive practice of law and reduce remedial litigation, in the vast majority of cases, we think it will merely raise the cost of going into business in the corporate form.

For the out-of-state practioner, the problem is compounded, because as more states adopt the revised Model Act, Alaska's unique departures will require special time and study to assure compliance.

2. The Bills contain very material departures from current law in substantive rights and liabilities among corporate management, shareholders, creditors, secondary acquirers of shares and third parties doing business with Alaskan and even foreign corporations in Alaska.

We have two concerns about these departures. First, some substantive changes, such as the proposed limitations on distributions and the proposed direct liability of Officers and Directors to creditors are significant barriers to stimulation of commercial activity in the state and ought not to be adopted as this state's public policy. Second, we believe that passing a law this session with a July 1, 1984, effective date that contains such significant changes will prove to be an unwarranted shock on the practicing bar, the affected business community and the public.

3. Many provisions of the current Alaska Corporations Code merit attention and any thorough revision of the Code should analyze these special provisions to test their current value. Many of these provisions, such as registration of controlling out-of-state shareholders and disclosure of alien ownership, are ripe for elimination.

We found numerous occasions in the bills and the accompanying comments where these provisions were restated in the revision without explanations to their continuing value.

4. In March, 1983, a final exposure draft of the revised Model Business Corporation Act drafted after much careful study, under the auspices of the American Bar Association was released. The revised Model Act is the product of top legal and business professionals from across the nation.

We recognize that Professor Fessler has drawn liberally, in his proposals to the Code Revision Commission version, from the Model Business Corporation Act before its 1983 revision. Submitted herewith for your reference is a copy of the March 1983 Model Act draft. The final version is due to be published in the summer of 1984, with minor changes.

Some members of the Task Force have reviewed the revised Model Act and the accompanying commentary had the benefit of nationwide consideration by practioners and academicians and, to the extent adopted in other states, will enhance interstate corporate commerce. In our opinion if a comprehensive revision is deemed necessary, the revised Model Act is the appropriate vehicle for Alaska to utilize.

Furthermore, we urge consideration of the Model Act because its adoption in many states will provide a body of decisional law upon which Alaskans may draw for guidance in interpreting the Act, something a very unique Act would not have available. In addition, an extensive legal commentary accompanies the Model Act aiding the reader in a clear understanding of the provisions. Finally, as is the case with the old Model Act, the draftmen of the revised Model Act will provide model bylaws and official corporate forms to assist the public. This should significantly reduce legal costs.

We hope that this rather hurried review is useful to your committees in your own deliberations on the bills.

It is our view that there are numerous questions about specific provisions in the that the Committees should require more study.

Since the HB 343 carries such important consequences and there has been no showing of urgency to change the law, nothing is lost by deferring action on a new comprehensive code for Alaska until next session. By so doing, the legislature could accomplish the following:

a. give the Legislature, Code Revision Commission, and the public a meaningful opportunity to fully consider the revised Model Act;

b. give all sectors of the business community an opportunity to consider and propose specific amendments;

c. explain to the non-lawyer business community the Legislature's interest in revising the Code and seek an expression of support or concern from affected economic sectors.

The Task Force is willing to continue working with your Committees and with the Code Revision Commission towards a bill that is the best possible statute for Alaskans.

Yours cordially,

Richard Block
Task Group Chairman

RB/pj
enclosures

ARTICLES 1. CORPORATE PURPOSES AND POWERS

By: Richard Block, David Bendell and Mark Copeland

A.S. 10.06.005. Purposes. This section assumes that banks and insurance companies have within their respective regulatory statutes comprehensive provisions dealing with incorporation. As to banks, there may be some justification for that assumption, but correlative changes to the banking law would have to be adopted to assure no conflict or gap. As to stock insurance companies, there is a statutory provision for special differences between the general corporation code and the incorporation provisions affecting insurance companies, but A.S. 21.69 does not provide a comprehensive scheme for all corporate matters, certainly not as comprehensive as the proposed code. Either the Code should be made applicable to insurance companies or the Insurance Code modified to make it a more comprehensive statutory scheme for regulating corporate affairs.

A.S. 10.06.010. General Powers. The Code would not prohibit loans to officers and directors which is a change from current Alaska law. e detect as a main theme in the Code, a tendency to require financial legitimization of the corporation, i.e. a tendency to require preservation of its financial substance for the protection of creditors and stockholders. This permission to make loans to officers and directors tends to defeat that objective.

Elsewhere in the code is specific authority for the corporation to indemnify officers and directors. If the "cookbook" approach is intended, would it not be appropriate to list authority to indemnify as one of the corporation's enumerated powers?

A.S. 10.06.015. Ultra Vires. This is a worthy protection for Alaskans in dealing with foreign corporations. Though we are not familiar with any assertions of "Ultra Vires" by foreign corporations in Alaska to annul a contract made here, the public policy approach of this section is welcome.

ARTICLE 2. NAME AND SERVICE OF PROCESS

By: Richard Block, Daivd Bendell and Mark Copeland

A.S. 10.06.105. Corporate Name. Prohibition of use of the words "city", "borough" or "village" would outlaw a number of currently valid trade names in Alaska such as "Village Inn" and "City Electric". The determination of deceptive similarity should be left to the Director of the Corporation Division as it is now, without numerous statutory restrictions.

A.S. 10.06.105(c). Prohibition of the word "Limited" by other than a corporation would preclude its use in Alaska by a limited partnership.

A.S. 10.06.135-145. Procedure for Registration of Corporate Name. These sections establish a procedure for reservation of name and registration of name which is more complex and more demanding than current procedures.

A.S. 10.06.155. Registration of Agent by Nonresident Agent. This section is indeed a recodification of a 1983 amendment to existing Alaska law, but is believed to be an unnecessary burden on corporations with out-of-state investors. If the basic concept of corporate existence is a valid one, there should be no valid reason for preserving a means of reaching its controlling shareholders.

A.S. 10.06.175. Service of Process on Corporation. This imposes a larger burden on plaintiffs to seek out a more direct link to the corporation for affecting service of process than the Director of Division of Corporations. Generally this is regarded as a beneficial change.

ARTICLE 3. FORMATION OF CORPORATIONS

By: Richard Block, David Bendell and Mark Copeland

A.S. 10.06.208. Articles of Incorporation. This, like section 155, carries forward the parochial requirement for disclosing the involvement of outsiders in Alaskan corporations. Since no law prohibits foreign or alien participation, why should there be special requirements for disclosing their involvement?

A.S. 10.06.208(6). There is inherent in this provision the requirement for a specific detailing of the relative rights and privileges of various classes and series of shares of stock. We question the necessity of such specificity if, by reason of section 315, the Board may be given the authority to determine the rights and privileges of particular series by its own resolution.

A.S. 10.06.210. Articles of Incorporation: Optional Provisions.

210(1)(C). This provision requires that for a restriction on qualifications of shareholders is to be effective, the restrictions must be set out in the Articles. This could prove to be a burden for a corporation which wishes to qualify an offering under one of the exemptions under the Federal Securities Act. It would appear that continued modification of the Articles ould be required to tailor the shareholder qualifications to the needs of differing offerings.

210(1)(H). Certain forms of bank and other institutional borrowing require that voting rights be conferred in the event of default. It is hard to know until the borrowing arrangements are made what the terms of such an agreement will be, yet the Articles must permit this authority. It could prove fatal to a borrowing transaction if the deal were held up pending approval of an amendment to the Articles of Incorporation.

As a general observation, it would appear that the general thrust of these sections is to use the Articles as much as a prospectus and disclosure statement as an organic document to bring the corporation into existence. This may, we suspect, be asking the corporation to unduly tie its hands, since changes to the Articles are made only after some time and difficulty, particularly if there are many shareholders.

A.S. 10.06.223. Organization Meeting. For most private corporations, it seems unnecessary to require 20 days notice before the organization meeting. We suspect that either the first meeting will be a "paper" meeting only, in which the case the requirement will be essentially ignored or the careful lawyer will have to insist on a basically needless delay in the incorporation process.

A.S. 10.06.230. By-laws: Number of Directors. There is offered no reason for putting statutory parameters on the number of directors that may be placed upon the Board. As long as the number does not exceed the limits if any placed in the Articles, the Board should not be further restricted in bringing needed or desired talent to its midst.

ARTICLE 4. CORPORATE FINANCE.

By: Richard Block, David Bendell and Mark Copeland

A.S. 10.06.320/323. Filing of Statement. These sections create a new way to amend the Articles-determine the specifics of a new stock offering and file a description of the new issue with Division of Corporations. Assuming that the offering does not require filing for a securities permit, these sections would be tantamount to making a securities filing anyway, with unclear responsibilities on the Director of the Corporations Division in dealing with the filing when it is made.

A.S. 10.06.325. Redemption of Shares. This provision unnecessarily prohibits what is believed to be a valid form of corporate financing, a security with a put. So long as all parties are cognizant of the terms there is no reason to prohibit such a financing option.

A.S. 10.06.333. Forfeiture of Shares. We here reiterate our concern for requiring the by-laws to contain things that can and ought to be merely a matter of contract. Remedies for failure to pay for subscribed shares are necessarily contained in what ever document the subscriber signs, making restatement in the by-laws redundant. Furthermore, the statute becomes unduly specific in the rights of a defaulting subscriber, including giving him a vested right in the realized appreciation in the value of shares for which he has failed to pay.

A.S. 10.06.348. Certificates Representing Shares. It is our concern whether the preservation of the certificate concept, even with the authority for facsimile signature, really will facilitate going to a book entry registration of share ownership capability.

A.S. 10.06.355. Issuance of Fractional Shares or Script. The proposed statute precludes the simplest method of dealing with fractional interests, the payment of cash. It is realignment of public policy to provide protection of the interests of infinitesimal minority shareholders by increasing the administrative burden on the corporation.

A.S. 10.06.358-363. The Financials. These sections introduce one of the most significant of substantive changes to the corporate law of this state. To achieve the intended result of prevention of asset dissipation for the protection of creditors, the Commission does away with the concept of "par value", establishes new criteria and more stringent criteria which must be met before dividends may be declared and imposes upon the corporate officers and directors standards for determining the propriety of dividends that can only be met, in our opinion, by obtaining a certified public audit of the books to determine if the criteria have been satisfied.

It is not within the province of this review to discuss the propriety of the public policy provisions, although the Task Force does not believe that the financial problems of debtors have been occasioned by abuses that would be stopped by these provisions. It is, however, our desire to bring to the attention of the Committees, what we perceive as the significant impacts of these provisions.

The oil of the free enterprise system is capital and the trick for a state that has as one of its manifestos, the attraction of capital, is to create an environment that permits the freest use of that capital consistent with equity and fairness for all involved with the enterprise. Recognizing that this last statement in a sense begs the issue, nonetheless, for the last many decades, at least, it has not seemed unfair to creditors to permit business enterprise the latitude to structure their capital to maximize their leveraged use of the resource, moving money from one enterprise to another.

The legislature should consider carefully what impact there will be on the attraction of capital to an enterprise that must by law reduce their leverage opportunity.

A.S. 10.06.368. Exception for Purchase or Redemption of Shares of Deceased Shareholder. This provision is of course important, but we cannot understand why the authority is limited to proceeds of insurance beyond the premiums paid. In other words, if over time $25,000 were paid in premiums for $500,000 life insurance to fund a buy-out provision, the corporation could only pay $475,000.

A.S. 10.06.378 Liability of Shareholders Receiving Prohibited Distribution. This provision raises some interesting prospective problems.

It should be noted that there are some on the Task Force that wonder why knowledge of the improprieties of the distribution is requisite to the cause of action. They argue that if the distribution is wrongful, akin to theft from the creditors, it should be returned, even though they may not have actually had knowledge of its illicit nature.

It is suspected by the Task Force that this section could be the foundation for a whole new source of complicated and expensive litigation.

ARTICLE 5. SHAREHOLDERS
By: Brian J. Brundin

A.S. 10.06.405 MEETINGS OF SHAREHOLDERS.

This section proposes three changes to the current Alaska Business Corporation Act. The first is that a shareholder may petition for a court order that an annual shareholder meeting be held if one has not been held within any 13-month period. The second is removal of the provision that failure to hold the annual meeting at the designated time does not work a forfeiture or dissolution of the corporation. The third adds the Chairman of the Board to the virtually unlimited number of persons who may be authorized to call a shareholders' meeting.

COMMENT: The first change, allowing any shareholder to obtain a court order to hold an annual meeting, presents more questions than it answers. Who will pay the court costs? May there be legitimate reasons for not holding a meeting within any 13 months? The major business usually conducted at the annual meeting of shareholders who can influence the electing of directors, namely who holds one-tenth or more of the shares entitled to vote, already have the statutory right to call a meeting. Under this proposal, the holder of one share could sue for an order that a meeting be held and probably charge the court costs to the corporation - even if he had no real ability to affect the business to be done at the meeting and even if there was a good reason why there had not been a meeting within the past 13 months. This change is unnecessary and gives the ability for an insignificant minority "trouble-maker" shareholder to either grab publicity or otherwise stir the pot to the detriment of other shareholders and the corporation. The holding of the meeting of a large corporation, and particularly one publicly held where proxie statements must be mailed, can be a very expensive undertaking.

Does the second proposed change mean to suggest that failure to hold the annual meeting at the designated time may work a forfeiture or dissolution of the corporation? That consequences could be disastrous.

As to the third proposed change, present law allows the president, the board, ten percent shareholders "or the other officers or persons provided in the articles of incorporation or the bylaws" to call a shareholders' meeting. If ommission of the Chairman of the Board is a problem, corporations may now resolve that problem by simply including his name in the Articles or Bylaws. A change of statute is not required. Apparently the Revised Model Act does not confer this right on the Chairman of the Board, since absent other authority given to the Chairman, he simply chairs the Board of Directors, and it is the Board of Directors who takes Board action, not the Chairman.

A.S. 10.06.408 CLOSING OF TRANSFER BOOKS AND FIXING RECORD DATE.

It appears three changes here are also proposed. The first is that instead of closing the stock transfer books for a period not exceeding 50 days, and for at least 10 days before a meeting, 60 days and 20 days are substituted. Secondly, a new way to fix record date is provided. If the Directors do not act, the date on which the notice of meeting is mailed or the date on which the resolution of the Board declaring the dividend is adopted is the record date. Thirdly, the determination of shareholders applies to an adjournment of the meeting of shareholders - under earlier law it would apply if the 50 days had expired.

COMMENT: As to the first change, this and the subsequent sections appear to make it impossible to hold a meeting of shareholders in less than 20 days without waiver of all shareholders; an extension of time which, in this day of modern communication, would seem to unnecessarily hamper the corporation in the holding of a meeting in less time if necessary. The Model Act retains 10 days. No reason is given why 20 days is suggested.

The second change seems unnecessary. In a very small corporation, the people who are shareholders remains relatively fixed, and no "new" way to determine who they are is required. In a large corporation, the present law is adequate and directors are capable of utilizing one of the two ways now provided.

The third change would seem to allow a possible "freezing out" of new shareholders by the adjournment of a meeting for longer than the 50-day period that the stock transfer books may now be closed.

A.S. 10.06.410 NOTICE OF SHAREHOLDERS' MEETINGS.

