REPRESENTING MINORITY SHAREHOLDERS IN CLOSE CORPORATIONS UNDER MODERN BUSINESS CORPORATION ACTS*

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"When you're up to your ass
in alligators,
it's hard to remember you
came to drain the swamp."[1]

Counsel who have represented minority shareholders under any modern corporation statute based on the Model Business Corporation Act,[2] will smile slyly at the above quotation. Passage through the thicket of problems that such representation presents is a learning experience never to be forgotten. Counsel will have found a statute strongly biased in favor of management and the corporation's majority shareholders,[3] a common law of corporations which until recently turned a cold shoulder to the legitimate needs of minority shareholders,[4] and if the counselor

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2. MODEL BUS. CORP. ACT ANN. 1-1791 (3rd Ed. 1985) (hereinafter referred to as MODEL ACT ANNOT.).

3. *E.g.*, the board of directors controls shareholder access to choices about a number of important matters. Unless the board puts the issue before the shareholders, the shareholders are barred from taking action to amend the articles of incorporation (*id.* at § 10.03(b)), approve a merger or share exchange (*id.* at § 11.03(b)) approve a sale of all assets (*id.* at § 12.02(b)), or voluntarily dissolve the corporation (*id.* at § 14.02(b)). Under the REV. MODEL BUS. CORP. ACT (1984) (hereinafter cited as MODEL ACT) a majority shareholder will have to exercise at most three options, by appropriate provisions in the articles of incorporation, to achieve a corporate structure which meets his needs. These options are: authorize directors to declare share dividends in shares of one class for distribution to another class (*id.* at § 6.23), authorize the directors to ignore redemption preferences, if any, in declaring dividends (*id.* at § 6.40), and authorize "blank" stock whereby the board can set the rights and preferences of new shares without further shareholder approval (*id.* at § 6.02).

4. Subject to two developments, traditional corporate law favors the control group and allows wide latitude to "freeze-out" and oppress the minority shareholders. From the 1930's through 1960's the courts discovered that close corporations were functionally different organisms with dramatically different needs for planning flexibility. *See, e.g.*, Galler v. Galler, 32 Ill. 2d 16, 203 N.E.2d 577 (1965); Hart v. Bell, 222 Minn. 69, 23 N.W.2d 375 (1946); Clark v. Dodge, 269 N.Y. 410, 199 N.E. 641 (1936). This led to a series of decisions authorizing departures, by varying degrees, from

were a corporate specialist, his own "cultural" bias toward his usual client class—those in control of the enterprise.

I. STATUTORY PHILOSOPHY

The 1984 Revised Model Business Corporation Act may be usefully contrasted with other modern statutes in order to dramatize some of the tacit policy decisions made by the Model Act's drafters. The 1981 Minnesota Business Corporation Act[5] is particularly suitable for this comparison because it was drafted contemporaneously with the revised Model Act and both statutes are based on the 1969 Model Act. In addition, the statutes differ dramatically in their treatment of important close corporation issues.[6]

The Model Act is drafted with the large, publicly held corporation as its paradigm. Although its overall flexibility lends itself to alterations to meet the needs of the close corporation, the basic statute does not do so. The Model Statutory Close Corporation Supplement[7] partially fills this statutory "gap." That statute, however, is merely supplementary,[8] leaving the Model Act's basic pro-management bias intact, and the Supplement's applicability depends upon election by a supramajority of the

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the "corporate norm" by way of special clauses in the articles, bylaws, or shareholders' agreements. The object of these cases was to provide flexible planning tools to meet foreseen needs. *See* Cary, *How Illinois Corporations May Enjoy Partnership Advantages: Planning for the Closely Held Firm*, 48 NW. U.L. REV. 427 (1953).

In the 1970's and 1980's the courts have further recognized that flexibility in planning is only part of the answer for close corporations. Minority shareholders need self-effectuating protections when planning is absent or overwhelmed by unforeseen events. Thus fiduciary duties have been held to exist among all shareholders and denial of the minority's reasonable expectations has led to remedial action. *See* Olson, *A Statutory Elixir for the Oppression Malady*, 36 MERCER L. REV. 627 (1985) [hereinafter cited as Olson, *A Statutory Elixir*].

5. MINN. STAT. ch. 302A (1984).

6. A corporation that is closely held will exhibit the following characteristics: (a) a small number of stockholders; (b) no ready market for the corporate stock; and (c) substantial direct participation by the majority shareholders in the management, direction, and operations of the corporation. Donahue v. Rodd Electrotype Co., 367 Mass. 578, 585-86, 328 N.E.2d 505, 511, (1975). The leading commentator on close corporation law and practice, after considering numerous alternatives, draws the line on the basis of whether a ready market exists for the corporation's shares—thus allowing a minority shareholder an escape from the power of the majority and management. F. O'NEAL, 1 CLOSE CORPORATIONS § 1.02 (2d ed. 1971) [hereinafter cited as F. O'NEAL]. *See also* N.Y. BUS CORP. ACT § 1104-a(a). This is the most appropriate definition of the term "close corporation" since the *same* potential for abuse exists whenever the minority shareholder cannot fairly retrieve his investment at will. *See* Olson, *A Statutory Elixir ,supra* note 4, at 627-28.

7. MODEL ACT ANNOT., *supra* note 2, at 1803-1879.

8. MODEL STATUTORY CLOSE CORPORATION SUPPLEMENT § 2 [hereinafter cited as CLOSE CORP. SUPP.); MODEL ACT ANNOT., *supra* note 2, at 1803-1879.

shareholders.[9] The Supplement contains *no* provisions of advantage to a majority shareholder. If a single shareholder or a small, strongly unified group, controls a majority of the shares, the minority shareholders will rarely have sufficient bargaining power to cause an election.[10]

The Supplement contains two provisions of utmost importance to minority shareholders—specific authorization for shareholder control agreements which are operative on the director or corporation level,[11] and expanded opportunity for judicial intervention when those in control of the corporation have mistreated[12] minority shareholders.[13] Similar provisions do not appear in the Model Act although similar results may be achieved with diligent planning. On the other hand, in a jurisdiction which has enacted both Acts, courts may erroneously conclude that the existence of these provisions in the Supplement precludes developing similar protections under the Model Act.[14]

The status of shareholder control agreements under the Model Act is unclear. The Act specifically validates shareholder voting agreements,[15] which are effective at the shareholder level, but is silent as to shareholder control agreements, which seek to exert control over the directors or the corporation. This silence may raise a negative inference that other agreements are not valid.[16] In opposition to this negative inference stands the interpretive rule that statutes must be clear in order to overrule common

9. CLOSE CORP. SUPP., *supra* note 8, at § 3(a). The restriction that only corporations "having 50 or fewer shareholders" may elect to become statutory close corporations further reduces the usefulness of the Supplement (although once the election is made, the Supplement provides no upper limit on the number of shareholders). *Id.* at § 3(b).

10. One may predict, with some assurance, that the Supplement will seldom be elected. *See* Dickson, *The Florida Close Corporation Act: An Experiment that Failed,* 21 MIAMI U.L. REV. 842 (1967); FLORIDA LAWS 1975, c. 75-250 § 139 (repealing FLA. STAT. §§ 608.70-.77).

11. CLOSE CORP. SUPP., *supra* note 8, at § 20. *Compare* MINN. STAT. § 302A.457 (1984).

12. "Mistreatment" is a general term that encompasses all acts of those in control which leave other shareholders at a disadvantage.

13. CLOSE CORP. SUPP., *supra* note 8, at §§ 40-43. *Compare* MINN. STAT. § 302A.751 (1984).

14. Toner v. Baltimore Envelope Co., 304 Md. 256, 498 A.2d 642, 653-54 (Md. 1985). *But see* Zion v Kurtz, 50 N.Y.2d 92, 405 N.E.2d 681 (1980) (existence of elective close corporation provisions indicates *no* public policy against general use of shareholder control agreements).

15. MODEL ACT, *supra* note 3, at § 7.31. Voting agreements are sometimes referred to as "shareholder pooling agreements."

16. *Compare* CLOSE CORP. SUPP., *supra* note 8, at § 20(h) (specific statutory authority for certain agreements does not prohibit use of other types). The "Special Comment—Close Corporations" which formerly appeared in the Model Act's Official Comments has been moved to Annotation following § 20 of the Close Corporation Supplement. MODEL ACT ANNOT., *supra* note 2, at 1863-67. An inference from this move is that the contents of the Special Comment may no longer apply to the Model Act itself.

law, and the long line of cases approving shareholder control agreements in close corporations.[17] The case law on this issue is strong enough to overcome any negative inference from the mere authorization of certain agreements.

The provisions of the Model Act which specifically authorize limitation of the board's powers and regulation of the business and affairs of the corporation by provisions in the articles of incorporation present a more serious obstacle.[18] Although these provisions indicate that the Model Act rejects the concept of "inherent areas" of authority for the board of shareholders, the issue remains as to the efficacy of a shareholder control agreement which is not embodied in the articles. Once again a negative inference may arise that "limitations"[19] outside the articles are invalid.[20] One commentator on the Texas Business Corporation Act, a model for the shareholder control agreement provision of the Supplement,[21] indicates that such invalidity does result.[22] However, the Model Act Annotation leaves the issue open.[23] Once again, the language of the Model Act is more in the nature of a safeharbor, describing one approved technique, than a derogation of the common law.[24] Surely, if exclusivity had been intended, the drafters could have clearly so specified.[25] Thus the common law shareholder control agreement should sur-

17. Westland Capital Corp. v. Lucht Eng'g, Inc., 308 N.W.2d 709, 712 (Minn. 1981); cases cited *supra* note 4; F. O'NEAL, *supra* note 6, at § 5.24; Z. CAVITCH, 6 BUSINESS ORGANIZATIONS—WITH TAX PLANNING § 114.01[3] (1985); Annot., *Validity of Stockholders' Agreement Allegedly Infringing on Directors' Management Powers—Modern Cases,* 15 A.L.R.4TH 1078 (1982).

