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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 understnding 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 16, 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.

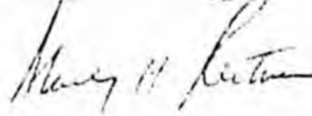
The Task Group is prepared to work with the Alaska Legislature, the Alaska Code Revision Commission and one or more economist(s), business leader(s), investor(s), jurist(s), academician(s) plus actual and potential enterpreneurs, to

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

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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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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.

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) <u>The Inadequate Disclosure and Explanation of the History of the MBCA.</u>

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.

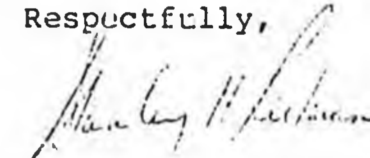
(c) The ACRC has the resources and the duty to review and carefully consider the proposed corporation code revision of the American Bar Association, before vigorously promoting its own product (the Fessler Code).

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

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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 cc 'ete 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 <u>Drafting Rules for Writing Uniform or Model Acts</u>, 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 source 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 considering possible revision of the Uniform Fraudulent Conveyance Act to make 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.

5. <u>The Committee on Corporate Laws</u>

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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.

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 (c) 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 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

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

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 (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.

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).
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

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

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.

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 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.

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

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).

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

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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
....	....
Signature	Type or print name
....	....
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 edition 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 20 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 Ma[illegible] [illegible]nd that I wished to accommodate that request.

In fairness to everyone, I am [illegible]esting 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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DANIEL A. GERETY
ROBERT L. EASTAUGH
STEPHEN M. ELLIS
CLAY A. YOUNG

KAREN L. HUNT
WILLIAM E. MOSELEY
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

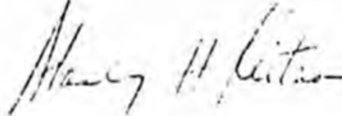
(e) the unseemly rush by lawyers and the public to use the corporate form vis-a-vis (i) joint ventures, and (ii) general and limited partnerships.

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.

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

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[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 humankind 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 articles is to undermine the premise upon which the expectation of public advantage is grounded. True, limited liability is claimed, but the view has already been asserted that this was a concession 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 fou[illegible] 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 <u>volenti non fit injuria</u> 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. <u>Arizona--The Creation of a New Business Form</u>

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. §303; 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. <u>Changes in Basic Structure</u>

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 officers 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?

Recommendations of the drafter: 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 pes-simistic 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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J. O. CELLARS
GREGORY J. MOTYKA
JAMES B. FRIDERICI

March 30, 1984

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

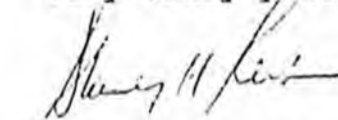
Re: SB 246
An Act Revising the
Corporate Code

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

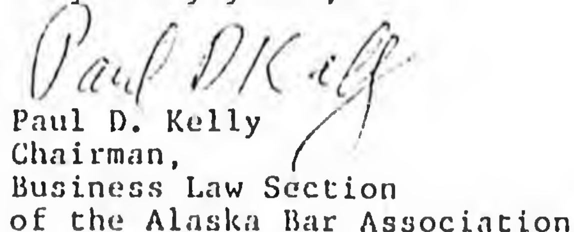
Re: Report of the Task Force of the Business Law Section of the Alaska Bar Association regarding HB 343 and SB 246, Corporate Code Revision.

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
Chairman,
Business Law Section
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PDK/ bj
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March 30, 1984

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House Labor and Commerce Committee
Pouch V
Juneau, Alaska 99811

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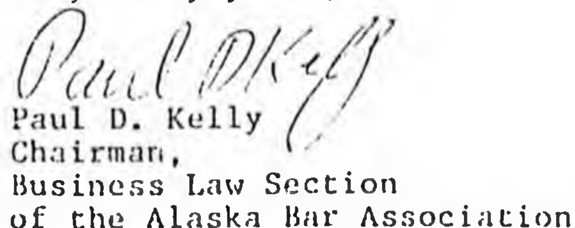

Paul D. Kelly
Chairman,
Business Law Section
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PDK/pj
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ALASKA BAR ASSOCIATION

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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:

ALASKA BAR ASSOCIATION

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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 provision such as registration of controlling out-of-state shareholder.. 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. We 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 would 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 <u>may</u> 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 allowing 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 418.

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 48[illegible].

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 [illegible]g Alaska law on foreign corporation no matter how minimal t[illegible]ntract may be with Alaska. This could very well discourage [illegible]ign corporations from looking at Alaska corporations for me[illegible] 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 <u>without reference</u> to the amount of authorized shares," whereas the commentary states that the filing fee shall be fixed "<u>with reference</u>" 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.