Besides some rewording, it appears the change in this section is to set a minimum time of 20 days rather than 10 days from the date notice is given until the meeting held. See comment above.

A.S. 10.06.413 VOTING LIST; LIABILITY.

Despite the long discussion of this section in the official comment, it appears there is no change to the prior law except again the 10 days to 20 days.

COMMENT: Shareholders now have an absolute right to view the shareholder list prior to a meeting, and so far as I know, the "proper purpose" doctrine is not applied in this instance, for it is manifestly a proper purpose for a shareholder to exercise his statutory right to view a voters' list prior to a meeting. See earlier comment regarding increase in time from 10 to 20 days.

A.S. 10.06.415 QUORUM OF SHAREHOLDERS.

The change proposed here allows a quorum once constituted to continue notwithstanding the withdrawal of enough shareholders to leave less than quorum and is intended to prevent a meeting from continuing by a "walk-out" of a minority.

COMMENT: While this change is not now in our statutes, it may be provided for by common law or by Roberts Rules of Order. While it seems to be a useful change, in my almost 18 years of practice, this question has never presented a problem to a client.

A.S. 10.06.418 PROXIES.

This proposed change expands the four-line section of current law to more than two pages in an attempt to regulate the giving of proxies under several enumerated situations. It undoes a 1972 amendment which prohibited proxies lasting more than eleven months.

COMMENT: While it is arguably useful to allow long-term proxies for security agreements, pledges, employment contracts, trusts and the like, the two new pages of proposed regulations will undoubtedly create many new opportunites for court battles. On balance I think it is cheaper and better to maintain the present law that only short-term proxies are allowed. The important right to vote should be difficult to take away from a shareholder. Requiring a shareholder who wishes to give a proxy to do so annually makes him think about his corporate investment at least annually and allows a reconsideration of whether a proxy given should be renewed.

A.S. 10.06.420 VOTING OF SHARES.

The major proposed change of this section is to lean back again toward cumulative voting, only more strongly than ever before. Alaska's law has bounced back and forth on this question, and presently allows cumulative voting unless the Bylaws provide otherwise. The suggested change presumes it unless the Articles say otherwise, and once cumulative voting is allowed, for no change to it if not approved by a shareholder who, under cumulative voting, could elect a director. Part (f) lists "administrator, executor" instead of personal representative as described in A.S. 13.06.050(30).

COMMENT: The issue of presuming or not presuming cumulative voting has long been debated and, as stated earlier, Alaska law has changed on this subject over the years. I am not aware of any Alaskan business proposal to change it back again.

Since the present statute has been unamended since 1964, adoption of this new provision would require many corporations to undergo the expenses of amending their Articles or Bylaws for a matter than does not appear to be a burning issue.

A.S. 10.06.423 ACTIONS TAKEN WITHOUT MEETING: MEETING CONSENT; REVOCATION OF CONSENT.

This appears only to rewrite and not change current law regarding unanimous consent. The official comment is confusing; it seems to say there is a change. Added to present law is a provision allowing revocation of such consent.

COMMENT: The rewriting does not seem to be required, nor is the addition of a provision alllowing revocation of consent. In my experience, consent is most always requested to confirm actions earlier taken.

A.S. 10.06.425 VOTING TRUSTS AND AGREEMENTS AMONG SHAREHOLDERS.

This provision again amplifies current law. Whether or not it changes the law is debatable. Current law requires a copy of the trust agreement to be deposited with the corporation for inspection. The new proposals spells out the names and addresses of all the holders of trust certificates also must be deposited, which may already be required. Additionally a new section is added from California law which does not invalidate pooling arrangements so long as they comply with the more complex proxy rules proposed by Section 413.

COMMENT: Voting trust and pooling interest have not been burning issues in Alaska. The proposal is to regulate them to a greater degree. The proposal is at variance with the Model Act and is apparently a synthesis of former Alaska law, the Model Act and California law.

Like other provisions proposed, where a question has not been an issue in Alaska and is unlikely therefore to have court interpretations, I think it is not useful to adopt proposals that synthesize the law of several jurisdictions. From a practitioner and businessman's view point it would be better to adopt the Model Act so that if questions do arise, decisions from other jurisdictions regarding the Model Act, and its commentaries, will provide guidance.

A.S. 10.06.428 SHAREHOLDERS' PRE-EMPTIVE RIGHTS.

This is again a one-page substitution for 12 lines of two current sections. Current law leaves the matter to the Articles of Incorportion and, if not covered by the Articles, provides for sales to officers or employees upon a two-thirds

vote of shareholders. The proposal continues the right to limit or deny (but apparently not to expand) pre-emptive rights and spells out several rules that will exist with respect to different kinds of shares if such rules are not changed by the Articles. The official comments suggest the Legislature intends to occupy the field with respect to circumstances under which pre-emptive rights are to be recognized and, apparently beyond the words of the proposed statute, for the Legislature to adopt the holding and reasoning of the Kazowitz case, which limits the ability of a corporation to issue additional stock, thus financially troubling shareholders who wish to exercise pre-emptive rights, unless a valid business purpose can be established for the issuance of the stock.

COMMENT: The proposal is stated to be "predicated" upon the Model Act, but apparently is not the same. For reasons suggested above, I think it is preferable, if any change needs to be made, the Model Act language be used.

A.S. 10.06.430 BOOKS AND RECORDS.

This proposal enlarges considerably the requirement for keeping of books and records and allowing inspection of them by shareholders. Under present law, a person who has been a shareholder of record for at least six months or who holds at least five percent of the outstanding shares may inspect and copy such reocrds. The proposal allows all shareholders to do so. Under current law refusal to give the information can result in payment of a penalty of ten percent of the value of the shares owned by the shareholder in addition to other damages. The new proposal is that the penalty be ten percent or $5,000.00, whichever is greater, in addition to other damages. Under current and proposed law a court may order inspection irrespective of the amount of shares owned or the time they have been owned. Official comments declare that the Legislature intends to adopt numerous cases cited.

COMMENT: This change would make it easier for a person to buy one share of the stock of a corporation and "stir up the pot". The citation of cases and the official comment which the writer requests that the Legislature adopt again suggests the proposal is not verbatim from the Model Act, which carries its own interpretive law, and accordingly the proposal may be "skewed" toward the bias of the drafter.

A.S. 10.06.433 ANNUAL REPORT TO SHAREHOLDERS: CONTENTS; FINANCIAL STATEMENT ON REQUEST.

This proposal, new to Alaska and taken from the California law according to the official comment, describes an elaborate three-page regulation requiring annual reporting by corporations to shareholders. Corporations with under 100 share-

holders will have to amend their Articles of Incorporation to avoid its complex rules. Corporations with 100 or more shareholders will have to make elaborate reporting such as is done by a publicly-owned corporation under provisions of the Securities & Exchange Act. Additionally the corporation must prepare quarterly financial statements, keep them on file, and mail them to any shareholder demanding a copy. A penalty of up to $1,500.00 per shareholder is provided for violation.

COMMENT: This is surely one of the "land mines" of the proposed statute, which would, on the one hand, blow the feet off a small corporation which fails to amend its Articles to avoid its onerous provisions or, on the other hand, create an entirely new and expensive level of reporting and penalties for corporations with more than 100 shareholders. It is unprecedented in Alaska law, and apparently draws on the "innovation" recently made in California law. No similar provision is contained in the Model Act.

The more one reads this proposed law, the more it appears that the drafter of it has a bias against corporations and an intention to "save" shareholders and others from the "ghastly beasts".

The proposed provision appears not only unnecessary but potentially very damaging. Any investor who buys stock in a large publicly-owned company is already protected by securities laws. Small closely-held corporations on the other hand are ordinarily not owned by other than those involved in the business closely enough to not require such "protection". Larger and publicly-owned corporations which must now comply with other regulation, such as securities laws, will be met in Alaska with an unnecessary additional layer of regulation which includes the costs of keeping and mailing additional financial reports to any shareholder who requests them. Would this add to what some feel is an "anti-business" attitude in Alaska? As earlier suggested, this proposal can only act to cause unnecessary potentially damaging problems to smaller corporations.

Again because the proposal, purportedly "adapted" from the new California law appears to be the words of the drafter, one can only begin to contemplate all of the new issues which might be raised and for which there would be no answer from other jurisdictions to guide the practitioner or businessman.

A.S. 10.06.435 SHAREHOLDERS' DERIVATIVE ACTION.

This is another proposal without precedent in Alaska statutory law. It is a four-page detailed scenario for the suing of a corporation by a disgruntled shareholder which requires eight pages of the official comment to describe. It sets out in detail some rules to be followed in pleading the action.

COMMENT: Provisions of this nature do not belong in the corporate statutory law. Rules of pleading in Alaska should be left to the court and the development of derivative actions to the common law. Again the proposal exhibits a bias against corporations by making it easier to bring and maintain such derivative actions. Again it is the words of the drafter, adapting the law of other jurisdictions, reportedly mostly New York and California, and accordingly will create problems of interpretation unique to Alaska.

A.S. 10.06.438 LIABILITY OF SHAREHOLDERS AND SUBSCRIBERS.

This proposal does not appear to change present statutory law, being almost verbatim.

COMMENT: The official comment suggests there are words in the proposal which I do not find, and the comment deals almost entirely with other liability which may arise under another section, Section 488.

ARTICLE 6. DIRECTORS AND OFFICERS
By: Julius J. Brecht

A.S. 10.06.450 Board of Directors: Duty of Care; Right of Inspection; Failure to Dissent.

Proposed 10.06.450(b) sets forth various individuals upon which a director may rely in performing his directorship functions. Subsection (c), however, removes the insulation from liability provided by Subsection (b) if the reliance is found to be "unwarranted". Substantial questions are therefore raised as to what protection, if any, is provided by the provision of Subsection (b).

A.S. 10.06.465. Vacancies and Resignation; Special Meeting of Shareholders.

Proposed 10.06.465(d) provides that a director may not be relieved from the responsibilities of his or her office until a qualified successor has been elected. Since the effective date of resignation is apparently unimportant for fixing liability, it is possible that a director who has resigned from the board will continue to be personally liable for board actions long after his active participation with the company has ended.

A.S. 10.06.488. Secondary Liability of Directors and Officers.

Proposed 10.06.488 imposes primary and secondary liability upon directors and officers which is an aberration and contrary to long standing corporate principals and judicial decisions. For all practical purposes, the distinction between "corporation" and "individual" has been lost in the proposed Senate Bill. This extension of liability is apparently designed to provide corporate creditors with an additional and/or secondary source for corporate business failures. As Mr. Reitman has indicated, these aberrations are almost guaranteed to generate traps for the unwary and result in a proliferation of litigation. Well known and understood business practices, such as personal guarantees have long been used to secure payment of corporate indebtedness. The liability of directors and officers is also a matter of long established statutory law and judicial precedent. The radical departure proposed by these sections should not be adopted without much additional study and justification. The potential impact of this provisioin was the subject of ample comment at the joint committee hearings in Anchorage on February 24, 1984, and will not be further developed here.

ARTICLE 7. AMENDMENTS AND CHANGES

By: Kenneth Eggers

AS 10.06.502 AUTHORIZATION: PERMITTED AND PROHIBITED AMENDMENTS.

Appears to be more confusing than is necessary. The MBCA (Revised Model Act) would appear to accomplish the same purpose in a more clear, streamline manner.

AS 10.06.504 PROCEDURE TO AMEND ARTICLES OF INCORPORATION.

Gives shareholders explicit power to initiate amendments. Merely need majority of shares entitled to vote as opposed to 2/3rds as required under present Alaska law unless otherwise provided.

AS 10.06.508 GREATER VOTING REQUIREMENTS.

If articles require super majority then amendment must be approved by same super majority. Consistent with MBCA.

AS 10.06.522 AMENDMENT OF ARTICLES OF INCORPORATION IN REORGANIZATION PROCEEDINGS.

Allows Amendment pursuant to order of Bankruptcy Court in reorganization proceeding. Section taken from MBCA.

ARTICLE 8. ORGANIC CHANGES
By: Kenneth Eggers

AS 10.06.542 DISPARATE TREATMENT OF THE SAME CLASS OR SERIES PROHIBITED: EXCEPTIONS.

New to Alaska, allows disparate treatment to preserve Sub S election, unanimous consent, or sound business reason. The last reason is undefined, leaves open the possibility of abuse and is an invitation to litigation.

AS 10.06.554 MERGER OF SUBSIDIARY CORPORATION.

Allows merger without shareholder vote if parent owns at least 90% of stock of subsidiary. Taken from Model Act. New to Alaska. Short form merger.

AS 10.06.556 PROCEDURE FOR MERGER OF SUBSIDIARY CORPORATION.

Premised on Model Act except require that provisions of 542 be met.

AS 10.06.562 MERGER, CONSOLIDATION, OR EXCHANGE OF SHARE DOMESTIC AND FOREIGN CORPORATION.

Domestic corporation must comply with Alaska law. If foreign corporation survives, it must comply with Alaska law for doing business. Must agree to pay dissenting shareholders. This section again calls into question the idea of imposing Alaska law on foreign corporation no matter how minimal their contract may be with Alaska. This could very well discourage foreign corporations from looking at Alaska corporations for merger partners and could adversely impact business opportunities for Alaska-owned corporation.

AS 10.06.566 SALE OF ASSETS IN REGULAR COURSE OF BUSINESS; MORTGAGE OR PLEDGE OF ASSETS.

New in that it ALLOWS MORTGAGE OR PLEDGE of any or all property and assets of corporation whether or not in the usual and regular course of business without shareholder approval. One must ask from a policy point of view if the directors of a corporation who need not have any financial interest in a corporation at all to hold office should have the power to mortgage all of the property of the corporation not in the usual and regular course of business without going to the shareholders. Obviously such decisions could lead to the bankruptcy of a corporation. While the Model Act has the same provision, it

specifically provides that shareholder approval can be required if such a provision is set forth in the Articles of Incorporation. At a minimum, the Alaska act should do the same.

AS 10.06.568 SALE OF ASSETS NOT IN REGULAR COURSE OF BUSINESS.

New in that it eliminates need for shareholder approval for mortgage or pledge of any or all property.

AS 10.06.570 APPROVAL OF TRANSACTION BY SHAREHOLDERS.

If Buyer in the sale is in control of or under the common control with the Seller 570(b) erects an extraordinary requirement of approval via at least 90% of the outstanding shares regardless of restrictions or limitations in the Articles or share indenture - UNPRECEDENTED IN ALASKA LAW. This gives minority shareholders (11%) tremendous power and one must question why a 2/3rds requirement is not sufficient and more practical.

AS 10.06.574 RIGHT OF SHAREHOLDER TO DISSENT.

No right in case of short merger (554) and shares traded on national securities exchange.

AS 10.06.582 ACTION TO DETERMINE VALUE OF SHARES UPON FAILURE TO AGREE.

Premised on Model Act. Burden on corporation to initiate action. A consolidated action. Corporation must bear costs and expenses unless shareholder acted in an arbitrary or vexatious manner or in bad faith. Costs exclude attorney fees and experts (except appraiser) unless fair value determined by court materially exceeds amount corporation offered to pay in which case, shareholders can obtain reimbursement for expenses. This is a very one sided provision in favor of the shareholders. Shareholders could recover costs from corporation even if corporation offer exceeded what the court ultimately awards. The effect of this section as written is to encourage dissent and unnecessary litigation. This section should be rewritten so that the possible risks are more fairly apportioned. This will serve to encourage settlement of any disputes which may arise.