18. MODEL ACT, *supra* note 3, at §§ 2.02(b)(2)(ii)& (iii), 8.01(b), 8.01(c). The Official Comment to § 20 of the Close Corporation Supplement states "[General Corporation] statutes . . . in general do not authorize as much flexibility [in a shareholders' control agreement], particularly with respect to restriction on the normal power of directors." MODEL ACT ANNOT., *supra* note 2, at 1835.

19. MODEL ACT., *supra* note 3, at § 8.01(b).

20. The Official Comment to § 8.01(b) states: "[This provision] was added to make clear that corporations with boards of directors may reserve power to the shareholders in the Articles of Incorporation if that is deemed appropriate." (emphasis added).

21. MODEL ACT ANNOT., *supra* note 2, at 1836.

22. Johnson, *Not With My Shares You Don't! Close Corporation Control Devices Under Texas Law: Problems and Drafting,* 26 S. TEX. L. REV. 201, 214-15 (1985).

23. The Annotation to § 7.31 (shareholder voting agreements) states that "language similar to that appearing in section 8.01(b) of the 1984 Model Act may validate shareholder control agreements generally." MODEL ACT ANNOT., *supra* note 2, at § 7.13.

24. *See supra* note 17.

25. The failure of the Model Act to clarify this important point is a significant defect. *Compare* MINN. STAT. § 302A.457 (1984) (authorizing control agreements for all corporations subject only to the practical limitation that all shareholders must be parties).

vive enactment of the Model Act. In addition, the specific authority for limitations in the articles would seem to validate a provision in the articles which expressly authorizes shareholder entry into control agreements.[26] Such an arrangement would provide public notice that the internal power structure of the corporation may differ from that generally provided in the Model Act[27] and allow creditors and other parties the opportunity to inquire as to the specific provisions of such an agreement.

The Minnesota Act takes a diametrically opposite approach. Under the Minnesota statute the shareholder control agreement[28] is the central planning document governing the affairs of a close corporation and its shareholders. So long as all shareholders join in the agreement, the document may relate to "the control of any phase of the business and affairs of the corporation, its liquidation and dissolution, or the relations among shareholders."[29] The Minnesota Act provides no "corporate norm" when a control agreement is prepared and the shareholders may therefore usurp traditional prerogatives of the board. The agreement may cover *any* matter connected with the corporation except that it may not be inconsistent with the few mandatory provisions of the Act or reduce the protections provided in the minimal provisions of the statute.[30] Provisions otherwise modifiable in the articles or bylaws may be included in a control agreement and the agreement may encompass matters otherwise covered by a shareholder voting agreement. The shareholder control agreement is the key document into which all other devices for allocating control and financial return are tied through incorporation by reference. Under the Minnesota statute, the shareholders have clear authority to design their own scheme of corporate governance.

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26. MODEL ACT, *supra* note 3, at § 8.01(b) provides that the board will manage the corporation "subject to *any limitation* in the articles" and § 8.01(c) provides, for corporations having 50 or fewer shareholders, that the shareholders may "limit the authority of a board . . . by describing . . . *who* will perform some or all of the board's duties." (emphasis added).

27. The existence of a public record is a significant policy behind the use of optional article provisions under MODEL ACT, *supra* note 3, at § 2.02(b)(2). *See* Official Comment to § 2.02, MODEL ACT ANNOT., *supra* note 2, at 108.

28. MINN. STAT. § 302A.457 (1984). The drafters of the Minnesota Act accepted the author's proposal to clearly distinguish between shareholders' voting agreements, MINN. STAT. § 302A.455, and shareholders' control agreements, MINN. STAT. § 302A.457. *See* OLSON, CORPORATE PRACTICE: PROBLEM AREAS UNDER THE MINNESOTA CORPORATION STATUTE (Minnesota CLE 1978).

29. MINN. STAT. § 302A.457 subd. 1 (1984).

30. The mandatory and minimal provisions of the Minnesota Act are identified in OLSON & SPENCER, SHAREHOLDER PLANNING 173-175 (Minnesota CLE 1984). *See generally infra* notes 65-72 and accompanying text.

With its large, public corporation viewpoint, the Model Act does not deal adequately with the problem of minority shareholder abuse in a close corporation. The Act simply carries over the provision of the 1969 Act authorizing judicial intervention when the acts of those in control of the corporation are "oppressive."[31] Although a few courts have recently begun to interpret oppression so as to provide effective relief,[32] most courts continue to require such a high quantum of bad conduct on the part of majority shareholders that relief is seldom provided.[33] The Close Corporation Supplement expands the grounds on which judicial intervention may be based to include acts by those in control of the corporation which are oppressive or "unfairly prejudicial" to the shareholder in his capacity as a director, officer or shareholder of the corporation.[34] Furthermore, the Supplement provides the court with an array of remedial tools short of involuntary dissolution of the corporation including a buy-out of the petitioner.[35] The non-controlling shareholders will only have access to the Supplement's broader protections, however, if the majority shareholder or shareholder group *chooses* to make these protections available.

The Minnesota Act makes these protections available to every shareholder.[36] The legislature was convinced that minority shareholder rights and protections were *too* important to be left to the mere desire or election of the majority.[37] The full range of equitable remedies, up to and including involuntary dissolution,[38] is available where those in control

31. 1969 MODEL ACT § 97(a); MODEL ACT § 14.20(2)(ii).

32. *See, e.g.*, Fox v. 7L Bar Ranch Co., 198 Mont. 201, 645 P.2d 929 (1982); Exadaktilos v. Cinnaminson Realty Co., 167 N.J. Super. 141, 400 A.2d 554 (1979), *aff'd*, 173 N.J. Super. 559, 414 A.2d 994 (1980); Gardstein v. Kemp & Beatly, Inc., 64 N.Y.2d 63, 473 N.E.2d 1173 (1984); Meiselman v. Meiselman, 309 N.C. 279, 307 S.E.2d 551 (1983); Masinter v. Webco Co., 262 S.E.2d 433 (W. Va. 1980).

33. *See, e.g.*, Fix v. Fix Material Co., 538 S.W.2d 351 (Mo. App. 1976); Baker v. Commercial Body Builders, Inc., 264 Ore. 614, 507 P.2d 387 (1973).

34. CLOSE CORP. SUPP., *supra* note 8, at § 40(a)(1). The "unfairly prejudicial" standard for judicial intervention *is* the present test in England (The [British] Company Act, 1980, § 75) and several states. *See, e.g.*, MINN. STAT. § 751 Subd. 1(b)(2) (1984); N.J. REV. STAT. § 14A:12-7(1)(c) (Supp. 1982); S.C. CODE ANN. § 33-21-150(a)(4)(B) (Supp. 1982).

35. CLOSE CORP. SUPP., *supra* note 8, at §§ 41-43.

36. MINN. STAT. § 302A.751 (1984).

37. The Legislature soundly rejected the elective approach of the Close Corporation Supplement. See Olson, *Statutory Changes Improve Position of Minority Shareholders in Closely-Held Corporations*, 53-1 HENNEPIN LAW. 10 (1983).

38. A court may order the buy-out of a complaining shareholder pursuant to subdivision 2 of § 751 (when grounds for dissolution have not been shown) if the corporation is "closely held," *i.e.*, has 35 or fewer shareholders. *See* MINN. STAT. § 302A.011 subd. 6a (1984). *Compare In re* Villa

have acted in an "unfairly prejudicial" manner toward the complaining shareholders in their capacities "as shareholders, directors, or officers [of a corporation] or as employees of a closely-held corporation."[39] Furthermore, the Minnesota Act mandates that all shareholders of a closely held corporation owe fiduciary duties to each other in the operation of the corporation and requires that the reasonable expectations of the shareholders be respected.[40] This represents the first legislative enactment of what has now become the universal rule of the American common law of corporations.[41] Thus, the position of minority shareholders is more secure under the Minnesota Act than it is under the Model Act.

II. ETHICAL CONSIDERATIONS

Representation of a minority shareholder or a group of them frequently presents the lawyer with personal and ethical issues. The personal issue arises from a lawyer's natural tendency to identify with the "cultural" bias of his usual client class and the need to cast aside those psychological tendencies when acting in a capacity opposite to his usual role. With the possible exception of academics, "corporate" lawyers represent and identify with management and controlling shareholders. Their continuing workload is under the control of those groups. Most often, lawyers in general practice, probate specialists and litigators represent minority shareholders. Thus, a corporate practitioner called upon to represent minority shareholders needs to recognize that he may have psychological "blind spots" which could adversely affect the quality of his representation. This is not to say that the lawyer cannot change gears and bring his experience and particular competence to bear from a new prospective. It is merely to point out that the lawyer should be conscious of the problem and take positive steps to alleviate it.

The ethical issue arises because all of the founding entrepreneurs or a

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Maria, 312 N.W.2d 921, 923 (Minn. 1981) (buy-out as an alternative to dissolution). Grounds for dissolution need not be shown as a predicate for granting any lesser relief. *Id.* at § 302A.751 subd. 3b (1986).

39. MINN. STAT. § 302A.751 subd. 1(b)(2) (1984). The Minnesota Act like that of New Jersey extends protection to shareholders of closely held corporations in their capacity *as employees*. Job rights are often among the most important inducements for the minority's investment. See Report of the Corporation Law Revision Committee, N.J. REV. STAT. § 14A, at 31 (Supp. 1983). *Compare Close Corp. Supp., supra* note 8, at § 40(a)(1). The discussion draft of the Supplement included "employee" but that status was removed from the final version. *See* 38 *Bus. Law.* 1031, 1032 (1983).

40. MINN. STAT. § 302A.751 subd. 3a (1984).

41. See Olson, *A Statutory Elixir, supra* note 4, at 646-58.

number of prospective minority shareholders usually will approach the lawyer seeking group representation. Inherent in this situation is a conflict of interest of potentially serious proportions. Although the entrepreneurs are united against the outside world, they are competitors with respect to the sharing of managerial control, current profit participation, and ultimate investment recapture. Their legal interests are not aligned and may be contradictory at various points. Because of the numerous planning options available under the Model Act, multiple representation has become much more difficult to achieve successfully. Imagine going through the thirty-five point checklist in the Official Comment to section 2.02 of the Model Act with a majority and minority shareholder at the same time![42] In providing competent advice, the lawyer must inform each client of what the statute and common law provide relative to that client's position and discuss commonly occurring negative scenarios so that the client's expectations and desires with respect to the venture can be fully articulated and appropriate steps taken to insure those needs will be met.[43] Often counsel will be unable to accomplish this task for all of the entrepreneurs as a group.

The ABA Model Rules of Professional Conduct recognize these issues but give the lawyer little effective guidance. Two overlapping provisions of the Model Rules cover the problems presented by group representation. Under Rule 1.7, when representation of one client *may* be materially adverse or materially limit representation of another, the lawyer may act for both parties only if:

> (1) the lawyer reasonably believes the representation will not be adversely affected; and (2) the client consents after consultation. When representation of multiple clients in a single matter is undertaken, the consultation shall include explanation of the implications of the common representation and the advantages and risks involved.[44]

The Comment to the Rule indicates that relevant factors to consider are the likelihood that an actual conflict will occur and, if it does, whether the conflict will materially interfere with the lawyer's professional judg-

42. MODEL ACT. ANNOT., *supra* note 2, at 109-111. The Minnesota Act provides over 50 specific choices in its nonexclusive checklist. *See* MINN. STAT. § 302A.111 (1984).

43. *See* Hetherington, *Special Characteristics, Problems, and Needs of the Close Corporation*, 1969 U. ILL. L.F. 10, 17.

44. MODEL RULES OF PROFESSIONAL CONDUCT, Rule 1.7(b) (1983) [hereinafter cited as MODEL RULES]. "Consultation" means "communication of information reasonably sufficient to permit the client to appreciate the significance of the matter in question." *Id.* at Preamble.

ment.[45] If the risk of adverse effect is minimal and the clients consent, the lawyer may undertake the multiple representation. However, the lawyer has a *continuing duty* to monitor the situation. When the conflict rises to the point where a disinterested lawyer would conclude that the clients should no longer agree to share the lawyer's loyalty, the clients' consent no longer suffices and the representation must be terminated.[46]

Rule 2.2[47] is new and may offer the lawyer additional opportunity to act with regard to multiple clients. This rule introduces the concept of the lawyer acting as an intermediary.[48] Rule 2.2 requires the lawyer to determine that intermediation is appropriate and to secure each client's informed consent. The lawyer must also ensure that he remains impartial and that intermediation remains appropriate for all the parties involved. This rule allows the lawyer to represent multiple parties as an intermediary[49] when their interests are "substantially although not entirely compatible."[50] The lawyer, however, must remain impartial as he has parallel duties to provide loyal and diligent representation to each

45. *Id.* at Rule 1.7, Comment. A conflict will "materially interfere" with the lawyer's professional judgment if it causes the lawyer to fail to consider, recommend or carry out an appropriate course of action for one client because of the interests of another. *Id.*

46. *Id.* The responsibility to cause termination is the lawyer's.

47. Rule 2.2 allows a lawyer to

> (a) . . . act as intermediary between clients if: (1) the lawyer consults with each client concerning the implications of the common representation, including the advantages and risks involved, and the effect of the attorney-client privileges, and obtains each client's consent to the common representation; (2) the lawyer reasonably believes that the matter can be resolved on terms compatible with the client's best interests, that each client will be able to make adequately informed decisions in the matter and that there is little risk of material prejudice to the interests of any of the clients if the contemplated resolution is unsuccessful; and (3) the lawyer reasonably believes that the common representation can be undertaken impartially and without improper effect on other responsibilities the lawyer has to any of the clients.
>
> (b) while acting as intermediary, the lawyer shall consult with each client concerning the decisions to be made and the considerations relevant in making them, so that each client can make adequately informed decisions.
>
> (c) A lawyer shall withdraw as intermediary if any of the clients so requests, or if any other conditions stated in paragraph (a) is no longer satisfied. Upon withdrawal, the lawyer shall not continue to represent any of the clients in the matter that was the subject of the intermediation.

Id. at Rule 2.2.

48. One example of intermediation is assisting in the organization of a business in which two or more clients are entrepreneurs. *Id.* at Rule 2.2, Comment.

49. An intermediary seeks to resolve potentially conflicting interests by developing the shared interests of the parties. In intermediation, the client ordinarily must assume greater responsibility for decisions than he would need to do if he had independent representation. *Id.* at Rule 2.2, Comment.

50. *Id.* The responsibility to terminate representation is the lawyer's.

client. These duties retain their full vigor. As under Rule 1.7, the attorney must monitor the client's ability to make adequately informed choices and ensure that material prejudice does not result. If the client should no longer consent, then his earlier consent no longer validates the multiple representation.

Important issues these Rules and Comments raise include: whether the interest is actually, as distinguished from potentially, differing; whether the difference of interests is so great that the independent judgment of the attorney on behalf of each client might be adversely affected; and whether the attorney's representation of each will, nevertheless, be competent. Subsidiary issues include standards for determining when the degree of divergence is too great, and when the level of legal service is adequate. Faced with these vague standards, the attorney might consider refusing to represent any of the parties until all the other parties procure separate legal advice. Experience indicates, however, that this approach is generally unworkable because the prospective clients most often will view the attempt to require separate representation as impractical and unnecessary. Entrepreneurs see their interest in successful initiation of the enterprise as overshadowing all "lawyers' quibbling," and may regard the attempt to require separate representation as simply another example of excessive legal expense.

Another approach is to choose one of the parties as "the client" and tell the other members of the entrepreneurial group that they should not look to the attorney for representation. This approach, however, begs the question, because the entire group will probably continue to believe that the attorney is putting the deal together for all of them. This belief is nearly impossible to dispel. Even if the other members of the group are provided a written warning in the strongest terms, they will as a practical, if not legal, matter continue to trust the attorney. The situation is especially difficult when more than one of the group has a prior client relationship with the attorney. In such a case, all former clients may presume no impairment of their representation, and the burden is on the attorney to break the bond of trust that the prior representation has created.[51]

How are attorneys to protect their clients and themselves under these circumstances? Effective protective action appears to have two aspects—disclosure and quality assurance. When undertaking this type of multi-

51. Allstate Ins. Co. v. Keller, 17 Ill. App. 2d 44, 149 N.E.2d 107 (1977).

ple representation, the attorney shoulders the burden of assessing and making full disclosure of all the facts and circumstances concerning the differing interests. This disclosure should include: any actual or potential differences in interest among the clients; the scope of those differences; the limitations which those differences might place on the attorney's representation of each client, i.e., how the attorney's advice and conduct may be modified due to the differences; and the severity of the conflict resulting from those differing interests. Simply stating that the clients may have differing interests is not enough. The clients should also be informed that the attorney may at some point have to completely withdraw from representation of all or any of them if a conflict develops which is severe enough that the attorney can no longer adequately represent all interests.

If all of the prospective clients give informed consent to representation by a single attorney, the lawyer may begin to advise the group.[52] The attorney is, however, under a *continuing duty* to assure the quality of his performance. In this context, adequate representation requires neither greater nor lesser care than the zealous protection of individual interests which each client would expect if that client's interests were the attorney's sole responsibility.[53] The attorney must point out at each stage of the negotiations the relative advantages and disadvantages of alternate courses of action to each client, so that the clients can agree on the choices to be made.

The unique circumstances of each case affect the adequacy of representation. These circumstances include the parties' relative bargaining power, the nature of the business, and the severity of any discord which arises among the group. If one party persists in demanding unfairly advantageous arrangements with regard to a particular item or if one client is obviously unable to effectively protect himself without independent representation, the attorney should terminate representation of the entire group. The test is that of objective fairness to each: Would independent representation have resulted in a substantially better deal for any of the clients?[54] The significant consideration is that each client accepts a deal

52. The consent should be in a signed writing. *See* Appendix, *infra* p.——

53. Hill v. Okay Const. Co., 312 Minn. 324, 252 N.W.2d 107 (1977). *See also* Evans v. Blesi, 345 N.W.2d 775 (Minn. App. 1984) (lawyers who represented corporation were in conflict of interest position when they also represented majority shareholder in attempt to freeze-out minority shareholder; therefore, their advice to the majority shareholder was not within lawyer-client privilege as to the minority shareholders).

54. Crest Investment Trust, Inc. v. Comstock, 23 Md. App. 280, 327 A.2d 891 (1974).

for business reasons, and not because the lawyer failed to competently and zealously represent that client. When this result is achieved, the clients have received adequate representation.