ARTICLE 9. DISSOLUTION

By: Richard Rosston, Stanley Reitman,
Ray Gardner and Bruce Frenzel

A.S. 10.06.605. Section 605 permits the Board of Directors under specified circumstances to authorize involuntary dissolution without a shareholder vote by filing a petition on behalf of the corporation in the Bankruptcy Court. Without safeguards, the Board of Directors may usurp a corporate opportunity by dissolving the existing corporation and then forming their own corporation to take advantage of opportunities available to the previously existing corporation.

A.S. 10.06.635. Section 635(a)(2) confers broad authority on the state to involuntarily dissolve a corporation which "has continued to exceed or abuse the authority conferred upon it by law." Additionally, it should be noted that subsection (3) ambiguously refers to the imposition of involuntary dissolution by the state if "the corporation has seriously violated a statute regulating corporations." The Subcommittee considers the interpretation of a serious violation as opposed to a minor violation to be overly subjective.

A.S. 10.06.605. By comparing provisions of the exposure draft of the old Model Act, as distinguished from the ABA revised MBCA, with Section 605, the Subcommittee concluded that certain provisions in Section 605 are counterproductive. For instance, the old Model Act requires notice of pending dissolution to all of the shareholders, rather than just the voting shareholders as set forth in Section 605. Nonvoting shareholders should be informed of the pending dissolution of a corporation in which they have a beneficial interest. Additionally, Section 605 needlessly requires class voting for dissolution, whereas the old Model Act relies upon the Articles of Incorporation for the voting structure in order to avoid conflicts.

A.S. 10.06.608. The requirement to file a "certificate of election" with the commissioner in addition to the "Articles of Incorporation" is superfluous and will result in unnecessary administrative burden.

A.S. 10.06.615. Provisions of Section 615 permitting the conduct of business after dissolution only to preserve "goodwill or going concern value" are ambiguous insofar as they do not specify what business activities are authorized thereunder.

A.S. 10.06.628. Section 628 curtails the rights of creditors to initiate involuntary dissolution proceedings. The commentary justifies this revision of existing law on the basis of the proposed Section 488 imposition of liability on officers and directors. To the extent that the revision represented by Section 628 is predicated upon the adoption of Section 488, it is opposed by the Subcommittee.

A.S. 10.06.633. Section 633 permits the Commissioner to administratively initiate involuntary dissolution proceedings against the corporation if "a misrepresentation of material fact has been made in the application, report, affidavit or other document" submitted to the Commission. Neither the revised code nor the commentary indicate whether such liability may be imposed for innocent misrepresentation or whether a negligence standard applies. Additionally, Section 633's provisions for an administrative appeal by a trial de novo in Superior Court could create a substantial burden on both the Department of Commerce and the court system.

A.S. 10.06.645. By invoking the equity jurisdiction of the court, Section 645 injects an element of uncertainty into the dissolution process and increases the possibility of unnecessary litigation.

A.S. 10.06.653. Section 653 requires the Commissioner of Revenue to act as a stake-holder of corporate assets which are the subject of dispute between shareholders or creditors. This provision could involve the Commissioner of Revenue in litigation and may increase administrative burdens.

A.S. 10.06.663. It is doubtful that any qualified individual would accept an appointment as a director under Section 663 given the potential liability created by Section 488.

ARTICLE 10. FOREIGN CORPORATIONS

By: Richard Rosston, Stanley Reitman, Ray Gardner and Bruce Frenzel

A.S. 10.06.743. Section 743 permits the commissioner to revoke a foreign corporation's certificate of authority if "the corporation" is a party to an illegal combination in restraint of trade." No similar statutory provision exists with respect to domestic corporations, and the Subcommittee is unaware of any reason to discriminate against foreign corporations. Although the provision is in the existing statute, it should be eliminated pursuant to a comprehensive code revision.

A.S. 10.06.773. Although foreign corporations are not required to file their Articles of Incorporation with the Commissioner, Section 773 mandates the filing of amendments. The subcommittee recommends that if the Articles are not to be filed, then the requirement to file amendments should also be deleted.

A.S. 10.06.828. Section 828 provides that "the filing fee should be uniform and fixed without reference to the amount of authorized shares," whereas the commentary states that the filing fee shall be fixed "with reference" to the amount of authorized shares.

A.S. 10.06.955. Section 955 makes Section 488 liability to directors and officers applicable to foreign corporations doing business in the State of Alaska. The Subcommittee believes that such imposition of liability will have a significant "chilling effect" on outside investments in the state.

A.S. 10.06.960. Corporations organized under PL 92-203: It should be noted that the provisions in Section 960 protecting officers and directors of Native corporations under Section 10.06.488 does not extend to subsidiary corporations which are wholly or partially owned by corporations formed under the Alaska Native Claims Settlement Act. Additionally, Section 960 may violate the equal protection clauses of the U.S. and Alaska Constitutions.

HB 343 CSSB 246 (L&C)
on
Business Corporations

Summary

The bill provides for replacing the Alaska Business Corporation Act, AS 10.05, with the Alaska Corporation Code (ACC), a comprehensive revision.

The proposed ACC sets minimum requirements that must be met for the privilege of doing business in the corporation form.

Within limits it leaves to incorporators how to divide powers between shareholders and directors.

It standardizes reporting required to shareholders and the state.

It seeks to clearly define in what circumstances it is permissible to pay a dividend.

While maintaining the right of shareholders to sue corporate officers and directors in appropriate circumstances, it seeks to control the misuse of these "derivative suits."

It also seeks to control misuse of the limited liability of officers and directors that the corporate form provides.

In the covering letter at the start of the commentary in House and Senate Joint Journal Supplement No. 11, there is an expanded summary of the bill. Following that is a section analysis which includes the background and basis for choices that have been made in drafting the bill.

STATE OF ALASKA 1984 LEGISLATIVE SESSION
FISCAL NOTE

Revision Date: January 31, 1984

REQUEST
Bill/Resolution No.: SB 246
Title: An act revising the Alaska Corporations Code.
Sponsor: Rules Committee
Requestor: Legislative Council
Date of Request: 4/8/83

FISCAL DETAIL
Agency Affected: Commerce and Economic Dev.
Program Category Affected: Consumer Protection.
BRU, Program or Subprogram(s) Affected: Banking, Securities and Corporations

EXPENDITURES/REVENUES: (Thousands of Dollars)

OPERATING	FY 84	FY 85	FY 86	FY 87	FY 88	FY 89
100 PERSONAL SERVICES						
200 TRAVEL						
300 CONTRACTUAL						
400 SUPPLIES						
500 EQUIPMENT						
600 LAND & STRUCTURES						
700 GRANTS, CLAIMS						
800 MISCELLANEOUS						
* TOTAL OPERATING	- 0 -	- 0 -	- 0 -	- 0 -	- 0 -	- 0 -
CAPITAL	- 0 -	- 0 -	- 0 -	- 0 -	- 0 -	- 0 -
REVENUE	- 0 -	- 0 -	- 0 -	- 0 -	- 0 -	- 0 -

FUNDING: (Thousands of Dollars)

GENERAL FUND						
FEDERAL FUNDS						
OTHER						
TOTAL						

POSITIONS:

FULL-TIME						
PART-TIME						
TEMPORARY						

SOURCE OF FUNDS TO OFFSET FISCAL IMPACT OF BILL:

* There will be no fiscal impact providing the adoption of the proposed amendment of the Alaska Code Revision Commission which deletes in Sec. 10.06.733 the words, "together with a verified copy of its articles of incorporation and all amendments to the articles."

ANALYSIS: Attach a separate page for analysis

Prepared By: Willis F. Kirkpatrick
Phone: 465-2521
Division: Banking, Securities and Corporations
Date: 1/31/84

Approved by Commissioner: Richard A. Lyon
Date: 2/3/84
Agency: Commerce and Economic Development

Distribution (by Agency preparing fiscal note):
Legislative Finance
Legislative Sponsor
Requestor
Office of Management and Budget
Impacted Agency(ies)

12/1/83

TESTIMONY OF JOHN W. ABBOTT, Chairman of the Alaska Code Revision Commission.

Subject: CSSB 246/HB 343

Delivered before a Subcommittee of the Senate Judiciary Committee, the Honorable Joseph P. Josephson presiding, Anchorage, Alaska, April 28, 1984.

MR. CHAIRMAN: My name is John W. Abbott, I am a resident of Anchorage, a member of the Alaska Bar Association and am the Chairman of the Alaska Code Revision Commission. I welcome the opportunity to appear before this Committee and to utilize this forum to respond on the record to the work product of the self-appointed ad hoc committee of Anchorage lawyers as well as several aspects of the conduct of members of that group as they have sought to influence legislative consideration of the proposed Alaska Corporations Code.

On February 24, 1984, Mr. Richard Block and Mr. Paul Kelly led a group of Anchorage attorneys in offering public commentary on S.B. 246 which had been favorably reported out of the Senate Labor and Commerce Committee following two hearings. The forum selected by the members of this self-appointed task force was a joint hearing conducted in Anchorage by the House Judiciary and Labor and Commerce Committees. At that time Mr. Block and his associates requested a thirty day grace period during which time they promised to prepare what was styled as "an economic impact" report on the pending legislation. On March 30, 1984, thirteen pages of cover letters accompanied a twenty-one page report

directed to committee chairmen in both the Senate and House. Rarely has such a diminutive substantive patty been served up on such a fluffy procedural bun. As a prelude to the Commission's response to that report I would like to comment upon several aspects of the public testimony given by task force members and written statements and representations made by Mr. Block and his confederate in this affair, Mr. Stanley Reitman, also of the Anchorage Bar.

Several of the witnesses, echoing the "if it ain't broke don't fix it" line, questioned the need for any legislative attention to Alaska statutory law respecting profit seeking corporations. Others questioned the role of the Code Revision Commission in terms which may have left members of the public and Legislature with the very inaccurate impression that the pending Alaska Corporations Code had been created in a vacuum with no previous exposure. With respect to the legal community in particular, the impression may have emerged that the Bar Association and its Business Law Section had been taken off-guard. Last, but perhaps most distressing, Mr. Reitman is responsible for repeated efforts to shift attention from the merits of the Commission's work to the identity of its consultant. In two letters intended for broad circulation among the leaders of both the Senate and House, Mr. Reitman insists upon terming S.B. 246 and H.B. 343 as the "Fessler Code." His most recent tactic is to question the identity of Professor Fessler and his influence over the members of the Commission and its work product. Let me take up these topics in the order which

I have raised them.

1. The Legislature's charge to the Code Revision Commission obligates it to undertake periodic review of the content of Alaska statutory law and, if it determines that conditions warrant, recommend revision of the law. Anyone who takes the time to review a transcript of the February 24 hearing will gain some interesting insight regarding the views of those who sought the thirty day grace period to perform their voluntary study of the proposed corporations code. Their admitted lack of familiarity with either the general goals or specific content of that reform effort is matched by their ignorance of the Legislature's decision to create a broadly based study group composed of both elected officials and appointed citizens and to charge that body with the task of reviewing the condition of Alaska statutory law, testing it against economic, demographic and theoretical developments and determining whether it continues to represent the best policy for this state and its citizens. The Code Revision Commission by law must include a member of the Senate and the House, a designee of the Court System, a representative of the Department of Law, a representative of the Alaska Bar Association, and three public members appointed by the Governor. While it has not always been the case, all but one of the current members of the Commission happen to be lawyers.

2. My letter of transmittal to Senator Ray dated March 3, 1983, sets forth the Commission's findings and conclusions respecting the need to revise the statutory law we borrowed from the State of Oregon at the time of statehood. The "ain't broke

don't fix it" school of thought has always left out the possibility that "it" might need fixing because "it" is simply worn out. Alaska's current statutory law on profit seeking corporations was adopted wholesale from a mid-1950's version of the Model Business Corporations Act. That Act was intended for the needs of no state but has enjoyed significant influence over the statutory content of smaller states of lesser economic consequence. If one is to be candid, it permitted the unstaffed part-time legislatures of such states to achieve legislation in the corporate area with little thought and little effort. Major states, such as New York and California, have always preferred to think matters through for themselves. Delaware, the most significant American state in terms of corporate law, has also preferred to create its own corporate law. Over the years the recommended content of the Model Act has been expanded. Even the "ain't broke" advocates were forced to admit at the February hearing that Alaska has been very tardy in considering, let alone adopting these amendments. Finally, in 1979, the American Bar Association acknowledged that the time had come to totally re-think the content of the Model Act. In the meantime few Alaskans need to be reminded that economic conditions in the mid-1980's bear little similarity to those of the late 1950's. It was in recognition of these factors that the Commission determined that it was appropriate to study with a view toward revision the profit seeking laws of this state.

The self-appointed task force has consumed thirty days of the public's legislative session and, far from supporting its

initial view that the law does not need revision, now advances specific proposals for change and urges that the Revised Model Business Corporations Act be adopted as the vehicle for that change. Given this apparent change of heart perhaps the Legislature will not be further impeded as it directs its attention to framing a code best suited to the needs of Alaskans.

3. Any impression that the Alaska Bar Association was not apprised of the Commission's work or that members were precluded from an opportunity to review and participate in the process is neither factual nor fair. The variety of witnesses who followed Mr. Block before the joint House Committee excused their ignorance of the proposed corporations code on the ground that it had only recently come to their attention. I find this remarkable. An exposure draft of the code was introduced as S.B. 873 in the Twelfth Legislature in March, 1982. At that time the Senate Journal Supplement carried several hundred pages of explanatory commentary. In May, 1982, a written summary of the Commission's proposed code was prepared for the state convention of the Alaska Bar Association held in Anchorage. In a further effort, the Commission directed its consultant, Professor Fessler, to present a two hour oral summary of highlights at that convention. Copies of S.B. 873 were made available at that meeting along with copies of the official comments. The Commission's Juneau office address was widely noted as well as the availability of both the bill and commentary at the various legislative information offices throughout the state.

In June, and again in July, 1982, Professor Fessler addres-

sed civic groups including both the Downtown and Matsu Valley Rotary Clubs. Again he was directed to spell out the highlights of the Commission's exposure draft.

In December, 1982, Professor Fessler returned to Anchorage this time at the invitation of the Business Law Section of the Bar Association. It is interesting to note that the individual most responsible for that invitation, and for discussing the scope of the two day seminar which spent half of its time focusing upon the new code, was Mr. Richard Block.

Members of the Legislature may wish to weigh these repeated and specific opportunities to gain knowledge and to participate against the transcript of professed surprise and ignorance on the part of individuals who would now like to appear highly motivated and public spirited.

It should also be remembered that these are members of the only profession in the state which, by law, is officially represented on the Commission. My colleague, Jerry Kurtz, has served on the Commission as the Bar Association's representative throughout the entire period when the current law was first evaluated and the proposed code was evolved. His background as a practicing lawyer specializing in a business related practice equals or exceeds that of any member of this self-selected task force. I might add that since concluding my period of service to the Alaska Supreme Court I have engaged in a private practice which has also concentrated on business matters.