Two general guidelines can be developed from application of the Model Rules to common close corporation settings. First, only in the most unusual circumstances may a single attorney represent a majority shareholder (or controlling group) and also represent a minority shareholder (or group) regarding the "deal" between them.[55] Even if such representation is undertaken with utmost care, disaster for the attorney is so probable that this situation should be avoided. On the other hand, a single attorney often can successfully represent a group of minority shareholders in negotiations in which each faces substantially the same risks in joining the venture because of the uniform effect of various control devices and other techniques on each.[56] Significant disparities among clients in age, health or business experience render multiple representation unwise.[57] Even when informed consent is given, the attorney would be well advised to formally review the multiple representation on an annual basis in order to assure himself that continued representation is appropriate under the Model Rules.[58]

III. SCOPE OF PERMISSIBLE PLANNING UNDER THE MODEL ACT

Modern corporation statutes, including both the Model Act and the Minnesota Act, are enabling acts designed to foster flexibility in devising the appropriate structure for a particular corporation. All but a very few of the provisions of the statutes can be modified in their application. The problem for the attorney-planner is to determine which provisions are

55. One might attempt this if the clients were extremely "savvy" about both business and legal matters and if the representation would not be continuing or the clients have independent counsel readily available to them.

56. Ghinger, *Shareholders' Agreements in Closely Held Corporations,* 4 U. BALT. L. REV. 211, 213-14 (1975).

57. Age or health disparities are especially crucial if the attorney's task is to develop a buy-sell agreement regarding corporate stock. *See generally* Helms v. Duckworth, 249 F.2d 482 (D.C. Cir. 1957).

58. Lawyers who run afoul of the conflict of interest prohibition most often side with the stronger client over time and fail to properly monitor the need of the other client or clients for independent counsel. *See* Evans v. Blesi, 345 N.W.2d 775 (Minn. App. 1984) (counsel representing a corporation assisted majority shareholder in planning a "freeze-out" of the minority; held: counsel were in conflict of interest position and had duty to advise minority shareholder regarding corporate matters, *i.e.,* the "freeze-out"). *See also In re* Brownstein, 288 Or. 83, 602 P.2d 655 (1979); National Texture Corp. v. Hynes, 282 N.W.2d 890 (Minn. 1979).

not modifiable at all and which allow for only limited modification. The Model Act does not resolve this problem of identifying *what* to change and *how* to accomplish the modification.

The Official Comment to Section 2.02 of the Model Act lists thirty-five modifications which can be made only in the articles or only in the bylaws,[59] but these lists are not exclusive.[60] Other portions of the Official Comments invite additional modifications to meet needs of close corporations but do not specify how those changes are to be validly accomplished.[61] Furthermore, several sections of the Model Act specifically authorize or preclude modifications,[62] usually with a comment that no inferences are to be drawn regarding other sections because these can or cannot be modified.[63] Unlike the Minnesota Act, the Model Act does not authorize sweeping deviations from the "corporate norm" in a unanimous shareholder control agreement.[64] The Model Act, therefore, provides no clear answer to the question: What provisions of the Model Act cannot be modified, in whole or in part, by various corporate governance documents? The following analysis, however, can resolve this dilemma.

A rational basis can be constructed for determining the permissible modifications of the provisions of the Model Act by recognizing that three types of provisions are present in the Act: mandatory sections;[65] minimal sections,[66] which may be altered to enhance but not reduce the statute's protection; and presumptive sections,[67] which often expressly

59. MODEL ACT, *supra* note 2, at § 2.02, Official Comment. The Minnesota Act lists 38 such modifications as well as 20 optional modifications (those most frequently made) for a total of 58 listed, but nonexhaustive, choices. MINN. STAT. § 302A.111 (1984).

60. Unlisted options that shareholders may elect only in the articles include those authorized by §§ 3.01, 3.02, 6.21, 10.01, 10.20 and 12.01(b) of the Model Act. Unlisted options that may be elected only in the articles or bylaws include those authorized by §§ 7.02, 8.11 and 14.02(e) of the Model Act.

61. *See, e.g.*, MODEL ACT, *supra* note 3, at §§ 8.07, 14.30, 16.20, Official Comments.

62. *See* MODEL ACT, *supra* note 3, at §§ 6.21(a) (can be modified), 8.03(b) & (c) (cannot be modified), 10.04(d) (cannot be denied), 16.02(d) (cannot be abolished or limited).

63. *Id.* at §§ 6.21, 10.04, 16.02, Official Comments. Inexplicably, no statement regarding permissible inferences is contained in the comment to § 8.03.

64. *See* MINN. STAT. § 302A.457 subd. 2 (1984). To statutorily validate a shareholder's control agreement under the Model Act, the corporation must elect to be governed by the Model Statutory Close Corporation Supplement. *See* CLOSE CORP. SUPP., *supra* note 2, at § 20. *See also supra* notes 15-27 and accompanying text.

65. *See infra* notes 69-72.

66. *See, e.g.*, MODEL ACT, *supra* note 2, at §§ 6.21, 6.30, 6.40, 7.02, 7.04, 7.20, 7.25, 7.27, 7.30, 7.31, 8.06, 8.08, 8.24, 8.31, 8.32, 8.51-.58, 10.04, 10.20-.22, 11.01, 11.02, 12.01, 12.02, 13.02, 16.01, 16.02, 16.20, 16.21.

67. *See supra* notes 59 and 60.

provide for change. The mandatory sections may be further subdivided into two classes: those not subject to modification even by unanimous shareholder action, and those subject to modification by unanimous shareholder action, but not by majority shareholder action. The question is how to identify the provisions falling into each of the mandatory classes because action to modify those provisions will be invalid.[68]

Three series of sections are not subject to change even by unanimous shareholder action. They are provisions which form the "skeleton" of the corporation,[69] provisions which are addressed to the courts,[70] and provisions which provide protection to the interests of creditors and other third parties.[71] Provisions which are not subject to limitation by majority shareholder action are those few sections which provide protections for the interests of minority shareholders.[72]

The Model Act also leaves unresolved a second question: How are legitimate modifications to the corporate structure set out in the Act to be accomplished? Some guidance is contained in the Official Comment list of changes that must be accomplished only in the articles or bylaws.[73] Furthermore, the Model Act authorizes optional provisions in the articles or bylaws[74] and shareholder voting agreements.[75] The Model Act does not specifically validate shareholder control agreements.[76] Thus, the planner is left to common law decisions in his search for a valid location for the various modifications which are necessary to protect his client's interests.[77]

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68. *See* Galler v. Galler, 302 N.E.2d at 585; Wilson v. McClenny, 262 N.C. 121, 129, 136 S.E.2d 569, 575 (1964).

69. *See, e.g.*, MODEL ACT, *supra* note 3, at §§ 1.01-.42, 2.01, 1.02(a), 2.03-.06, 4.01.03, 5.01-.04, 6.01(a) (partially), 6.02(b) & (d), 6.03, 6.22 (partially), 6.25, 7.01, 7.21(a) (partially), 8.01 (partially), 8.03(a) (partially), 8.03(b), (c) and (d), 8.25(e), 8.30, 8.33, 8.42, 10.01, 10.05-.09, 11.06, 11.07, 14.01, 14.03, 14.05, 14.20-.23, 16.22.

70. *See, e.g., id.* at §§ 7.03, 7.40, 8.09, 14.30.

71. *See, e.g., id.* at §§ 3.04, 6.40(c)(1), 8.32, 14.06, 14.07 (creditors); §§ 6.27(b), 7.22(g) (purchasers without knowledge).

72. *E.g., id.* at §§ 10.04, 13.02, 13.15-.31.

73. *Id.* at § 2.02, Official Comment.

74. *Id.* at § 2.02(b)(2) (articles), § 2.06(b) (bylaws).

75. *Id.* at § 7.31.

76. *See supra* notes 15-27 and accompanying text. Under the Minnesota Act, on the other hand, the shareholders' control agreement is not subject to the "corporate norm" and is the central planning document into which all other devices are tied. *See supra* notes 28-30 and accompanying text.

77. The failure of the Model Act to broadly validate shareholders control agreements is a major defect. *Compare* CLOSE CORP. SUPP., *supra* note 8, at § 20.

The technical methods which planners have traditionally used to achieve the desired allocation of control and financial return and to maintain that allocation are:

> (1) stock transfer restrictions, (2) shareholder pooling agreements, (3) voting trusts, (4) irrevocable proxies, (5) cumulative voting provisions, (6) classification of shares (including provisions for nonvoting or other specialized types of shares), and (7) shareholder agreements which restrict action by directors, provide for management of the corporation by the shareholders or provide for so-called veto powers whereby, through high voting or quorum requirements, minority shareholders may effectively be given a veto over corporate actions.[78]

These devises remain available under the Model Act and are discussed in the materials which follow.

A. Planning Opportunities Using The Articles of Incorporation

Modern analysis views the articles of incorporation as a contract among the shareholders which sets out the terms of their endeavor and the hazards which they accept in joining together. Thus the Model Act provides that the articles may contain any provisions[79] regarding "managing the business and regulating the affairs of the corporation . . . [or] defining, limiting, and regulating the powers of the corporation, its board of directors, and shareholders. . . ."[80] The articles may contain any control or financial arrangments upon which the shareholders have decided, and the articles *must* contain those modifications which, by virtue of the substantive provisions of the Model Act, may be made only in the articles.[81] The list of options provided in the Official Comment may be used as a "road map" for planning. When representing minority shareholders, almost every substantive section, both presumptive and minimal, should be considered for modification because of the strong statutory bias towards management and controlling shareholders. Although the potential list of modifications which counsel may find desirable under the

78. W. PAINTER, PROBLEMS AND MATERIALS IN BUSINESS PLANNING 22 (2d Ed. 1984).

79. The provisions must not be "inconsistent with law." However, there is no indication as to when such inconsistency will arise. *See supra* notes 59-72 and accompanying text.

80. MODEL ACT, *supra* note 3, at § 2.02(b)(2)(ii) & (iii).

81. The Official Comment to § 2.02 contains a list of 23 options which may be elected only in the articles. MODEL ACT ANNOT., *supra* note 2, at 109-10. At least seven other options may be elected only in the articles. *See supra* note 60. The Minnesota Act contains a similar nonexclusive list of 19 options which may be elected only in the articles. MINN. STAT. § 302A.111 subd. 2 (1984). However, under the Minnesota Act even these options may be contained in an unanimous shareholder control agreement. *Id.* at § 302A.457.

circumstances of a particular case is infinite, certain options should be considered in every case.

1. Include in the articles of incorporation the statement that the corporation is a statutory close corporation.

In a jurisdiction which has enacted the Model Statutory Close Corporation Supplement this statement constitutes an election that the Supplement as well as the Model Act governs the corporation.[82]

2. Provide that the fiduciary duty and reasonable expectations doctrines apply to the corporation.

The clear trend in the Anglo-American common law of corporations is to apply both the fiduciary duty and reasonable expectations doctrines to close corporations. The case law is, however, not always clear and the courts have not spoken in all jurisdictions.[83] The articles should include the following statement:

> All shareholders of this corporation owe one another a duty to act in an honest, fair, and reasonable manner in the operation of the corporation and in their relations toward each other involving the corporation. The shareholders shall honor the reasonable expectations which they share as those expectations exist at the inception and develop during the course of the shareholders' relationship with the corporation and with each other.[84]

In no instance should a minority shareholder accept an "anti-*Donahue* clause" which provides that neither the fiduciary duty nor the reasonable expectations doctrine are applicable to this corporation and its shareholders.[85] The controlling shareholders should, instead, be required to specifically identify and negotiate an agreement as to each circumstance in which they feel unable to act in an honest, fair and reasonable manner respecting the reasonable[86] expectations of the minority.[87]

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82. CLOSE CORP. SUPP., *supra* note 8, at § 3(a). The Close Corporation Supplement provides: a prepared form of stock transfer restrictions and a buy-out on the death of a shareholder; clear authorization for shareholder control agreements and for article provisions giving a shareholder power to dissolve the corporation at will; and access to enhance equitable relief for mistreatment of minority shareholders. *Id.* at §§ 11, 14, 20, 33, 40.

83. *See* Olson, *A Statutory Elixir, supra* note 4, at 646-58.

84. This statement is based upon MINN. STAT. § 302A.751 subd. 3a (1984).

85. *See* Note, *Contractual Disclaimer of the* Donahue *Fiduciary Duty: The Efficacy of the Anti-*Donahue *Clause,* 26 B.C.L. REV. 1215 (1985).

86. "Reasonable" expectations are those which the majority shareholders know or should know are held by the noncontrolling participants. Olson, *A Statutory Elixir, supra* note 4 at 655-56.

87. *Id.* at 658.

3. Expressly authorize the shareholders to enter into a shareholder control agreement.

This provision should remove any doubt as to the validity of a shareholder control agreement under the Model Act.[88] The articles could contain a statement as follows: "The shareholders are authorized to enter into a unanimous written agreement to regulate the exercise of the corporate powers, the management of the business and affairs of the corporation, and the relations among the shareholders of the corporation."[89] The articles also should require that the agreement be filed with the corporation and that shares bear a conspicuous legend declaring the existence of the agreement.[90]

4. Elect to dispense with the board of directors by describing who will perform the duties of the board.

This option, which allows direct shareholder management of the corporation,[91] is available to corporations which have 50 or fewer shareholders.[92] This provision, if adopted, will eliminate questions concerning the validity of shareholder actions which usurp the traditional discretion of the board of directors. Because the shareholders directly conduct management, a shareholder voting agreement under section 7.31 of the Model Act may be used to specify *how* the business and affairs of the corporation will be managed.[93]

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88. *See supra* notes 15-27 and accompanying text.

89. This statement is based upon CLOSE CORP. SUPP., *supra* note 8, at § 11.

90. "Conspicuous" includes typing in capitals or underlying. MODEL ACT, *supra* note 3, at § 1.40(3). The legend might provide:

> The articles and bylaws of this corporation contain many provisions designed to meet the unique needs of its shareholders, including authorization for any shareholder to cause dissolution of the corporation under specified circumstances. The shareholders have entered into a Shareholder Control Agreement which contains further provisions particular to this corporation, including restrictions on the transfer of shares of the corporation. All such documents may be examined by bona fide prospective transferees of shares and other appropriate persons upon written request to the corporate Secretary. All transferees of shares must become parties to the Shareholder Control Agreement and be bound thereby. No shares will be transferred on the books of the corporation until the transferee has filed a consent to be bound, on the form provided by the corporate Secretary, with the corporation.

91. *Compare* CLOSE CORP. SUPP., *supra* note 8, at § 10.

92. MODEL ACT, *supra* note 3, at § 8.01(c).

93. Little precedent supports direct shareholder management. It holds the potential, however, for eliminating many of the legal issues which have plagued planning efforts on behalf of minority shareholders in the past. *Compare* DEL. GEN. CORP. LAW § 351.

5. The number of directors of the corporation should be fixed.

Almost all special control arrangements in a close corporation, such as cumulative voting or class voting for directors, depend for their efficacy on the number of directors remaining constant. Because management decisions are traditionally made at the board level, minority shareholders must be assured that changes in the number of directors cannot erode their power and influence.[94]

6. Provide that the shareholders are entitled to exercise cumulative voting.

The Model Act is an "opt-in" statute.[95] The shareholders do not have cumulative voting rights unless expressly provided in the articles. Cumulative voting is a device which increases the likelihood, but does not guarantee, that a minority shareholder will obtain some representation on the board. The effectiveness of cumulative voting may be eroded through a number of techniques. If cumulative voting is provided, further provisions must be included in the articles to deny authority to reduce the number of directors or stagger the terms of directors[96] if sufficient votes are cast against the amendment to have elected a director under cumulative voting.[97] Such provision allows minority shareholders having operative and effective cumulative voting rights to prevent loss of those rights. Similar provisions must be included in the articles to deny authority to amend the articles so as to remove cumulative voting rights.[98] Furthermore, shareholders depending on cumulative voting rights must be able to prevent the corporation from issuing more shares or ensure that they have an adequate opportunity to retain their proportionate voting power.[99]

7. Provide for a classified board of directors with class voting for directors.

This technique for ensuring shareholder representation on the board of

94. The effectiveness of cumulative voting is particularly subject to dilution by changes in the size of the board of directors. *See generally* Mills, *The Mathematics of Cumulative Voting,* 1968 DUKE L.J. 28.

95. MODEL ACT, *supra* note 3, at § 7.28(b).

96. *See id.* at § 8.06 (authorizing staggered elections for directors under certain circumstances).

97. See MINN. STAT. § 302A.413 subd. 9 (1984) for an example of this type of limitation.

98. *See id.*

99. *See infra* notes 131-40 and accompanying text.

directors, which the Model Act specifically authorizes,[100] is vastly superior to cumulative voting because the complicated mathematics of cumulative voting are avoided. When class voting for the board is provided, cumulative voting should not be provided, because the two mechanisms are inconsistent.

Class voting offers significant flexibility because the number of shares in a given class can vary, for example, to reflect differing investments of the various classes. Class voting also allows a shareholder holding all of the shares of a given class to engage in simplified estate planning by giving away shares of the class to his children or other beneficiaries while retaining a majority of them. Alternatively the shareholder could give away more shares provided that all of the holders of shares of that class entered into a shareholders voting agreement which left the original shareholder in practical control of the votes of the entire class. An expansion of this concept would be to classify the officers of the corporation as well and provide that only persons owning shares in a particular class may hold various offices. Class voting for directors must be protected in much the same way as cumulative voting. Unless the class agrees, the corporation should be prevented from amending the articles to eliminate the class vote, increasing the size of the board of directors, or issuing more shares of that class.

8. Provide that directors can be removed prior to the expiration of their term only for cause.

The Model Act specifically authorizes this provision.[101] If the articles provide class voting for directors, however, this limitation may be unnecessary. The Model Act allows some protection against unwarranted removal of directors elected by class voting or cumulative voting.[102] Additionally, if the directorship is an element of an agreed upon allocation of control, further protection from removal may be appropriate. On the other hand, if the shareholders fail to remove a director for cause and real grounds for removal exist, judicial removal is available under the Model Act.[103]

100. MODEL ACT, *supra* note 3, at § 8.04.

101. *Id.* at § 8.08(a).

102. *Id.* at § 8.08(b) & (c).

103. *Id.* at § 8.09.

9. Provide that vacancies occurring on the board of directors, for whatever reason, may be filled only by the shareholders and that the board cannot act while a vacancy exists except in a bonafide emergency situation.

The Model Act provides that either shareholders or the board of directors may fill director vacancies without specifying any priority between the two groups.[104] The Model Act further provides that a classified directorship may be filled only by the class of shareholders entitled to elect the director, *if* it is filled by the shareholders.[105] These two subsections, read together, create a possibility for substantial abuse of shareholder rights. For example, assume that the board is classified into A, B, and C directors who are elected respectively by class A, B, and C shares. The C director dies at 6 a.m. At 10 a.m. the A and B directors meet and pursuant to the statute, elect BW (B's wife) to fill the vacancy.[106] At 2 p.m. the widow and executor of C holds a class meeting of the C shareholders (herself) and elects herself to fill the vacancy. Who is the third director? If the earlier board action is effective, the C shareholders have no board position to fill and the class election is inoperative. Such a result is inconsistent with the purpose of classified directorships. Nevertheless, the result appears proper under the Model Act.[107] Restricting the power to fill vacancies to the shareholders eliminates the inequitable result described in this example.