4. Mr. Block's assertion that Professor Fessler was not available to meet with members of the ad hoc task force in time

to assist them is incorrect. As early as February 24, Professor Fessler in my presence informed Mr. Kelly and others of his willingness to meet with them either in person or by conference call. This was the same conversation in which, with my consent, he volunteered to forward the various working documents which had been used by the Commission in evolving the content of the current proposal. In telephone conversations with Judge Stewart, Mr. Reitman was also assured of Professor Fessler's strong desire to meet with members of the task force. The fact that no such meeting took place reflects a decision of Mr. Block and his colleagues and they ought to be sufficiently open with members of the Legislature to admit that fact.

5. Mr. Reitman's sudden curiosity concerning the identity and views of the Commission's consultant reveal a self-imposed ignorance which can quickly be dispelled.

On March 12, 1984, Mr. Reitman wrote to the Chairman of this Sub-Committee a nine page letter in which he outlined his views on the Model Act, the efforts to generate a revised version of that recommended legislation, the status of close corporations and his opposition to Section 488 (dealing with the secondary liability of officers and directors). He concluded by stating that ". . .nothing contained here is intended to downgrade the scholarship or craftsmanship of Professor Fessler, substantially relied on by the ACRC, nor of the laudable motives of the ACRC." In a footnote to that statement, Mr. Reitman reports his participation in a telephone conversation with Professor Fessler in which ". . .he [Fessler] was most gracious in answering

questions posed, and in correcting my [Reitman's] misreading or inadequate reading of a number of specific provisions thereof."

Eighteen days later, Mr. Reitman again corresponded with the Chairman of this Sub-committee and asked that his letters be made part of the public record. His attitude toward the Commission and Professor Fessler have undergone substantial change. An explanation for this change can be found in Reitman's reaction to a memorandum which Professor Fessler had prepared in 1981 as one of a series of study papers for the Commission. This particular one dealt with the topic of close corporations. Mr. Reitman could not have intended to portray himself as some investigative reporter for that would have been at variance with the truth. It is thus unfortunate that he did not tell Senator Josephson that he was reacting to a large volume of background papers which the Commission and Professor Fessler furnished the self-appointed task force in efforts to overcome their three year lack of interest and participation.

Mr. Reitman, the man who only days earlier was urging the Senate to look before it leapt, made no effort to contact me or any other member of the Commission concerning Professor Fessler or the reaction of the members to the specific memorandum concerning close corporations. Were it not that we would have to add it to a growing list of omissions one could assign this lack of contact to inadvertence. Since he appended the text of the memorandum I will not comment on it save to note that all references to "corporations" in Mr. Reitman's letter of March 30, 1984, should read to "close corporations." To suggest that Professor Fessler "does not approve of the corporate vehicle" is

thus fundamentally misleading. (Mr. Reitman owes the Senate, the Commission, and Professor Fessler an apology.)

Mr. Reitman does, however, raise a question as to Professor Fessler's background. Since he has asked that the question be spread on the public record it deserves a public response.

Daniel Fessler is a Professor of Law at the University of California, Davis. He has held that post since 1971. He was reared in a small town in Wyoming where his parents published a semi-weekly newspaper. A graduate of Wyoming public schools, he attended Georgetown University where he was graduated with honors in 1963. He then attended the Georgetown University Law Center and received his LL.B. degree with distinction in 1966. For five of the seven years spent in Washington, D.C. as a student he worked, in turn, for three members of the Congress. He served as a clerk to Representative William Henry Harrison and Senator Milward Simpson both of Wyoming. He also served as a law clerk to Senator Everett McKinley Dirksen, the Republican Minority Leader.

Following his graduation from Georgetown, Fessler was appointed as a law clerk to Judge James R. Browning of the United States Court of Appeals for the Ninth Circuit. Upon the expiration of that one year appointment he moved to Spokane, Washington, where he served on the faculty of Gonzaga University. While living in Spokane Fessler bec[illegible] active in the Rockefeller for President Committee and tra[illegible] extensively in Idaho, Oregon and eastern Washington. In 196[illegible] accepted an invitation from Professor David Cavers to become [illegible] fellow in urban legal studies

at Harvard. At the same time he was appointed as a special assistant to Secretary of Health, Education and Welfare Robert Finch. For the next fifteen months, Professor Fessler divided his time between Cambridge and Washington. He authored a thesis in which he speculated as to whether government entitlement benefits should be classed as "property" so as to afford a citizen due process rights when those benefits are revoked and reduced.

In 1971, with his period of residence completed at Harvard, Fessler accepted the invitation from the University of California to join the law faculty on the Davis Campus. In 1973 Harvard conferred upon him an earned doctorate degree in jurisprudence, perhaps the rarest degree in American higher education. There would not be fifty living persons ever to attain such a distinction. In that same year he was made a full professor at the University of California completing the requirements for tenure in record time.

Since 1973 Professor Fessler has served as a visiting professor of law at the University of Virginia (1975-76); the University of Texas at Austin (1978), and the University of California at Los Angeles (1983). In 1982 he was named the William and Sally Rutter Distinguished Professor of Law.

Throughout his academic career Professor Fessler has taught contracts, business organizations, security regulation and other related business courses. At the age of forty-two he is the author of two major casebooks, one dealing with contracts and the other with alternatives to incorporation. The latter book has been used in more than thirty American law schools.

Professor Fessler first came into contact with Alaska through his efforts to place recent graduates of his law school in clerkship positions with the Alaska Supreme Court. Few efforts could have been more successful. Today more than twenty of his former students have served that court and our court of appeals. Most have remained in Alaska where they occupy positions ranging from federal and state government to the private practice.

In 1978 he came to the attention of the Legislature when the House State Affairs Committee sought his assessment of the Government Stock Ownership Corporation Bill then pending. Members who dealt with him on that subject recommended his appointment as consultant to the Commission at the time when we were entertaining thought of revising the content of Title 10 of the Revised Statutes. In the four years since we retained his services we have met repeatedly with Professor Fessler. Suffice it to say that we have found him to be the gracious, scholarly, and patient individual praised in Mr. Reitman's letter of March 12. His views have been sought and taken into account as the members of the Commission have framed the value judgments which are now pending before this Committee. Reitman is plainly wrong in termining the work of nearly a dozen Alaskans as the "Fessler Code". Such a misdirected charge reveals that Mr. Reitman not only does not know Professor Fessler, but he is also ignorant of the dedication of the members of this Commission who have labored for four years without compensation to bring their experience and collective wisdom to bear upon a better statutory foundation for

incorporated enterprise in our state. It is time we moved forward with that important business.

SUBCOMMITTEE HEARING OF SENATE JUDICIARY ON
CSSB 246/HB 343--FOR PROFIT CORPORATIONS CODE
ANCHORAGE, ALASKA - APRIL 28, 1984

JOSEPHSON: This is a subcomittee meeting of the Senate Judiciary Committee on CSSB 246. And I will say that I have in a packet a memorandum from Mr. Regan of the code revision commission of March 5th, correspondence from Mr. Reitman attaching a report of the task force of the Business Law Section of the Alaska Bar Association. That letter dated March 30 and the report is dated March 30 as well. We have other correspondence from Mr. Reitman including a letter of March 12. We have a report from the code revision commission regarding limited liability under HB 343 and various materials, memorandum from Daniel Fessler dated March 14 which attempted to answer questions raised by Rex Butler of my staff. A memorandum and enclosures regarding this subject was sent to me on January 18 by Mr. Dick Regan, and various other materials. This is not to say that I have personally digested them, but Mr. Butler of my staff has. And I've had conversations with various of you. Is Mr. Fessler here now?

FESSLER: Yes.

JOSEPHSON: Professor Fessler, would you like to come forward then.

FESSLER: I think that Mr. Abbott, the chairman of the commission, should speak first.

ABBOTT: I have an opening statement which I am going to read into the record, Senator Josephson, and I'll make a copy of that available to you and that will probably put the matter into prospective.

JOSEPHSON: I should also say I was requested to have a hearing in Anchorage and ordinarily on bar issues, unless they involve personal injuries and products liability, there is usually a very broad concensus of opinion and here we have, if we proceed to find two strenuously different points of view, it seems to me we should give both sides an opportunity not only to review the bill but then to give testimony in Anchorage. And that is why we are here. John, if you'd like to start.

ABBOTT: Thank you Senator. NOTE: JOHN ABBOTT'S TESTIMONY IS APPENDED TO THIS TRANSCRIPT.

JOSEPHSON: Thank you. Mr. Reitman, do you wish to . .

KELLY: I'd like to say one . . . preceding to that. I think Mr. Abbott's comments . . .

JOSEPHSON: Would you begin by identifying yourself . . .

KELLY: Late of the Business Law Section of the Executive Director. And I think Mr. Abbott's comments are a personal attack on the integrity of the ten members of the group who involved themselves without pay and a lot of time that they invested. And I think it was a juvenile statement, I'll have to say that that's the last personal attack I'm going to make on him, I mean Mr. Abbott. Excuse me, I'm just a little bit upset myself. It was a juvenile statement on his part. Mr. Abbott, just to sit down and attack each member of the group any one of whom o. most of whom I think have had quite a lot more experience than he has.

JOSEPHSON: Let's set some ground rules because I'd like to hopefully complete hearing testimony by 11:00 a.m. It's Easter weekend and I think that should be an adequate time. And I have afternoon constituent meetings ahead of me. And by the way, if any of you are in my district, you are welcome to come back and talk to me again. Let's try as an agreement of ladies and gentlemen to try to use the next remaining part of our time for as much illumination of the merits from a public policy standpoint as we can and shed light on . . .

KELLY: I'll agree to that.

JOSEPHSON: Because what I want to do is be able to understand and convey to other legislators where the deficiencies of existing are, whether they are in dispute, where the statute we have may be improved, what the remedies are, what the merits and demerits of the proposed bill are. Frankly, there are I think three or four attorneys in the Senate. And I find and Senator Rodey finds and Senator Pettyjohn and Senator Ziegler find that the sixteen lay persons in the Senate could care less about intramural arguments among lawyers. And moreover, even if they could care I really hate to shed all that out in the Senate eye because of professional implications. So I would like to talk about the merits of the bill.

KURTZ: I think we would, too, Mr. Kelly.

KELLY: Yes, I would. But I'm deeply concerned about the tremendous misrepresentations that were just presented . . .

JOSEPHSON: Well, when I hear from . . .

KELLY: A written statement that's been made a part of

the record.

JOSEPHSON: If you want opportunity to speak to that, you're welcome to do that. What I gather is that there are, all I derive from it, frankly, is that there are a lot of feelings and that Dr. Fessler is a very reputable expert. That's about what I . . .

KELLY: That's not what I heard. I heard Mr. Abbott slander certain members of the bar association just now. And I think that that thing should be pulled from the record that he just submitted to you so that we can deal with the merits of the bill that's before this group today. And secondly, I was concerned because we tried to establish the format that was going to take place, that was going to govern the hearing today. And it was our knowledge, we were told that it was not going to be a formal hearing. And that was my concern because our past meetings with Mr. Abbott this has been typical. These personal attacks. And that is why we've been unable to reach a resolution.

JOSEPHSON: Thank you, Mr. Kelly. But I will assure you I'm not going to pull things out of the tapes. I don't think that's permitted. But what I will do is in my report which you will have a copy of I will address my perceptions of the merits and demerits of the legislative proposition. And I will confine my report to that. I'm not, for the reasons I've stated, am not going to indulge the Senate in personalities and arguments and counterarguments. If you want to tell me for my edification, that's fine. But I'm not going to put that into the dialogue with the senators.

KELLY: Well, O.K., I'm concerned about that document that he filed, the written statement and the slander it contains. It's neither here nor there at this point. I guess I'm going to just turn it over to Mr. Reitman. I guess he does have to respond to some of this. And I don't know if you did receive a letter yet. But Chugach Native Association was supposed to submit a response to your office today, I think.

JOSEPHSON: Chugach Native Inc. or Chugach Native . . .

KELLY: Native Inc. Or Native Association. Their attorney had called me because he was quite concerned about this bill.

JOSEPHSON: Was that Mr. Norman? O.K. I received something . . .

KELLY: O.K. And I just received from Mr. Norman's office this morning a copy of the letter that he has forwarded or

is forwarding to your office.

JOSEPHSON: I have a copy.

KELLY: O.K.

JOSEPHSON: Has the Anchorage Bar or the Alaska Bar by any type of meeting or voting process either endorsed or opposed this legislation?

KELLY: No. We never . . . There's never been any stand taken by the Alaska Bar, and there's never been any stand taken by the Anchorage Bar. And I think that's been clarified since the beginning that this is a task group made up of Business Law Section members of the Alaska Bar Association.

JOSEPHSON: O.K. This letter is from John Norman, member of Business Law Section, Alaska Bar Association, researching rejection of CSSB 246 during this session on the basis of insufficient public scrutiny and a lack of awareness in the business community. Expressing the view that any deficiencies in the UCC act can be corrected more easily and economically by adoption of relevant provisions in the current revised edition of the model business corporation act.

KELLY: Thank you. And rather than take up any more time, I don't see where, this is typical. The discussion is going to be difficult to make this morning, I think, because it's been set off on an improper tone. And I frankly don't know what I can contribute any more to this meeting. It sounds like a, we open up with the, a significant. Significant members of the bar, Mr. Norman, Mr. Reitman, other members of this task group whom I think are some of the top business lawyers. Mr. Brundin, who is one to be affected by this legislation. Mr. Eggers. Their integrity was attacked, and I don't know what we can do to contribute at this point. I'll leave it up to them to provide a response. Thank you.

JOSEPHSON: Mr. Reitman, do you want to comment?

REITMAN: I think I'll let the opponent speak . . .

JOSEPHSON: All right. Do you wish to come forward now, either Mr. Kurtz or Dr. Fessler.

KURTZ: Thank you, Senator Josephson. My name is L.S. Kurtz, Jr. Probably nobody knows but I'm usually known as Jerry Kurtz. I'm here on behalf of the code revision commission urging consideration and passage of the bill. I am a member of the Alaska Bar Association and the Business Law Committee of the Alaska Bar Association as well as the code revision commission.

I will be very brief in my comments regarding the mud throwing that has occurred in connection with this bill. But I will say two things. First of all, I agree generally with what John Abbott said. Secondly, the code revision commission did not start that, and I think that's enough on that point.

I think that there are a number of areas of the proposed bill where attorneys will take many different views. Any time you're representing the bar association of several thousand attorneys on a bill of this complexity, you're in a hot seat. And I'm there; that doesn't bother me particularly. But I knew I was going to be in that hot seat when we started working on this bill. And as a result I made extraordinary efforts to bring not only commission members and the bill, but Dr. Fessler to the bar association trying to give the bar overall some indication of what was happening. And while Richard Block has alleged surprise at times, I don't think Stan Reitman ever has. And I think the other members of the committee have been relatively fair about agreeing that the bill was brought to the attention of the bar as early as 1982. And the bar did not respond as quickly as it should, which is I think typical of most attorneys. The only reason I bring this up is that it's important in guaging how the bar feels about the bill.

In 1982 at the convention of the bar which, I emphasize, was held in Anchorage where most of the attorneys are. A business law section seminar was devoted to this bill. And after that seminar I eagerly awaited response from attorneys. And I was still waiting when this ad hoc committee of the Business Law Section was formed a month or so ago. I did get calls from a number of attorneys concerning sec. 488, the limited liability section. And I think it's very safe to say that I could not appear saying that the bar was for that section or against it. It's a controversial section; it stands alone in the bill. I don't think it makes any difference what the legislature does with that particular section. And in terms of considering the merits of the bill, that section should be set aside and considered by itself, in my opinion. And that's the position I've taken with the bar all along.