If the articles require cumulative voting as the technique for insuring a minority shareholder representation on the board of directors, an alternative mechanism must be used. The articles should provide that any vacancy on the board of directors requires the full board to stand for election and the board may take no action, other than in bona fide emergencies, prior to the election. Cumulative voting only works when all directors are standing for election.

104. *Id.* § 8.10(a).
105. *Id.* at § 8.10(b).
106. *Id.* at § 8.10(a)(2).
107. The Official Comment to § 8.10 is silent on this issue.

10. Provide that any shareholder may call a meeting of shareholders, that notice of a meeting must be sent to all shareholders whether or not entitled to vote, that the notice must specify the purpose or purposes for which the meeting has been called and that no action may be taken at a shareholders meeting (except for bona fide emergencies) unless that action has been specified in the notice.

In order for shareholder democracy to work, the shareholder must be given an adequate opportunity to participate. In a close corporation, the interests of each shareholder will be significant enough so that any shareholder should be able to call the shareholders together and place before them questions concerning their enterprise. The potential for abuse of this privilege is small and can be alleviated by requiring, for example, that two shareholders or the holders of 3 percent of the shares join in calling the meeting.[108]

11. Provide that any shareholder may bring a proposal before the shareholders for vote.

With respect to significant issues such as amendment of the articles of incorporation, merger, share exchange, sale of all the corporate assets, or dissolution, the Model Act provides that the shareholders are powerless to consider a proposal unless the board of directors have first approved it.[109] Because the board may always withhold its approval entirely and not submit the proposal, the board may preclude shareholder action.[110] In order to regain their power to control fundamental choices with respect to their corporation, the shareholders must specify a different procedure in the articles.[111]

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108. *Compare* MINN. STAT. §§ 302A.135 subd. 2 & 302A.433 subd. 2 (1984). When shareholders desire to act by unanimous written action, provision must be made for waiver of any notice requirements.

109. *See* MODEL ACT, *supra* note 3, at §§ 10.03(b), 11.03(b), 12.02(b), 14.02(b).

110. This procedure, requiring board approval, is ineffective to block shareholder proposals which are made under the federal proxy rules in cases involving publicly held corporations. SEC v. Transamerica Corp., 163 F.2d 522 (3d Cir. 1947). *Compare* MINN. STAT. § 302A.135 subd. 2 (1984) (allowing holders of 3% of the voting power to bring proposals before the shareholders).

111. The shareholders may change the procedure notwithstanding the statement in the Official Comment to § 10.01 that these rights "must be exercised pursuant to the procedures" of this chapter. MODEL ACT ANNOT., *supra* note 2, at 1174. Substantive provisions regarding proposals, such as the vote required for approval, may be modified only as authorized in the statute. *See* MODEL ACT, *supra* note 3, at § 7.27. It is interesting to note that with respect to bylaws (traditionally the province of the board), shareholders are clearly given the power and authority to amend the bylaws

12. Provide a high quorum for shareholder action.

The articles may contain provisions increasing the quorum to any extent desired up to and including unanimity or decreasing the quorum to zero.[112] High quorum provisions give minority shareholders an opportunity to veto corporate action by failing to attend a shareholders' meeting.[113] Furthermore, if a separate provision is included in the articles reversing the presumptive rule under the Model Act, a shareholder may leave a meeting, break the quorum, and prevent further action.[114] A high quorum requirement can be dangerous, however, because a shareholder may be under a duty, at least in some instances, to attend shareholders meetings or waive his right to challenge a quorum.[115]

13. Provide that shareholders may take action only by the vote of a high percentage of the outstanding shares or by unanimous action.

The Model Act provides that the shareholders may act if the votes *cast* favoring the proposition exceed the votes *cast* opposing it.[116] Thus, abstentions are not counted at all, while at common law they were deemed negative votes. The effect of this provision is to allow holders of a very small number of votes to take shareholder action. If a unanimous vote is not required, the percentage of voting power of the outstanding shares required for action must be high enough to provide the minority shareholder or shareholders with veto power.[117] Although the veto power over all items requiring shareholder action is more appropriate than similar power at the board level, the scope of the veto may be limited so long as certain critical actions are included.[118]

Whenever a high vote requirement is included in the articles, the

to the exclusion of the board. *Id.* at § 10.20(b). It is incongruous that the shareholders' power with respect to their investment contract, the articles of incorporation, is not similarly in their hands.

112. MODEL ACT, *supra* note 3, at §§ 7.25, 7.27.

113. Any veto power increases the likelihood of deadlock. Arbitration or other dispute resolution devices should be considered in these circumstances. *See infra* notes 207-08 and accompanying text.

114. *See* MODEL ACT, *supra* note 3, at § 7.25(b). The rule is exactly the opposite for the board of directors—a quorum must exist at all times before valid action may be taken. *Id.* at § 8.24(c).

115. *Compare* Gearing v. Kelly, 11 N.Y.2d 201, 182 N.E.2d 391 (1962) *with* Hall v. Hall, 506 S.W.2d 42 (Mo. App. 1974).

116. MODEL ACT, *supra* note 3, at § 7.25(c).

117. *See supra* note 113.

118. One commentator lists more than a dozen matters which may be subject to veto power depending on the circumstances affecting the corporation and its shareholders:

shareholder holding the veto power must be able to prevent the issuance of more shares of voting stock.[119] Furthermore, while the Model Act authorizes the shareholders, by express provisions in the articles of incorporation, to provide that greater quorum or voting requirements for shareholder action may be specified *in the bylaws*,[120] this option should not be exercised in the close corporation.[121] As an alternative to a high vote requirement, the articles may provide for classified shares with class voting rights with respect to specified transactions. If the corporation has a classified board and classified shares, this alternative is quite appropriate. The transactions which are likely candidates for a class vote are the same as those for a high vote requirement.[122]

14. Expand dissenters' rights to cover all transactions subject to high vote or class vote requirements.

The Model Act provides that a shareholder is entitled to dissent from and obtain payment of the fair value of his shares upon the occurrence of certain fundamental changes in the corporation or the shareholders' in-

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(a) Major organic changes, including an increase in the authorized number of shares, reductions or capital, recapitalizations, reclassifications, mergers, consolidations, or sales of assets;
(b) Issuance of additional shares or sales of treasury shares;
(c) Corporate repurchase of outstanding shares;
(d) Creation of new corporate indebtedness;
(e) Reduction in amount of dividends paid on common stock;
(f) Reduction in salaries of officers or major employees;
(g) Involuntary termination of employment officers or major employees;
(h) Reduction in the number of directors constituting the board;
(i) Classification of directors, staggering the terms of directors;
(j) Amendment of the articles of incorporation or by-laws (particularly amendments which purport to delete high quorum or voting requirements);
(k) Authorization of contracts with corporations, partnerships or other entities in which any shareholder has a substantial interest;
(l) Dissolution of the corporation;
(m) Filing or consent to a petition in bankruptcy, reorganization or compromise with creditors.

W. PAINTER, *supra* note 78, at 41-42.

119. Veto power is not a pure blessing for the shareholder who holds it because it may cause that shareholder to be "in control" of the corporation for purposes of judicial intervention. MODEL ACT, *supra* note 3, at § 14.30(2)(ii). *See* Smith v. Atlantic Properties, Inc., 12 Mass. App. 201, 422 N.E.2d 798 (1981).

120. MODEL ACT, *supra* note 3, at § 10.21(a).

121. *See infra* note 125.

122. *See supra* note 18. Several sections of the Model Act either provide for class voting or authorize its provision. *See* MODEL ACT, *supra* note 3, at §§ 10.04(a), 11.03(f), 12.02(e), 14.02(e). A high vote requirement within class voting may be desireable when shares of the class are held by several persons. *See supra* note 100 and accompanying text.

vestment contract.[123] These rights may be extended to other transactions by a provision in the articles, the bylaws, or a board resolution.[124] Voluntary extension of dissenters rights may be used in conjunction with high vote and class vote requirements to encourage a dissatisfied shareholder to recapture his investment and leave the corporation rather than prevent the other shareholders from taking action which they believe is appropriate.

15. Provide that the bylaws of the corporation may only be amended or repealed by action of the shareholders.

Unless the articles provide that power to change the bylaws resides exclusively with the shareholders, the bylaws will be within the province of the board.[125] In a close corporation, the bylaws will often be as important a part of the overall control and financial return allocation as the articles of incorporation. Therefore, the shareholders will want to retain control over them as well.

16. Provide for nonvoting shares, preferred shares, and other classes of shares as appropriate.

The Model Act authorizes the creation of innovative classes of shares without significant limitation.[126] Classes of shares may be used to effectuate desired control arrangements among the shareholders as well as to allocate both current and ultimate financial return among the investors. The shares may vary in voting rights, redemption or conversion rights, rights to corporate distributions, and other respects.[127] Minority shareholders will want to prevent the creation of callable common shares unless the call is pursuant to a properly priced buy-sell agreement between the shareholder and the corporation.[128] Furthermore, the articles should provide that the corporation may not take any action which would result in the creation of fractional shares.[129]

Stock clauses may, for example, provide for: (1) two classes of shares

123. MODEL ACT, *supra* note 3, at § 13.02(a)(5).

124. *Id.*

125. *Id.* at § 10.20(a).

126. *Id.* at § 6.01.

127. The Official Comment to § 6.01 gives several examples of classification schemes which may be used. MODEL ACT ANNOT., *supra* note 2, at 312.

128. *See infra* note 162.

129. This eliminates the possibility that a reverse stock split might be used as a device to eliminate the minority shareholders. *Compare* Teschner v. Chicago Title and Trust Co., 59 Ill. 2d 452,

with equal voting rights but different dividend and liquidation rights; (2) two classes of shares, one voting and one nonvoting; (3) two classes of shares with class voting for directors; (4) class voting with classified directors and classified officers; (5) class voting with a classified board where one class is held by a financially disinterested party whose function is to break deadlocks among the shareholders or the other classes;[130] (6) two classes of shares, one with voting rights and one with preferred rights to cumulative or mandatory dividends; (7) classes of shares with class voting rights for specified shareholder action.

17. Provide that shares may be issued only upon authorization of the shareholders.

The Model Act authorizes the board of directors to issue shares for any consideration, including various promises to pay or perform services in the future, subject to the limitation that the consideration be "adequate."[131] The Model Act does not require that the board determine the value of consideration and, therefore, the shareholders are relegated solely to the board's judgment that the sale is "an appropriate transaction" for protection from unfair dilution of their financial interests or voting power.[132] Because the issuance of additional shares may undermine cumulative voting rights or even class voting rights, the shareholders should determine the circumstances under which additional shares may be issued. For example, the issuance of additional shares of a class holding valuable rights is an appropriate occasion for a class vote by those shareholders.

In conjunction with reserving the right to issue shares to the shareholders, the articles should not authorize the board of directors to issue "blank" shares. "Blank" shares are authorized shares which do not have their terms specified in the articles of incorporation so that the board may, at its discretion, endow those shares with voting rights, distribution rights, and other attributes which may derogate the rights of existing shareholders.[133] Additionally the articles should normally contain a prohibition on the reissuance of acquired shares and a requirement that

322 N.E. 2d 54 (1974) *with* Clark v. Pattern, Analysis and Recognition Corp., 87 Misc. 2d 385, 384 N.Y.S. 2d 660 (1976).

130. Lehrman v. Cohen, 43 Del. Ch. 222, 222 A.2d 800 (1966).

131. MODEL ACT, *supra* note 3, at § 6.21(b) & (c).

132. MODEL ACT ANNOT., *supra* note 2, at 358-59 Official Comment to § 6.21.

133. MODEL ACT, *supra* note 3, at § 6.02.

those shares be cancelled.[134] These provisions are especially important if power to issue shares is left in the hands of the board of directors. The shareholders should also ensure that the articles prohibit the issuance of shares of one class as a dividend to shareholders of another class.[135]

18. Provide that the shareholders have preemptive rights and that shares may be issued only for cash.

The Model Act takes the opt-in approach to preemptive rights.[136] If pre-emptive rights are elected, unless the articles provide otherwise, the Act provides standard terms for the rights which do not favor the interests of minority shareholders.[137] The articles should therefore provide that shares may not be issued other than for cash. Alternatively, the articles could extend preemptive rights to every corporate issue or sale of shares for any form of consideration and for any purpose.[138]

Preemptive rights alone do not provide a minority shareholder with security against dilution of his interest. The shareholder must also be able and willing to make a further investment in the corporation in order to protect his position.[139] Some protection is provided to minority shareholders if the offering price is designed to unfairly dilute the equity of a nonpurchaser.[140] Preemptive rights do not provide the same degree of protection to the minority shareholders' proportionate interest in control and financial return that an outright ban on the issuance of shares provides. If an outright ban on the issuance of shares without the approval of a high percentage of shareholders (sufficient to protect the minority shareholder in question) is provided in the articles, preemptive rights should not also be provided because the two mechanisms are inconsistent.

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134. *Id.* at § 6.31(a).

135. *See id.* at § 6.23(b).

136. *Id.* at § 6.30(a).

137. *Id.* at § 6.30(b)(3). The standard model for preemptive rights contained in the statute provides a one year "window"during which the corporation may sell shares free of unexercised preemptive rights. *Id.* at § 6.30(b)(6) (the sale must be made for consideration which is not lower than the offer to shareholders). The one year period will often be too long and it should be shortened by an appropriate provision in the articles.

138. It may be necessary to authorize stock options and other devices to attract certain employees. If so, care must be taken to ensure that control arrangements are not undermined by these transactions. Thus, the shareholders should retain, at least, power to approve any stock option plan.

139. *See generally* Johnson, *Freezing Out Minority Shareholders Through the Issuance of Additional Shares*, 2 MEMPHIS ST. U.L. REV. 375 (1972).

140. *See* Katzowitz v. Sidler, 24 N.Y.2d 512, 249 N.E.2d 359 (1969).

19. Restrict the circumstances in which the board may declare dividends or make other distributions to shareholder.

The Model Act's only limitation on the board's discretion to make distributions to shareholders is that the corporation, after making the distribution, must be able to pay its debts as they become due in the ordinary course of business.[141] This standard allows the board of directors to make estimates of future cash flow and expenditures in determining whether the corporation can continue to pay its obligations. The result is the compounding of business judgment upon business judgment with respect to forecasts of future events so that the statutory limitation is, in practice, no limit at all. The minority shareholders will need to consult carefully with their accountant in order to construct appropriate limitations on the declaration of dividends and the making of other shareholder distributions.

20. Provide that the corporation may not mortgage, pledge, or otherwise encumber any or all of its property otherwise than in the usual and regular course of business without shareholder approval.

The Model Act allows the corporation to mortgage or pledge the corporation's assets outside of the ordinary course of business without limitation.[142] Transactions outside the ordinary course of business are so extraordinary in nature that a requirement of shareholder approval is appropriate to protect the interests of minority shareholders. Otherwise, illegitimate distributions to controlling parties are possible through the medium of a pledge foreclosure by an accommodating outside creditor.

21. Prohibit reduction of directors' standard of care.

The Model Act standard of care for directors follows the traditional pattern in requiring that a director discharge his duties in good faith, with the care an ordinarily prudent person in a like position would exercise under similar circumstances, and in a manner he reasonably believes to be in the best interests of the corporation.[143] This is not an onerous burden and directors should not be allowed to demand provisions in the

141. MODEL ACT, *supra* note 3, at § 6.40(c)(1).
142. *Id.* at § 12.01(a)(1).
143. *Id.* at § 8.30(a).

articles which exculpate them for failure to live up to this standard.[144]

22. Provide that all corporate indemnification is voluntary and all claims for indemnification receive shareholder approval.

The indemnification provisions of the Model Act are extremely broad. Directors and officers are entitled to mandatory indemnification while other employees and agents of the corporation may be indemnified at the board's discretion.[145] An unsuccessful defendant may even petition the court for indemnification on the basis that he is fairly and reasonably entitled to it notwithstanding the finding of liability in the original action.[146] Furthermore, the corporation is authorized to purchase insurance that would provide indemnification in circumstances in which the corporation itself would not have the necessary power.[147] Thus, those in control of the corporation have a substantial opportunity to favor themselves at the expense of the other owners of the business. The articles should, therefore, provide that only disinterested shareholders can approve claims for voluntary indemnification.

23. Provide expanded grounds for dissolution of the corporation based on unfair prejudice to the non-controlling shareholders.

The Model Act continues the traditional grounds for involuntary dissolution based upon the "oppressive" conduct of those in control of the corporation.[148] The articles of incorporation should include a broader provision providing that the corporation shall be voluntarily dissolved upon a court's or arbitrator's finding that the directors or those in control of the corporation have acted in a manner unfairly prejudicial toward one or more shareholders in their capacities as shareholders, directors, officers, or employees.[149] Because voluntary dissolution is within the control of the shareholders,[150] a provision in the articles calling for dissolution on the occurrence of a specified event should be valid.

144. *See, e.g.,* DEL. CORP. CODE tit. 8, § 102(b)(7)(1986); IND. CODE ANN. § 23-1-35-1(e)(2) (1985) (willful misconduct or recklessness).

145. MODEL ACT, *supra* note 3, at §§ 8.52-.56.

146. *Id.* at § 8.54.

147. *Id.* at § 8.57.

148. *Id.* at § 14.30(2)(ii).

149. *See* MINN. STAT. § 302A.751 subd. 1(b)(2) (1984). *See generally* Olson, *A Statutory Elixir, supra* note 4, at 638-42.

150. MODEL ACT, *supra* note 3, at § 14.02.

In an alternative, a provision could be inserted in the articles defining the term "oppressive" as encompassing unfairly prejudicial conduct which injures a shareholder in any capacity relating to the corporation. The Model Act contains no definition of the term "oppressive" and the suggested definition is not a significant departure from many of the cases interpreting statutes based on the Model Act.[151]

24. Provide that any shareholder may demand voluntary dissolution of the corporation at will.

This provision is valid under the Close Corporation Supplement.[152] Its validity under the Model Act, however, is an open question.[153] Because voluntary dissolution is within the province of the shareholders, they should be able to agree in advance that the election of any shareholder will trigger dissolution. Certainly, a provision in a shareholder voting agreement requiring all shareholders to vote in favor of dissolution if any shareholder desires to dissolve the corporation would be valid.[154] An advance agreement contained in the articles would seem to stand on the same footing. If dissolution at will is provided, it may be appropriate to grant the other shareholders of the corporation an option to buy-out the petitioner at a fair price.[155]

25. Provide that the purposes of the corporation are limited to a specific line of business.

The corporation has general business purposes unless otherwise provided in the articles.[156] A limitation on the purposes of the corporation will have limited effectiveness because of the narrow scope of the *ultra vires* doctrine under the Model Act.[157] Such a provision will, nevertheless, have a deterrent effect upon the controlling shareholders. Furthermore, the articles may provide remedies for a substantial breach of the purpose limitation, such as dissolution of the corporation or a provision for the extension of dissenter's rights to the non-controlling shareholders.