JOSEPHSON: Do you mean that the committee could excise that section and proceed with the rest of the bill as far as you're concerned?

KURTZ: It would be just fine as far as I'm concerned.

JOSEPHSON: And have that stand on its own merits . . .

KURTZ: Or the committee could look at that section and decide what to do with it and whether it goes in the bill or stays out of the bill. The rest of the bill is not affected by

it. And I think that's very important because . . .

JOSEPHSON: It's severable from the rest of the . . .

KURTZ: It's very severable, and there's nothing else in the bill that ties in with it. Another thing that's important is the legislature. I think the attorney members, particularly the Senate Judiciary Committee, has had a lot of experience with model acts over the years and uniform acts. And one of the things the code revision commission is particularly charged with doing is looking at uniform acts and model acts and determining whether they should be enacted in Alaska. Some of these acts aren't very good. And some of them that we've adopted haven't been too good. I think in 1952 the Model Corporations Act was probably a good thing for Alaska and maybe even in 1960 or 64. It's been outrun by the economic development in this state completely.

JOSEPHSON: O.K., Jerry, let me just stop you there, if you don't mind. I used to be taught that there was one advantage in the uniformity in the commercial area which was the facility with which a corporation could move from state to state without getting the jolt of different legal principles. Do you see that as an issue here in terms of companies considering economic development in Alaska that we would want to have come into our state?

KURTZ: I see it as a very minor issue and I'm glad you asked that question because I would have gotten there probably in four minutes. And this way we'll save four minutes. The first problem is that the existing model act has been substantially adopted in only twenty states. There are another ten states that have adopted portions of it. My source of that information is a text that's probably most widely used by Alaska attorneys, the West Ocean Company. Four volumes originally and now five or six editions on the Model Corporation Act which I suspect that most of the attorneys here have in their office.

The major commercial states by and large and particularly New York and California have never adopted the model act. Now that's the existing model act. It's very interesting, the National Conference on Uniform Laws puts out a list of record of passage of uniform and model acts. It covers all the uniform acts, all the model acts. And the Model Corporations Act, what I'll call the old one, which is what we have, is not even on that list. I'm not quite sure why, but I think it's because it was put together by the Business Law Section of the American Bar and was never comletely endorsed by the American Bar Association. So when we talk about uniformity, we don't have it now. More important, we don't have uniformity with the major commercial states.

Now investment money in this state by and la[illegible] is coming from New York, from California, a lot of it fro[illegible]xas. And New York has never had the model act, still [illegible]n't. California not only hasn't had the model act, it's taken a very hard look at the state of its corporations code within the last ten years and passed a completely new code.

On the other hand, no one has adopted the new model act because it's not yet even in final form. It may be adopted by a number of states over the years, but on the basis of experience with the last act I don't think it's going to be adopted by the major commercial states. The only thing that's important to notice if it is, the bill you have before you includes a great number of provisions drawn from the new model act. And it includes a number that are the result of looking at the new model act and at the California and New York acts. Does that answer the question? My conclusion would be that it is not a uniformity issue.

JOSEPHSON: Usually when there are differences of opinion about legislation, you know they may be manifested in the personality issue or challenges of personal integrity, there is some underlying economic interest or consideration at stake. Can you tell me in your opinion if 246 were adopted let's say with sec. 488 for starters, in the field of people that I relate to, who are going to claim to be winners and losers? Talking about investors and consumers and creditors and debtors and regulators, who gains and loses here and what are the economic interests that are around?

KURTZ: That's a large, that question requires a large answer. I will try and give you a brief one, but feel free to stop because I'm sure I won't succeed in that goal. First of all, let's talk about large pubicly held corporations. In Alaska we only have one broadly held public corporation that I'm aware of, other than the Native corporations, and that's Alaska Airlines. Wien and Northern Consolidated used to be in that category. There may be one or two others that have a fair distribution of stock, but the only big board listed company certainly is Alaska Airlines. Alaska Airlines supports this bill.

JOSEPHSON: As a domestic Alaska corporation?

KURTZ: That's right. And Alaska Airlines attorneys have been looking at the bill for some time, and Irv Bertram has appeared for the code revision commission. He's also appeared I think it was before the House Commerce Committee, the hearing, supporting the bill. As he is the assistant general counsel of Alaska Airlines and the person that's worked with the bill. A

number of the Native corporations also support the bill. These corporations are looking ahead not very many years, I think it's 1990, at a time when their stock will be inalienable. It will be bought and sold by anyone.

JOSEPHSON: 1991.

KURTZ: 1991. And both Alaska Airlines and the Native corporations are operating in a world which most attorneys in Alaska have never operated in. They are going to be dealing with very large numbers of shareholders, with . . .

JOSEPHSON: Takeover problems?

KURTZ: Takeover problems, with more and more derivative suits. All the problems that large corporations in the south 48 have. Our present legislation utterly fails to come to grips with most of those problems. Others it does give you something to work with, but one of the big advantages I see in revising the corporation code whether the bill under consideration now is adopted as is or some other bill is adopted is that it gives us an opportunity to help solve these problems or help deal with the problems before they get here in mass. Otherwise, we're going to have one of the most fertile litigation grounds in the early 1990's for corporation attorneys that's been seen for a long time in the United States given the propensity of Alaskans to litigate. We've seen a certain amount of this in shareholder's derivative suits already in this state.

Now turning to another aspect of it, that's the smaller corporation. The smaller business corporation or the close corporation, perhaps that's the best term to use, is going to have to do a little bit of work because of this bill. But on the other hand, maybe a lot better off in the long run because of this bill. If I were a shareholder in a close corporation, actually I am in a few, but looking at it as an attorney, I think that the long run benefits of the bill for close corporations are substantial for the shareholders and for the directors. On the other hand, for the person that's using the close corporation as a tool to avoid personal liability and to avoid being held accountable, the bill will be a bad bill. We've had many collapsible corporations in Alaska, and here I'm making these statements without regard to sec. 488. We've had many collapsible corporations in Alaska; we've had a lot of corporation fraud in Alaska. Alaska has a very mobile population. Our population turnover is much higher than it is in most states, and in this kind of an atmosphere it's much easier for somebody to come in, set up a corporation with no capitalization, play games with it for a while, make some money and run. It will be a lot tougher to do that under this new bill than it is under the old bill. And one of the big reasons is

there is more protection for shareholders, and there is more access to information regarding the structure of the corporation than there is in present law.

JOSEPHSON: Could you, or maybe Dr. Fessler when he testifies, refer me to the section that you think . . .

KURTZ: I'll never make it, I can guarantee that. I think Dr. Fessler probably could.

JOSEPHSON: What I want is the sectional references that relate to protection for people dealing with or investing in the small corporations.

KURTZ: Now, finally, and I am trying to keep this very brief. When you get to the question of 488, limited liability section, this ties in with what I just was talking about. The people, I do a lot of work with debtor and creditor law. And these days most of it's representing creditors, although some of it's still representing debtors. And the place where I see Alaska businessmen, people who lived in Alaska and worked in Alaska and have for a number of years, being hurt the most often is on trade receivables. Representing banks, which I do a great deal of, as does some of the other attorneys here, you see it from another standpoint. The bank loans money to businessmen on the strength of their receivables, and the receivables aren't collected and then the businessmen can't pay the bank. Trade receivables is a term generally used in the business world for thirty day accounts payable for paper, wood, cleaning supplies, whatever you have in the way of merchandise that's ordinarily sold in that manner. Section 488 is a section aimed primarily at that type of debt, and it does make directors personally liable and officers for . . . . I take that back. It makes officers personally liable for certain types of debt and particularly for trade receivables up to a certain amount per officer.

JOSEPHSON: You mean when they financed at a bank?

KURTZ: No, when it, let's assume you have the Ajax Contracting Company. And Ajax orders a bunch of wood from United Building Supply and doesn't pay for it. That's the sort of thing that I think those officers would be liable for . . .

JOSEPHSON: There is nothing to prevent United Building Supply under existing law from when it sets up an account with Ajax, from requiring the individual officers to guarantee or cosign or otherwise indemnify is there?

KURTZ: No, there isn't. And indeed United Building Supply is a good example to use in contrast with Joe Doakes, the subcontractor or the little guy who runs a janitorial service.

If United Building Supply is sophisticated enough, large enough, it might well go after those personal guarantees it was worried about. The fellow that runs the janitorial service or whose cleaning up houses following a construction job doesn't have that kind of sophistication. And he's the one that invariably gets hurt. When a collapsible corporation goes under, the smart people that got their guarantees get paid. But they are the sophisticated ones, usually the large ones, usually the ones that can afford an attorney. Like one of the members of this ad hoc business law committee that's involved in that sort of thing. Or me. The ones that don't have attorneys get stuck, and I consider 488 a basic, philosophical issue as to whether you want to try to protect people who can't continually go to an attorney or not. And that's an issue for the legislature to decide. And the bar's split on it. There's no question about it.

JOSEPHSON: Well, now, does 488 represent a major break with century-old, Anglo-American tradition? How much of a pioneer, what pioneers here, how much of a pathfinder does this section, is this going to be. Or has someone else used a similar approach somewhere else?

KURTZ: Nobody has used exactly this approach. New York has used the approach regarding certain types of debt with directors, pardon me, with shareholders, which to me is weird. I would say, yes, we're blazing new ground with 488. And whether we should . . .

JOSEPHSON: I mean the argument, as I recall from my old law school days, was that the corporation was created to allow for an enactment of capital to meet the requirement in the industrial revolution.

KURTZ: That's the theory.

JOSEPHSON: And was an essential part of that economic development in England and in America . . . [TAPE CHANGE]

KURTZ: Two things that I can think of right off. One done by the Alaska legislature and one done by the Congress which go against that theory apparently for overriding social reasons. One, of course, is the Internal Revenue Code where if a corporation doesn't pay certain types of taxes, withholding taxes, the officers of that corporation responsible for payment are personally liable for it. A similar provision is in the Alaska Workmen's Compensation law where if a corporation does not carry workmen's compensation insurance, officers of the corporation are personally liable for paying not the insurance bill, for paying whatever compensation is due a worker who gets injured when he isn't covered by insurance. Now there may be others, but those are two limited changes from the traditional

law. And so there is no question ~~why~~ it can be done without killing business development, and it's a policy question as to whether it's worth protecting these little, very small business firms around town that can't afford ~~and~~ use legal assistance on a continuing basis. That's one for the legislature. I don't think that's a decision that should be made by the Alaska Bar Association or any subcommittee thereof.

JOSEPHSON: By the way, . . . testify, indicate what areas of common ground there are and you mentioned there are two. There are apparently more provisions as to which the code revision commission and the task force see eye to eye, and I'd like to have those identified also. Not necessarily by you, Jerry, but . . .

KURTZ: I would like to comment on one other provision, and then I'll cease and desist. There was some objection by members of the task, ad hoc committee, to the change in notice requirements from ten days to twenty days for notice of shareholders' meetings and several other things. And the commission thought that was a pretty important change. I don't know of another state that has the twenty day notice requirement. I don't know of another state that's fighting the geographical problems that Alaska is in terms of finding shareholders, finding directors and giving them notice of what's going on. Like most of the commission's decisions, that one wasn't made by Dr. Fessler. It was made by the commission after a lot of consideration at several meetings, and I would hope that the legislature, I'm sure the legislature will because people in the bush that realize this problem in addition to Native corporations who are very aware of it. The present law provides only ten days notice to shareholders and to directors and in many cases is just not enough to function in a state where people are separated, sometimes completely out of communication, and seem to spend a fair amount of time in the south 48.

JOSEPHSON: Are the time . . . waivable . . .

KURTZ: They are always waivable, yes. And with the close corporations are waivable, twenty days shouldn't create any problem. One final comment on your question are we in agreement on anything. I'm not sure. I think it depends which portion of the ad hoc committee look, I get the idea that most of the members of the ad hoc committee do like some portions of the bill, but are opposed to other portions. A substantial portion of the ad hoc committee just wants to spend more time looking at it. The feeling I get is that almost everybody agrees there should be some changes in the law, that we're dealing with an act that's outmoded.

Now Brian Brundin I don't think agrees with that. I'm

not sure what Stan Reitman thinks. But the impression I've had from the other members of the ad hoc committee and from the bar generally is that we need to take a look at this. And anybody that works with Native corporations strongly feels we not only need to take a look at it, we need to do something with it and well before 1991.

JOSEPHSON: And there was reference I thought to Mr.______ of Chugach Native has taken a different view than that . . .

KELLY: I spoke with him, I had to leave town Thursday, so I spoke with him Thursday morning, and he said he would have a letter to you and he did have authority from the board . . . at that time to issue a statement . . . Thank you.

KURTZ: There is one other thing I'd like to mention as far as attorney input on this goes. The Alaska Federation of Natives, we knew this would have a big impact on Native corporations, and we went to them a year, year and a half ago and went to the Alaska Federation of Natives and asked them to give us some help. They appointed a subcommittee of attorneys who work with Native corporations. We got an awful lot of helpful input from Ray Plummer, from Elizabeth Johnston, and from Mr. McNeill of the Sealaska Corporation, from someone else in Fairbanks, I can't remember who. And again I think in the area of broadly held public corporations, we desperately need more legislation. And we desperately need it before it becomes a political hot potato and the question of how the procedural aspects of corporations of that size should be handled gets lost in the political ramifications of whether various restrictions should be continued for Native corporations or whether Native corporations should have disparate treatment which we looked at very closely and concluded was probably unconstitutional. I will stop at this point. I can well imagine talk all day, and I think most of the other attorneys here can too. And I don't think that that would be fair given your time requirements. Unless you have any other questions.

JOSEPHSON: Appreciate your coming up to talk. Mr. Reitman.

REITMAN: My name is Stanley H. Reitman. I'm an attorney in Anchorage. I've lived and practiced in Anchorage since the early 1960's. And my work is primarily in the area of business law, some amount of tax and banking. I'd like to first request that when the transcript of this hearing has been prepared that the number of us on the task force group have an opportunity to respond on the record to Mr. Abbott's diatribe. I'd also like for me to hand you just for the purposes of the Judiciary Committee of the Senate a copy of the 1983 Revised Model Business

Corporation Act which is a product of the American Bar Association, American Bar Foundation and related groups.

I realize we're under some time constraints this morning, and I'll try to be as brief as I can. Let me just make some random observations because starting with the very latest one that Mr. Kurtz noted with respect to the AFN support. And he mentioned a year to a year and a half ago which was a time of contact with the AFN group or subcommittee. And that precedes, if you will, March, 1983 which is on the cover page of that document in front of you captioned 1983 Revised Model Business Corporation Act. At the time that, it's my understanding and, of course, is obviously second and third hand information, I wasn't a participant in any of those conversations. At that time this particular, this product was not available. And I had talked independently with three lawyers representing three different regional corporations of the developed Native regionals here in Alaska. I haven't contacted any more than three. But of the three, they were unanimousd in saying that their position was that they felt that this revised model business corporation act was a far better vehicle to utilize as a spring board for revising or dealing with the existing Alaska statute for a number of reasons. So I think when any illusion or any reference is made to the support of the AFN group, it should be noted very, very carefully as to when that support was given. And one of the things I got was that at that time the passage of this SB 246 of the code revision code or Fessler code as it's sometimes referred to appeared to be rather, fairly noncontroversial. And the Native groups were able to extract what they considered to be a number of tradeoffs as a condition for their support included among which was a specially carved out niche for the Native corporations, vis a vis, the section 488 which has generated so much controversy.

So . . . is just something that if you really want to rely on, you ought to check currently and not with a purported support that emminates a year and a half, over a year ago.

JOSEPHSON: Excuse me, there is a letter in the file from Jean Leask, AFN President, expressing support . . .

REITMAN: What date does that say?

JOSEPHSON: April 8, 1983.

REITMAN: My understanding is that was before this product was released. I did, I thought I had but maybe Mr. Abbott received his mail from a different locale, but I sent a number of communications to you, Senator, including a letter of March 12, 1984, a letter of March 30, 1984, and a third, another letter of March 30, '84, all of which to the best of my knowledge

was sent to Mr. Abbott as Chairman of the Alaska Code Revision Commission, Jerry Kurtz and Judge Stewart. The only reason I just sent to those three was because those were the three I had talked to. And I had not talked to any other members of the code revision commission. At any rate, they were copied.

I think a good point of departure and I hope that this correspondence of mine commencing with this March 12, 1984 letter can be made part of the record of this subcommittee hearing. In my March, in that initial letter, March 12th if you will, yes, I think I set out with some detail what my position is, was and still substantially is and I think this is and without reading any prepared statement here. As far as I'm concerned I think we want the best for Alaska. When I started to practice here in the early 60's, we had the Uniform Partnership Act and we had the Limited Partnership Act appended thereto. We were about to get the Uniform Commercial Code and we had this model corporation act which, characterizing as it is being borrowed from Oregon is misleading. What I found is that the model act was a very useful tool. Many practitioners here in Alaska, for example, in preparing articles of incorporation used to go through ten, fifteen pages of closely typed written material and charge the client a very handsome stipend for the work. And I recall all I had to do was pull this West Publishing book off the shelf and there I had basically articles of incorporation which track the statute. I had bylaws there, a model form of bylaws, very readily available. And we could either work with a modicum of effort and with a very reduced fee to the consumer. And it stood in good stead and as a form book and as bylaws. Now that model act was produced by some of the most prestigious, able practitioners and academicians in the nation. It wasn't just based on one academician or two or three or four practitioners, it was a diverse group with wide experience.

Over the years that model act was amended. There was a flurry of activity particularly in the last ten years going back to 1974. We didn't keep up with it, there's no question about it. I remember being the chairman of a business law committee, this predates Paul Kelly, and I'm sure a number of people in the room will remember our experiences. Either you called a committee meeting and you were lucky if you had one or two people show up. It was very difficult to engender any great amount of you know effort. The bar was delinquent. There is no question about it. But on the other hand, we were lucky because we had legislators who in the past had the wisdom to select what I thought was very useful tools. To repeat, the Uniform Commercial Code, the model act in the corporate area. We had the partnership act. Those are the three fundamentals. And what, unquestionably I think that we are a little behind time. My basic thrust is that if we're going to revise this act, I think we ought to use the revised act rather than the commission's

product. Now why the commission wasn't cognizant or didn't pay any attention to the revision that was in process is immaterial. I think, and it's immaterial how much effort has gone and how much, and granted the code revision commission has a very essential job and I support that. I think that the purpose of the code revision is sound. I think they're there to monitor and to suggest and to urge and to push changes. But my basic point is that I think that the bill before us is too narrowly conceived. And I don't think it profits us to go into the history. I've layed it out to some extent in that March 12, 1984 letter.

But I'd like to talk a little about closed corporations, if I may, which is the family corporation, the corporation with a small number of shareholders. And there are various definitions as to what we are talking about. If you start out with the premise that the corporation, one of its essential features, of course, is this limited liability which historically has proved its value. Of course, if you have a conviction that it's being used as a sword for evil, then you're concerned that any time you grant the privilege of limited liability, you're going to very closely monitor it. And I gather the theme of the code revision commission and Professor Fessler is that this is an area that has to be very, very closely guarded because there have been all kinds of abuses. And you don't just willy nilly grant limited liability. Well, I think we can talk for a great deal of, about whether or not there's been an abuse, or whether there's sufficient remedies. I think it's overdrawn, their concern about the abuses that exist. And I don't think we need, you know, the, I have more confidence in the business community. I have more confidence in directors than I think comes through in reading what I perceive in SB 246 and the commentary. I don't think they're all crooks. I don't think they're out to pillage necessarily. And I think that's something that I get a flavor of here.

With regard to the close corporations, most small business people that I've dealt with and I don't have the most extensive experience in the world, but there are others, view the corporation as a very useful device for doing business, a means of doing business. And they tend to be less formal about their relations between themselves and with the corporation. In my mind, the norms of corporate management which are important as the group gets larger are less important as they get into a smaller group. Whether you have a formal meeting or not, or how you communicate with each other, how you give notice. Those things don't have as much importance and should they. Well, if you read the material that was submitted with respect to the close corporation, you'll see the drafters, the people that have worked with the revised model, have prepared what they call a supplement of close corporations which is an adjunct or which can

be used if you choose to with the revised model act. And the history of the statutes are layed out there. Professor Fessler addressed that. But, of course, he has a very jaundiced view about the close corporation concept. He views the close corporations I gather from his memorandum, and more particularly pages 3 through 22 of the memorandum that I submitted to you, he's not very sympathetic to the close corporations concept. I respectfully disagree. And so do a lot of other legislators and academicians and business people throughout the nation. I believe it's worth considering.

JOSEPHSON: Well, I guess the talk of the day is what's the beef, where's the beef. I mean I'm not asking you where's the beef with 246, but where's the beef as you understand it with close corporations? Is it a device allegedly for cheating persons that it deals with? I understand that's not your position, but that is what you think Dr. Fessler . . .

REITMAN: Well, if you read pages 2 to 22 of his memorandum I think you'll see very clearly what he thinks about the close corporations. I'd be delighted to read it to you, time permitting. I think it would be a revelation. I think it's a revelation also in his attitude toward the corporate form. And in my letter, I read that memorandum of Professor Fessler after . . .

JOSEPHSON: What date is, what memorandum are you talking about?

REITMAN: All right. If you'll look at the letter of March 30, 1984, it's addressed to you.

JOSEPHSON: From you.

REITMAN: That's correct. All right. Do you have that?

JOSEPHSON: I got that.

REITMAN: All right. Well, attached to that letter, O.K., it's labeled appendix 1, if you will. There are two March 30 letters, Senator. Maybe you have the wrong one.

JOSEPHSON: Yes, O.K.

REITMAN: Starting at page 2, there is a discussion about the statutory treatment of closely held business. And I think this is a very interesting analysis or memorandum. I respectfully disagree with the thrust of the comments. And I'd be delighted to go into it in more detail, but I think your time is limited here.

JOSEPHSON: Well, I can study it . . .

REITMAN: I think its worthy. I think if you don't read it, I think it's going to be a definite detriment in trying to come to any kind of judgment.

JOSEPHSON: One question that occurred to me, Mr. Fessler and Mr. Reitman, is how we assess this issue of protecting tradesmen and third parties in the light of liberalized bankruptcy clause. I mean it just seems to me . . .

REITMAN: Well, let me say this. You know originally the Alaska Statutes which also a model act revision as I recollect, did provide that one of the conditions of obtaining a corporate charter was that you had to have a thousand dollars of take in capital or words to that effect. That was deleted. I can't recall precisely when.

JOSEPHSON: Was that in money or kind?

REITMAN: Yes, money or property. And that was sort of an entree price. And there are some people who feel that if you grant limited liability . . . Right, exactly. That if you're going to grant a, I'm not suggesting that I necessarily support it, but I think there is a rational view that if you're going to give limited liability there should be some pool of capital, you see, which is available to creditors. And there is something to that. On the other hand, you know you're dealing with business people when they grant credit are supposed to understand what they're doing. This hasn't seemed to be a problem throughout the nation. We have statutes dealing with fraud. We've got the piercing of the corporate veil concept that's been around for a long time, despite the fact that some people pooh-pooh it and say well it's too elongated a procedure. I think there are certain risks that you have in doing business. This is like to create a riskless society, cradle to grave. We're going to provide for every little misstep that you're going to take. And in the process of doing that, what you're going to create is a discouragement or impediment to commerce and to business.

JOSEPHSON: I may be confused. We're talking about section 488 in terms of close corporations. Is section 488 limited to that situation? Is it limited to the large . . .

REITMAN: You mean the proposed 488 . . .

JOSEPHSON: Proposed 488 is limited to any corporation.

REITMAN: Correct. Yes, as far as I know is to any corporation. Close corporation is simply a concept that in

effect relaxes some of the more formal mechanisms or procedures that are implicit in the governance of a corporation. And particularly deals, Senator, with dealings among shareholders. Also transfer restrictions which are buy-sell agreements, which are an essential ingredient of any bargain amongs small business people. That's a very important concept. And that . . . what I said is that in the small corporation area, what is a matter of concern in the relations among shareholders, for example, transfer restrictions, buy-sell agreements designed to append to a partnership form to retain the identity of the shareholders and the people who are the equity owners in the . . . Now, those types of arrangements are, I won't say they're peculiar, but they're more apt to be utilized in the small corporation mode than they will be for large publicly held corporations.

JOSEPHSON: And how does this bill affect that, the buy-sell?

REITMAN: SB 246?

JOSEPHSON: Yes.

REITMAN: All right. For example, if I may, I believe I sent you material that comes out of the Revised Model Business Corporation Act for example. More particularly section 6.27. Let me see if I can find it. I think I sent this to you, but if I didn't I'd like to point it out now. This is in the Revised Model Business Corporation Act. It's section 6.27; it's captioned Restrictions on Transfer or Registration of Shares or Other Securities. And is a very extensive provision in a model.

JOSEPHSON: Do the articles and bylaws impose restrictions . . .

REITMAN: What I was just going to tell you is that there is much more flexibility in my judgment there than in here. Now, for example, let me just point this out if I may, one of the tools that practitioners have used not only in Alaska but in many other jurisdictions is a shareholders agreement. Now the shareholders agreement has run the gambit of judicial tolerance, and the law is not altogether clear. My understanding is that where there is unanimity among shareholders, you can do a great deal to in effect impinge on the norms of corporate governance. Now that particular tool, I think, is a very useful one. And it can deal with transfers, reasonable restrictions. Now in the commentary on SB 246, more particularly at page 37, sorry to have to get you into this, but if you want to get some of the . . .

JOSEPHSON: This is fun for me, it's practicing law again without the remuneration . . .

REITMAN: Well, join the club then. All right, page 37. And obviously you know we're just in all fairness, you have to

read a great deal more than I'm just pointing out to you. But the commentary, for example, says, and I'm about in the middle of a page, if you don't mind, please. "While the language of section 210(2) would not prohibit transfer restrictions from being introduced in a bylaw (this is referring to articles of incorporation) while the language would not prohibit transfer restrictions from being introduced in a bylaw, it would have to be a bylaw adopted by the vote or consent of the shareholders and could not bind shares outstanding prior to its adoption which neither voted for nor consented to such a scheme." Well, my concern was that very frequently these restrictions will appear not in a, they can't appear in a bylaw, no question, or they can appear in the articles, but they also are going to appear in shareholder agreements. I asked this question of Professor Fessler, and he pointed out to me that well there is no reference in the commentary to shareholder agreements, but the comments could certainly be expanded to include shareholder agreements. Now maybe that will assuage me, I don't think so. Rather, I think that the treatment that's in the Revised Model Business Corporation Act, and more particularly 6.27, is far more flexible and useful and is much more, and covers the waterfront far better than I believe is in here. This is an example simply of where I think the Revised Model Business Corporation Act provides a better vehicle for dealing with this particular area than does the proposed SB 246.

Staying with major themes if you will, Senator, I don't think there is any compelliing need that we must have a bill this session. Now I realize there's been a lot of work put into this revised code, but I don't think we have, I don't feel any compulsion to jump. We want to get the best product, we want to look for alternatives. The model act is an excellent alternative, and we should be convinced that this product which, incidentally, has been worked upon and there were contributions here from lawyers from Delaware, from lawyers from New York, from lawyers from California and other big states, Texas. In fact the professor of the ------ reporter is a professor from the University of Texas Law School at Hamilton who has written extensively in this area. And I daresay that if you talked to Professor Hamilton you might get slightly different views than you get from Professor Fessler.

JOSEPHSON: Let me ask you a question, maybe this is a farfetched thing, but it may eliminate one aspect of it. And I'd like Dr. Fessler to talk about this, too. Suppose I were to hypothetically retire from the Senate, voluntarily or otherwise, and somebody came to me and said we'd like to start a business and hand you, and we're going to put a monthly newsletter out about government in Alaska, and we'd like you to write a feature article and serve as vice president of this corporation to be called "Alaska Government Reports Incorporated." And we'll give you some shares in the business and you're going to do some editorial work for us and we'll handle everything else. Under

the bill, would I have to be thinking about my liabilities under 488 if I got into such a venture without, I wanted to do it as a service or I wanted . . . Would I have to be thinking about potential exposure, contingent liability anyway.

REITMAN: Let me answer this way. First, let's take out even the granting of an equity interest. Let's suppose you don't even give them any equity. Well, I would say you bet your boots you better bet concerned. I think you better read 488 and see what it does for you, because you're going to be surprised. And let me say something else. I know, Jerry Kurtz said that he's neutral on 488 . . .

JOSEPHSON: I don't think he said that, he said it could be severable.

REITMAN: I've heard him say he's neutral on it. He thinks that's the position that has to be decided. Apparently the commission feels quite strongly because they put 488 in there. Of course, now I suppose it's kind of a throw away. In other words I get the message now you know you knock it out, we won't fight you on it to save our bill. But I think you've got a bigger problem than 488 in here, Senator.

JOSEPHSON: Do have anything else you want to add right now?

REITMAN: Well, I'd like to, I think it's imperative, I really do, and I, in all fairness to Professor Fessler, I see time is running out. I think you ought to read that pages 2 through 22 of that memorandum because it not only gives you a flavor of close corporations, you get a flavor of Professor Fessler's attitude on corporations. And I think it's important because, and the reason for it, if you don't mind, Senator, there is for example at, let me see if I can find it quickly. There is a phrase in one of the memorandum. I wish I could put my finger on it about, well, it's a reference to giving the key to the penthouse of the thoughts. It comes right from Professor Fessler's memorandum. It's an old saw. But the concern I have, Senator, is that the attitude here of that there are all kinds of misconduct going on in Alaska and directors are not to be trusted, officers are not necessarily to be trusted, we've got to protect. You know, we're going to protect the consumer, you know, let us at it. And that permeates the statute, and I think that's the wrong philosophy. I don't share those concerns. I think there are abuses, sure there are abuses. There are abuses under the tightest statute you can draft and that's why we have them.

JOSEPHSON: We just discussed the hypothetical of the small group that wants to publish a monthly news letter. What about the question of a major investor who wants to come in with us and say start an airline in competition with Alaska Airlines?

And he has the choice of domestic Alaska incorporation or a foreign corporation chartered somewhere else I suppose. I would assume that if HB 343 were enacted with 488 that that investor's attorneys would say you may want to incorporate in the State of Washington or California or someplace . . .

FESSLER: Senator, if 488 were applied to officers and directors of a foreign corporation doing business in Alaska, does it mean the bill left Alaska citizens unpaid?

JOSEPHSON: O.K. It wouldn't have a choice of incorporation. Well, in that instance would there be any tendency not to do business in Alaska at all because of the potential exposure of the officers if the economic venture went belly up? And if that's so, is that good policy. I mean it may be good policy because you protect the Alaska creditors or it may not be good policy because you leave undone some imaginative venture that would benefit Alaska's economy. I don't know the answer to that.

REITMAN: Senator, may I answer that question a little differently?

JOSEPHSON: Sure.

REITMAN: You ask the question assuming 488 was excised in the bill, let's assume that the you know the throw away is adopted, I don't think the legislature will. My personal opinion is I would be real surprised if the legislature adopted 488. But let's suppose the legislature buys excising 488 and adopting the rest of SB 246 . . . All right. I've heard a couple of experienced practitioners here, and we do have some experienced practitioners here in the business area, even if these ten people, ten lawyers on this committee have a fair amount of experience, including areas that I haven't had that much experience. And there's one chap that's had a fair amount of securities work which I don't think I've done but a smattering of. And incidentally I don't think any of the ten of us has had the experience, the varied experience and exposure, that the members of this American Bar Association group have had. They've had more extensive experience. But if I were advising a small Alaskan corporation, aside from 488 now, all right, and you had SB 246, I would look very, very hard at not using, not incorporating that group in another jurisdiction. Of course, obviously qualifying them to do business in Alaska. Why? Because the rest of SB 246 to repeat is not as utilitarian, as flexible, and as sympathetic, if you will, to the needs of the users of that particular business form.

JOSEPHSON: All right. Thank you, Mr. Reitman. Dr. Fessler.

FESSLER: Well, Senator, you can first comment to the

record that I probably look more frumpy than radical. I am the individual described at great length in Mr. Reitman's letter, and I am the individual who Mr. Abbott as chairman of the committee was doubtless moved to seek to hold harmless against the accusations in Mr. Reitman's letter in the statement that he read.

There are a number of things which I would like to comment on, but I am most anxious to respond and enter into a dialogue with you on matters of your concern. If I could I'd like to talk about these ideas and if they're not ones that interest you, then I'll talk about others. It seems to me legitimate to first take up the question, is the code revision commission's product unique. Had you been handed a suggested piece of legislation which, for whatever reason, is so without precedent that it would create for Alaska a sort of insular corporations code that other people would find difficult to understand and off putting because of their lack of familiarity with it. An ancilliary charge that is leveled is that the code reflects the peculiar biases of which I have somehow managed to convince the Alaskans who have worked to employ my services over the last four years. I will ask that there be incorporated in the record the chart which is prepared which tracks and makes quite graphic the paternity of every provision of this statute.

We will begin by noting that there is only one provision of the statute which is repeated in two other places which is without an ability to trace its paternity to the laws of other jurisdictions including the model act, and that is the provision which the legislature recently inserted regarding the disclosure of alien affiliates and alien control persons which was a particular value judgment made by the legislature which the code revision commission declined to question because of its recent origin, a legislative value judgment which is excoriated as being unnecessary, and the commission is twice taken to task in subcommittees or task force report for its failure to eliminate these recent things. So, is this a strange act. No, sir, not if you read it. It is accompanied by a commentary which has a source, which explains the impact upon existing Alaska statutory law, identifies the statutory bases, indicates where modifications of those statutory bases have been for every single provision. One only wishes, as a personal aside, that these matters had been read before they were characterized. I think that fortunately your staff and Mr. Butler have taken the time and the trouble to read this document, rather than to speak about it in generalities.

So the ACC is not unique. Now is it a carbon copy of existing Alaska law. No, sir, it is not. Although as you will see in the very first column the tracking of the impact on existing Alaska law is done with regard to every section. This is because, and one can find no more eloquent statement for the reason as to why it is not a carbon copy of existing Alaska law,

than the book which Mr. Reitman has thrust upon you with the zeal of someone converted to a new religion. And this biblical text which sets forth the reasons why the American Bar Association's committee on corporate laws has chosen to engage in its work beginning at Roman 15, that's the page and not the scriptural citation, sets forth the major changes in the concepts of corporate law thinking that have taken place since 1969. Now those changes would be interesting to contrast with the major thrust of the reforms which the commission in its independent work has come up with. You will notice that the first major change noticed here deals with financial provisions. What has happened is that the State of California spending approximately three years in the gestation process in 1977 came up with a corporations code which for the first time broke with all the traditional concepts of legal accounting and substituted very simple and easily understood concepts of when it was licit for a corporation to make a distribution of its assets to its beneficial owners and when it was . . . [TAPE CHANGE] Concepts of legal accounting follows California by using a surplus, excuse me, a ratio between assets and liabilities as a very straightforward approach, and this is, of course, the very provision which the Alaska Code Revision Commission had embraced some two years ago when in its provision on financials which are intriguingly reviewed by one of the task force members, Mr. Brundin, sets forth the very provision now embraced by the Revised Model Business Corporation Act.

B. Standard of care for directors and officers. The ACC, the Alaska Corporations Code, were the legislature to adopt the commission's recommendation, anticipates and also defines standards of care for directors and officers withdrawing this from the realm of conjecture where it is currently under Alaska law.

Principles relating to derivative litigation. There have been major changes. Alaska has the dubious distinction of being one of two American states which has no statute on derivative actions. The task force suggests we stay in that position, since the Revised Model Business Corporation Act laughs at such a nonsensical idea. You will notice that the task force report, therefore, is at variance again with the very document which they are urging be the substitute for the work done by the Alaskans who worked up this code now pending in the legislature over a period of four years.

JOSEPHSON: What you're telling me is that between their written material and the Model Business Corporation Act, that there are discrepancies.

FESSLER: There is heresy, sir. Yes, the bible isn't followed at all. And I will [illegible]vide your committee, because I think it is necessary with a section by section response which also compares to the Revised Model Business Corporation Act, the

recommendations of the task force. I want to be very clear. As I read the recommendations of the task force, I found some interesting ideas. There are some ideas there which I believe would improve not only the bill which we have proposed, but also the Revised Model Business Corporation Act. I believe, however, that one cannot come away with a fair reading of the work of the task force with the conclusion that there has been generated some reason to stop the legislative development of the Alaska Corporations Code. To study it, to refine it, to revise it, to amend it, that's part of the legislative process. The code revision commission has to my knowledge never been fairly susceptible of a charge of handing a bill to the legislature with the imperious attitude that you had to take this thing lock, stock and barrel. There are no "throw away" provisions in this bill to my knowledge. That again is some of the terminology injected by Mr. Reitman. But there are keen sensibilities that the commission's legislative task is to propose legislation, it is the legislature's duty to dispose of those proposals.

We have been and I was peculiarly offended by the statement in the letter of transmittal by Mr. Block that I was unavailable in a timely manner. That, sir, simply is not true. And if there are individuals in this audience who are offended by having that lack of accuracy pointed out, the offense lies with the inaccuracy not with the accusation. I continue to remain willing because it is my responsibility. I have a strong interest in seeing Alaska get, along with Mr. Reitman, the best possible corporations code you can have. Now, would it be wise for Alaska to simply adopt the Revised Model Business Corporation Act. Mr. Reitman is offended by the use of the phrase in Chairman Abbott's letter of transmittal to Senator Ray that the first Alaska Business Corporation Act was off the rack. And yet there is not much tailored about asking you to take a gray comb out of a brown envelope and simply enact it because it came from Chicago.

There are indeed a number of very distinguished lawyers who are on the Business Law Section, but Mr. Reitman is confused if he is representing that they are the individuals who in deliberate body have sat down and passed upon all of the provisions of the exposure draft. The exposure draft is basically and essentially the work of a colleague of mine, Professor Robert Hamilton, at the University of Texas. I got to know Bob fairly well when I was invited to teach at the University of Texas as a visitor and had an office directly across the hall. It is, of course, noted that there are no Alaskans on that particular committee. This bill is not now the law in any jurisdiction. When you read the task force continued lauding of the Model Business Corporation Act and the fact that it is widespread among jurisdictions, a statement which has elements of truth about it as Mr. Kurtz noted for you, please understand that those are referring to the historical Model Business Corporation Act. The continuing utility is now impeached

by the framers of the Revised Model Business Corporation Act. How long it will be, or what state will have the distinction of becoming the first to adopt the Revised Model Business Corporation Act, we do not know. It could conceivably be, if Mr. Reitman is correct, that it ought to be Alaska. But it is not now the law in any jurisdiction.

You will read statements in the task force report which indicate that it is highly desirable that Alaska have a statute which is congruent with the laws of other jurisdictions. You will have a statute, sir, congruent with the laws of other jurisdictions, including the major commercial jurisdiction on which much Alaska business depends, the State of California organized along the very useful mode set out by the State of New York, were the legislature to follow the recommendations of the code revision commission and adopt this bill. So far from painting yourself into a corner, it would be my considered judgment that you would be moving yourself into the mainstream of the thinking of corporate thought were the Senate to grant favorable consideration, the Judiciary Committee and then on the floor to the recommendations of the Labor and Commerce Committee, which has reported this bill forward.

Now, one problem that does exist which I would urge is a good reason to think a long time before sticking with the suggestion that you merely attempt to follow suit or indeed bid because you would be leading the suit here with regard to the Revised Model Business Corporation Act. The existing Model Business Corporation Act has been adopted in many states including the basis of the law of Oregon and Washington. It has also been judicially interpreted in those many states. Unfortunately, the judicial interpretation of that act is frequently not in one mind. There are contradictory interpretations which render the provisions of what appears to be a singular statute having a cacophony of different judicial views.

JOSEPHSON: You know, as I remember the uniform act as interpreted in one jurisdiction was susceptible to the same interpretation elsewhere.

FESSLER: Indeed, the Uniform Commercial Code has a provision in it by which the legislature commends the desire of maintaining uniformity to the trial courts of its state . . .

JOSEPHSON: But the model acts do not contain . . .

FESSLER: They have never aspired to such a thing. And one of the reasons that we've spent a great deal of time developing these commentaries, because you see we've carried forward so much of the model act, it would be silly not to. But we've also tried to identify where there are divergent lines of case law interpretation to characterize the value judgments which

those basic lines of case law interpretation embrace. And then to state for the legislature that in adopting this act twenty some years after we've done it the first time, it is the intention of the legislature to sanction and approve the following line of cases. In other words, to make a choice. So that a trial judge in Alaska who has very little appellate precedent law to go with in interpreting the model act is not forced to spend a great deal of time and generate substantial fees for attorneys who are in good faith peddling West Virginia's view on this topic, as against an intermediate court of appeals in Florida, as against a rather obtuse decision of the supreme court of South Dakota. My job was to try and gather those divergent lines and to interpret them. And that is one of the work products which the legislature has the opportunity to take avail of. Professor Hamilton candidly concedes that he did not undertake to do that. That that was simply too large a task.

JOSEPHSON: Professor Hamilton, the reporter . . .

FESSLER: Yes, they're not going to try and resolve the fire fights and disputes that they do admit exist in the decisional law which has grown up around the model act. Even in instances where the model act is essentially repeating itself. As I say, it would be silly for any of us to believe that we would have to reinvent the wheel.

Now, there has been a lot of discussion about section 488 . . .

JOSEPHSON: Excuse me, Professor, should the legislature adopt the bill, something like the form we have it, you would recommend perhaps that the commentary be a part of the legislative history or . . .

FESSLER: Yes, indeed, your colleague, Senator Mulcahy, made the point in the Labor and Commerce Committee that it would be wise. I believe he used the term a concurrent resolution be adopted to recognize the comments and to give them the status of legislative history. That I think would be a very, very useful step in guiding Alaska practitioners. There simply is no need to have every one of these matters cast into doubt when they could in a seminal look at the business law recognize that we're talking not only about statutory law, but we're talking about decisional law as well which grows up and is influenced the statute.

If I might for a moment on the topic of limited liability. I think you put your finger on my basic problem here when you noted that the corporation as we currently recognize it as it was reflected in the model act when it was originally drafted was conceived as a means of gathering capital from passive investors to put it in the hands of a dynamic management which would then go out and make jobs and make opportunities in

the marketplace. I urge you along with Mr. Reitman to read the memorandum, the background memorandum which my office furnished along with all other background memorandum to the members of the task force, and which they are all sitting in Juneau and available to your staff as well. Mr. Reitman, however, is extolling a very different animal when he speaks of close corporations. He's speaking of a corporation owned by one or two persons who intends to gather capital from no distant source whatsoever. A corporation which, according to Mr. Reitman's view of the world, should be allowed to relax the observance of any norms of corporate existence. Won't have meetings, won't do anything. What will it then do. President Reagan and the Congress has pretty well eliminated most of the federal tax advantage. When you read my memorandum you will find it in that sense prophetic. It wouldn't be very sensible to have me paying $4,000 in taxes on one income because I call myself Dan Fessler, Inc. And you, because you are just plain Joe Josephson, paying $14,500 in taxes on the identical federal income. That's the way it was before the Congress two years ago began to revise the Internal Revenue Code. Limited liability is therefore, according to Mr. Reitman's own view of the world, the reason for my putting inc. after my name.

Now, one man's limited liability is another man's unpaid bill. The economic impact analysis which we were told as going to be forthcoming from the task force is one which occupies a paragraph, and I invite you to read it. It talks about the oil of the future being the ability to move capital around. Well, I am perfectly sympathetic to corporations. The notion that I am not would make it rather strange the way I have spent my professional career. But perhaps because I work with a lot of students who ask a lot of questions, long before Clara phrased the matter for Wendy's, began to look at some of these one and two man corporations with no formal matters which can be successfully knocked over when using the alter ego or instrumentality theories by creditors who have the amount of money to hire attorneys to do so. But the little fellows who don't, of course, they can't pierce the corporate veil. There never has been at the appellate level in Alaska a successful piercing of the corporate veil. It's been tried twice. So to suggest that small creditors, the targets of protection under section 488, are currently well provided is something the legislature, I think most of the members including the 16 brothers and sisters that you have who are lay people, will have a fairly decent idea about.

And please note this, section 488 you had indicated in one line of questioning to one of the witnesses, I believe it was Commissioner Kurtz, couldn't a creditor under existing law ask for the personal guarantees of an officer and director. And the answer, of course, is yes. But under section 488, the corporation is also quite free to confront creditors with the fact that it will ask creditors to waive the liability which is

created presumptively up to $25,000 per the creditor under section 488, and ask him to waive it. And if he does so in writing, it's gone. It's gone.

JOSEPHSON: That would be kind of an alarming thing, though, to go to a supplier and say I want to order 300 widgets, and the supplier says wonderful, we have the best widgets in the world. And then you say oh by the way, I am an officer of the corporation and I want you to sign this form waiving my individual responsibilities . . .

FESSLER: Certainly, it focuses his idea on the practical risk you are asking him to take, isn't it?

JOSEPHSON: As a practical matter, that's not going to happen very often. Well, I hear what you're saying. But let me just ask this. I'm grateful that you are here, Dr., for this kind of exchange, but . . .

FESSLER: By the way, I'll be in Juneau, sir, next week. We don't have classes a week from this coming Monday and could meet with any interested parties including members of the task force at that time to engage in a dialogue . . .

JOSEPHSON: You say that one person's limited liability is another person's unpaid bill which is a good way of putting it. But then on the other hand, there seems to be some countervailing policy about encouraging people in the private sector to take risks and . . . its course as a consequence sometimes other people get stuck with those risks. But there will be some forms of economic activity that will be undertaken if there is limited liability. I'm positive of this, and which will not be taken if there is no limitation on liability. Is that probably fair to say?

FESSLER: Yes, but it's not historically fair to say. You see, historically corporations did not have the notion that one person could become a corporation. Historically corporations did not have the very low capitalization requirements. Historically there was no relaxation with respect to shareholder agreements or things of this matter. What has happened is that, and it's human nature, individuals doing busines in the corporate form have wanted more and more of the benefits while at the same time wishing to pay less and less heed to the exactions which historically have been asked of people who wanted those benefits. And so the suggestion which 488 presents your Judiciary Committee with is the opportunity to look to see whether or not in now looking at the matter in its entire picture it would be wise in any way to redress that balance.

JOSEPHSON: But 488 goes beyond the one or two people . . .

FESSLER: Indeed it does, sir. Indeed it does.

JOSEPHSON: So that's my point. Someone's leaving out SEC type problems. Someone comes to me and says we're getting together a group of investors because we think that at Jones Creek 57 miles out of Anchorage there may be the El Dorado gold mine. And we're asking everybody to chip in some dollars and here is, and we're going to use the corporate form. 488 would perhaps be a further dampening down of that kind of activity, wouldn't it?

FESSLER: Well, as to the investors it would not because unlike the New York model which imposes the liability for the unpaid claims of employees on the ten largest shareholders, whether they are active in the business or not. Section 488 suggests imposing no liability on shareholders per se at all. That the thought wsa better to have the liability consequences on those who are actually running the business and . . .

JOSEPHSON: Passive members don't have to worry . . .

FESSLER: Passive members have no concern at all. Indeed, a large shareholder who is not an officer or director would have no liability here. It is the officers and the directors who would have the liability under section 488 because they are the ones who go out and enter into contracts. And then I think you'd have to have ask yourself, well, would it be prudential in having them scale back the level of commitments they make with persons who would have the benefit of the protection of section 488 to realize that if corporate assets prove insufficient, then their own assets up to $25,000 in a joint and several liability setting would be available to this defined class of creditors.

JOSEPHSON: Per creditor.

FESSLER: Absolutely. We have repeatedly made the statement that the $25,000 is per creditor. Further, that it cannot be, that $25,000 limitation cannot be evaded by my assigning to you an interest in the claim. It is a nondivisible interest per creditor. Again, the $25,000 figure was the figure which was set here in the commission. I can tell you the genesis of it. The figure was kicked around. It was higher at one time, lower in another in discussion. And then the thought was well how much money really has to be at stake before you could ever get a lawyer interested in litigating a piercing of the corporate veil. Well, for a four, five or ten thousand dollar claim it won't happen, Senator. It just won't happen. And so that figure, as Mr. Butler asked in his memorandum to the commission to which I responded, that figure of course is malleable. It could be made larger, it could be made smaller. But I do agree with Mr. Reitman, I suppose on more areas than would have ever emerged in

this colloquy, but I do agree in one area. That this is something which the legislature should take a very hard look at. And I guess I merely resent any implication that it has been anything other than widely touted. This was the topic of the talk I gave to the Alaska Bar Association convention in 1982. Again in the Rotary Clubs around Anchorage. Again by videotape and in person in 1982 in December.

JOSEPHSON: O.K. Well, I was asking this question before you came to the witness stand regarding bankruptcy. The creditors and business people I talked to were meant the ease with which debts are discharged in bankruptcy. And I guess what I'm seeing here is an effort to provide creditors with protection when they deal with Alaska corporations on the one hand, and the present federal policy which seems to ease the way in which debtors rid themselves of their obligations. In that light, is this all futile anyway? Are the creditors still going to get any protection since it's so easy to discharge your debts?

FESSLER: Well, if the corporation is declaring itself bankrupt or forced involuntarily into bankruptcy, it would remain to be seen definitively how federal law would coordinate with section 488 should the Alaska legislature adopt it. The general coordination policy is then that the assets of the bankrupt would be augmented by all liabilities that the bankrupt is able to assert either primarily or secondarily. So that it would not be a futile act. But it would simply mean that the assets of that bankrupt would be augmented to the extent permitted under section 488 under state law. If there ever were obviously a conflict between state and federal law in the bankruptcy field, federal law would have primacy.

JOSEPHSON: I'm not sure I know what you mean by augmentation in this case . . .

FESSLER: Well, let us say that I run Fat Chance Corporation, and it's now been run into the ground. It has a hundred thousand dollars in outstanding liabilities, and it has two thousand dollars in assets. Now the question that the bankruptcy court has to determine are what are the real dimension of the assets of Fat Chance Corporation and are available to the creditors. And it is the task of the bankruptcy referee now bankruptcy judge to make those determinations. If he saw section 488 on the state books, then you see the creditors who were protected under that would be given an augmentation of the bankrupt's assets. In other words it would not discharge the liability of the individuals who would have this secondary liability.

JOSEPHSON: They can be remanded in some form to the assets of the directors or officers.

FESSLER: Yes. Now you had asked also and it might for

time reasons be better if I submitted to you in writing a list of certain of the articles, excuse me, of the provisions of the ACC which would afford greater protection to stockholders. If I can I would be happy to provide that to the committee in writing, and I will also forward copies to the members of the task force.

JOSEPHSON: All right. Thank you.

FESSLER: If there are no other questions, thank you, sir.

JOSEPHSON: We have now heard from all who've asked to be heard except from Mr. Eggers.

EGGERS: What's your pleasure, Senator, do you want to listen to me for five minutes or . . . For the record my name is Kenneth Eggers. And first of all let me state that I felt that today was not going to be a formal hearing but rather was going to be a meeting between the code revision commission and certain members of the bar association who have taken an interest in the product of the code revision commission. So I'm not really prepared with a formal statement.

JOSEPHSON: By the way after I leave if the rest of you want to sit and chat about this, go ahead . . .

EGGERS: Well, you've stolen some words from my mouth because quite frankly after hearing the comments of John Abbott, I don't think I want to sit down with Mr. Abbott and try to discuss it. I do take his comments very personal. I do take them as an attack on my integrity. And for the record, because I do oppose adoption of SB 246, I would like to state where I am coming from if you will.

I've practiced in Alaska for eleven years. Have numerous clients who are corporations, and I work with the corporation code on if not a daily basis on a weekly basis. I'm proud that I'm part of this so called self appointed committee. The members of the bar have been criticized over the years for not volunteering their time, and that's exactly what each of us are doing. As far as I am aware, nobody on this so called self appointed committee is being compensated by clients or otherwise. And the only reason we are here is because we are interested in the statute that is being considered by the legislature. I've probably spent twenty hours of my time on this particular project, and I'm sure that others have done the same, if not more. I believe that Mr. Reitman probably approaches a hundred hours or better. I've had conferences with him, and just on the basis of those conferences I know that he's spent a great deal of time.

I think some of the ill will that may have developed is because you know, I speak just for myself, but I am somewhat of a

johnny-come-lately. And I have, I know, apologize to Mr. Abbott informally because if that is what's causing his problems with my actions. And now formally I will apologize to him in his capacity as chairman of the code revision commission, to Jerry Kurtz, Professor Fessler and any other members of that committee that are offended by the fact that where have I been for the last two or three years. But I have to live by the adage, better late than never.

In the interest of time, there has been a committee hearing, joint committee hearing, by the House Judiciary and Labor and Commerce Committees on February 24th, and that has been transcribed and Mr. Kelly will be submitting to you a copy of that transcript and I would like that to be incorporated into the record if you would.

My concern is that I perceive the proposed statute to be a unique bill contrary to what others may have said. And I say that if you look at the letter of transmittal to Chairman Ray, I think an accurate characterization of that letter is as they say, it's not the New York, it's not the California bill and it's not the model act. Well, to me I think an apt characterization of what we have then is a unique bill.

JOSEPHSON: It's unique but it's eclectic, I guess that's . . .

EGGERS: I believe that that is the case. And then so what are we going to have, we're going to have a unique bill which our supreme court is probably going to put a unique interpretation on. And that does concern me as a practitioner. In the last two or three years I've been contacted by some major corporations that were interested in doing work in Alaska. And normally the first question that they ask is what is your tax structure. And then the second question they ask is is there anything unique that we should be aware of about doing business in Alaska.

What I would like to see, and I don't know if the legislature as a legislature or the Judiciary Committee as a committee could do this is quite frankly I do feel more comfortable with the model act, O.K., but I'm not ready to adopt it. And I'm not asking, and I'm speaking for myself. And I think everybody on the committee is doing the same, speaking for themselves. I'm not asking you to adopt the most current exposure draft of the model act, but I think what would make me feel more comfortable is if the code revision commission would take the model act, and I think that it will be finally signed off on here within the next couple months. At least that's my understanding. Take that and then use that as the medium and point out where Alaska is different, where the proposed code revision commission differs. And then if I can see those differences, I would feel more comfortable. I've examined the

proposed statute. I've examined the commentary. And in reading those two, and like I say twenty hours I'm sure based upon the time that the commission that Jerry Kurtz and John Abbott and Professor Fessler sent that, that's probably maybe one-tenth of the amount of time. Or maybe one percent, I don't know, of the time that they've spent, and I realize that that's not a great deal of time. It's a great deal of time out of my practice, but overall it may not be a great deal of time. But in that time in looking at it, I am unable to figure out if you will where the differences lie. And I think that's something the legislature should be concerned with.

I disagree that section 488 you know stands alone. I think somebody said that it stands alone, or that's just my characterization of what they said. I really, I guess prior to John Abbott's comments I would have thought that it was not a red herring, now I'm really starting to wonder if it wasn't thrown in there sort of as a set up. But I'm glad that they put it in there, because that is what attracted people's attention . . . [TAPE CHANGE] And so I want to make it very clear that it is not my position that if you delete section 488 that then I have no further problems with the code because that certainly is not true and it is not accurate.

But let me just say something about section 488, and I will be brief. I think that as a policy in this state we do want to encourage venture capital, we do want to encourage good people to serve as directors and officers on the corporation, and I think that this will, section 488, will be a disincentive to that goal. I believe that we are presently protected from fraud by case law, and I stand to be corrected but I'm almost certain within the last one or two years contrary to what Professor Fessler said, I think our supreme court has upheld a case out of Southeastern where the lower court had pierced the corporate veil. And I feel fairly comfortable, but you know I stand to be corrected on that. Now to the extent the legislature and the commission may be concerned about fraud or fraudulent corporations, you know the type of people who set up these fraudulent corporations, they are the same type of people that will have no qualms about doing business as a partnership or as a sole proprietorship and walking over to the bankruptcy court and taking care of their problems in that manner. So I just think that that's a red herring.

That's really are my comments, and I want to thank you for coming to Anchorage and thank you for your time.

JOSEPHSON: Thank you.

GARDNER: Gentlemen, I didn't get on the list. I have eleven comments of Mr Eggers, if I could have a moment. I missed most of Mr. Abbott's comments so I'm not as outraged as I might be after I ask what they were, so I'm not going to respond to

that.

JOSEPHSON: I'm not going to tell you. Would you identify yourself.

GARDNER: My name is Ray Gardner, and I work with Hartig, Rhodes, etc., and I've served on the I guess task force or ad hoc committee depending on your prospective. The only thing that I wanted to point out, and it was an issue that I think that was raised in your mind but I wanted to emphasize it is that I think that this code, not just 488, I think 488 is probably the greatest example of that, has a great disregard for the venture capitalists in Alaska and the importance of those individuals who are able and willing to take risks with certain limited portions of their available funds in activities such as mining and certainly fishing. I think those are the two most important areas. My practice revolves around the mining and resources area. And particularly the miners are willing to take large sums of money and take substantial risks with it. But they don't want to be in the position of selling their house and their car, and their families and their future is going to be completely put at risk. And that's the advantage of the kind of corporate form that we see in Alaska.

JOSEPHSON: Well, Mr. Gardner, I asked that question as you recall because I was concerned about mining and the answer was that the passive investor should have no concern and only the active . . .

GARDNER: Well, that's true. But the normal mining venture that I encounter is about three different individuals. They serve as officers and directors and shareholders, and I see that very, very common throughout my practice.

JOSEPHSON: In the mining field, the old tradition was the grubstake kind of thing where you dealt with a tradesman on a basis of a contingency, I suppose, as shared. Is that still the custom? In other words instead of going to the suppliers of, the D-8 caterpillar store if they use D-8 caterpillars . . .

GARDNER: Well, they still do, I can assure you of that.

JOSEPHSON: And saying I want to lease or buy your caterpillar, but I'm not going to, but I want you to also to waive my individual liability, you probably wouldn't do that. You'd probably go and say I want to use it up at such and such a creek, and if I strike it what interest do you want in the mine? Is that what's happening?

GARDNER: That still happens. That does still happen, but to a large degree some of the equipment is so much more sophisticated now. Rather than just a cat going out on the Kenai

Peninsula to some few unpatented claims and having an adventure for the summer, so see what you can come up. But even still in the mining industry you see a whole significant number of people who are just kind of old salty Alaskans who are taking maybe their life savings. They've pooled it together, three, four, maybe as many as five people, they want to form a corporation and put that money in there without incurring any further personal risk beyond that and going out and giving it a try for a season or two seasons and seeing what they come up with. They're not out to defraud anybody. They're going to take some risk. They're willing to put their money on the line. And I think that that is a typically Alaskan activity that is nowhere considered in this code.

Now commercial fishing I think is very much the same way. I don't represent many fishermen, but I see that as happening.

JOSEPHSON: What about the other side of the coin where they go down to Lee's Cafe or someplace, and they find someone to work on this venture and can't pay him at the end of the season. What's the result there?

GARDNER: I think more often than not, most of the individuals that are working the mining claims who don't have a direct equity interest in the venture have no other expectation than receiving their pay out of production. Whatever that may be. And those are generally, they cut agreements. Unfortunately they don't put them in writing, but I think that it's on the handshake and they go in it knowing if it doesn't pan out, I'm not going to get paid. And that's not unusual at all. That's a risk they know they're taking, and they're certainly not looking at something like 488 to protect them.

JOSEPHSON: I do have to excuse myself. Is there anything else that you wanted to say?

GARDNER: One thing and that is I think this bill is largely misperceived in the business community. And I know that we've heard that the bar has been spoken to on a number of occasions, and they may have or should have a better understanding. When Ken Calhoun presented this bill to the Chamber of Commerce at one of their weekly meetings, he said there was $25,000 exposure. They don't know it's per creditor. They don't know the implications of this, and I think it needs more publicity and more comment. And those comments should be elicited from the business community.

JOSEPHSON: Well, I'm very grateful to all of you for coming on this holiday Saturday. And thank you for your time.