151. *See* Comment, *Involuntary Dissolution of Close Corporation for Mistreatment of Minority Shareholders*, 60 WASH. U.L.Q. 1119 (1982).

152. CLOSE CORP. SUPP., *supra* note 8, at § 15.

153. The Official Comments to § 31 (termination of statutory close corporation status) indicate that an option to dissolve may not be valid under the Model Act. MODEL ACT SUPP. 1847.

154. *See infra* notes 243-49 and accompanying text.

155. *See, e.g.*, N.Y. BUS. CORP. ACT. § 1118; *infra* note 162.

156. MODEL ACT, *supra* note 3, at § 3.01(a).

157. *Id.* at § 3.04.

B. Planning Opportunities Using the Bylaws

The Model Act requires that every corporation have bylaws.[158] Those bylaws may contain any provision for "managing the business and regulating the affairs of the corporation" which is consistent with the articles or law.[159] The primary guideline for choosing whether special provisions will be placed in the articles or the bylaws is whether public notice of the provision is significant or whether the provision deals merely with internal governance of the corporation. The Official Comment to section 2.02 of the Model Act contains a list of optional provisions which are valid if contained in the bylaws.[160] That list may be used as a road map when considering the planning options open to a minority shareholder. Those sections of the statute, both presumptive and minimal, that have not been modified in the articles are candidates for change in the bylaws. Suggested provisions for inclusion in the bylaws are discussed below.

1. Provide for share transfer restrictions.

Share transfer restrictions are a mixed blessing. They do keep outsiders from joining the shareholder group,[161] but unless the shareholders include a buy-sell agreement,[162] share transfer restrictions also severely restrict the marketability of the stock in the corporation. If combined with a buy-sell agreement, however, the total package may eliminate a major source of dissension among shareholders. The Model Act provides broad authority for share transfer restrictions serving any reasonable purpose.[163] The Act requires that the existence of the restriction be conspicuously noted on the share certificate.[164] The Act specifically au-

158. *Id.* § 2.06(a). Not every statute requires bylaws. *See* MINN. STAT. § 302A.181 (1984); CLOSE CORP. SUPP., *supra* note 8, at § 12.

159. MODEL ACT, *supra* note 3, at § 2.06(b).

160. MODEL ACT ANNOT., *supra* note 2, at §§ 110-111. The list is not exclusive. *See supra* note 60.

161. This use for transfer restrictions is over-emphasized. The position of minority shareholders, absent planning such as that discussed in this article, is so weak that minority shares are, as a practical matter, unsaleable.

162. A buy-sell agreement commits the shareholder or his estate to sell and the corporation or surviving shareholders to buy stock in the corporation at a price fixed or determined under the agreement. *See generally* Kahn, *Mandatory Buy-out Agreements for Stock of Closely Held Corporations*, 68 MICH. L. REV. 1 (1969); Lynch, *New Look at Buy-Sell Agreements*, 30 S. CAL. TAX INST. 775 (1978).

163. MODEL ACT, *supra* note 3, at § 6.27(c).

164. *Id.* at § 6.27(b). *See id.* at § 1.40(3) (defining conspicuous).

thorizes four types of restrictions which are in common use.[165] These restrictions should meet the needs of most close corporations. Careful drafting of a stock transfer restriction requires consideration of the following:

(a) whether the restriction applies to transfers between parties to the restriction,
(b) whether pledges and forms of disposition which do not constitue "sales or transfers" are covered,
(c) whether certain sales are exempt from the restriction, such as inter-family gifts and bequests,
(d) whether the restriction, if a right of first refusal or an option to purchase, requires that all shares held by the offeror be included or that all shares which are offfered be taken up as a block by the holder(s) of purchase rights (pro rata or otherwise),
(e) whether the shareholder or executor holding the shares in question may vote (as director or shareholder) with respect to a corporate purchase,
(f) whether installment payments are authorized and security required.[166]

2. *Provide that all meetings of the board of directors require notice to directors which specifies the purpose of the meeting and precludes action beyond those purposes.*

Many of the devices discussed in the previous section on planning opportunities using the articles attempt to ensure minority shareholder input at the board level. In order that the minority shareholder may make rational determinations about his attendance at directors' meetings, the bylaws should require regular directors' meetings, with notice to each director of the meeting, stating the purposes for which the meeting is to be held. The bylaws should further limit the board to taking action only on matters specified in the notice except, of course, in a bona fide emer-

165. MODEL ACT § 6.27(d) provides as follows:

(d) A restriction on the transfer or registration of transfer of shares may:
(1) obligate the shareholder first to offer the corporation or other persons (separately, consecutively, or simultaneously) an opportunity to acquire the restricted shares;
(2) obligate the corporation or other persons (separately, consecutively, or simultaneously) to acquire the restricted shares;
(3) require the corporation, the holders of any class of its shares, or another person to approve the transfer of the restricted shares, if the requirement is not manifestly unreasonable;
(4) prohibit the transfer of the restricted shares to designated persons or classes of persons, if the prohibition is not manifestly unreasonable.

166. *See generally* Gregory, *Stock Transfer Restrictions in Close Corporations*, 1978 S. ILL. U.L.J. 477.

gency.[167] This provision is especially important if the minority director is not regularly employed by the corporation at its principal place of business.

3. *Provide for high quorum and high vote requirements at the board level.*

High quorum requirements are more significant at the board level because that is where substantial discussion will take place concerning the operations and management of the business. The quorum is normally a majority of the fixed number of directorships. However, it can be raised to unanimity if desired,[168] or reduced to as low as one-third.[169] Minority shareholders seeking an effective voice at the director level should never agree to a lower quorum.[170] If for some reason the shareholders have not reserved the exclusive power to make the bylaws, they should provide in any bylaw fixing the vote or quorum for board action that such bylaw can be amended or repealed only by shareholder action.[171] High vote requirements are also authorized, including a requirement for unanimity.

Whenever a high vote requirement for board action is part of corporate planning, appropriate provisions must be placed in the articles to ensure that the size of the board of directors is not increased thus impairing the veto power granted to the minority director. Furthermore, if the bylaws require a high vote for director action, the bylaws should not authorize the board to act by written action concurred in by less than all directors.[172] In addition, if the shareholders feel that face to face director confrontation is an essential part of the management plan, the bylaws may deny the board authority to conduct its meetings by conference call.[173] The impracticalities of such a requirement, however, may weigh heavily against its use.

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167. *See* MODEL ACT, *supra* note 3, at § 8.22.

168. *Id.* at § 8.24(a).

169. *Id.* at § 8.24(b).

170. *Id.* at § 8.24(c). A unanimity requirement at the board level may be particularly attractive to minority shareholders as it will provide, in effect, for management by consensus. *See supra* note 113.

171. *See* MODEL ACT, *supra* note 3, at § 10.22(b).

172. *Id.* at § 8.21(a) allowed the articles or bylaws to provide for other than unanimous written consent. *See* MINN. STAT. § 302A.239 (1984) (authorizing the articles to provide for written action by mere majority vote).

173. *See* MODEL ACT, *supra* note 3, at § 8.20.

4. Deny the board authority to create special litigation committees or executive committees or enter into management contracts.

Unless limited, the board of directors may create committees having some or all of the authority of the board with respect to any or all action which the board of directors might take.[174] Defendant directors have designed special litigation committees to terminate derivative actions brought against them on behalf of the corporation. Such committees almost always favor management and recommend that any derivative action be dismissed as not in the best interest of the corporation.[175] No legitimate need for such committee exists in the close corporation context.[176]

Unless the minority shareholder is assured of a position on the executive committee with the same veto power that he has on the board of directors, the appointment of an executive committee with full powers of the board can defeat the carefully planned mechanisms which protect the interests of the minority shareholder. Furthermore, the board of a close corporation is usually small enough that there is no business necessity for acting through any group smaller than the full board.

Management contracts are agreements through which the board of directors delegates substantially all management power to another person or company.[177] Unless the minority shareholder is the delegate, such contracts should be prohibited so that board level control devices can operate effectively.

5. Restrict the board's ability to fix the compensation of directors and officers.

The Model Act authorizes the board to fix the compensation of directors[178] and the compensation of officers.[179] Through the innovative use of compensation techniques such as incentive stock options, directors can

174. *Id.* at § 8.25(a). The creation of a committee must be approved by a high vote if that is generally required for director action. *See id.* at § 8.25(b)(2).

175. *See* Cox & Musinger, *Bias in the Boardroom: Psychological Foundations and Legal Implications of Corporate Cohesion,* 48 LAW & CONTEMP. PROBS. 83 (1985).

176. *See generally* Comment (e) to § 7.01(d) of the ALI PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATION COUNSEL DRAFT 5 (1984), which provides special rules for characterizing a derivative suit as a personal action by the shareholder when a closely-held corporation is involved.

177. Pohn v. Diversified Indus., Inc., 403 F. Supp. 413 (N.D. Ill. 1975).

178. MODEL ACT, *supra* note 3, at § 8.11.

179. *Id.* at § 8.40(a).

alter the balance of power in the corporation.[180] Shareholders should always retain control over payment of compensation in forms other than cash. If all of the shareholders are employees of the corporation, the bylaws may deny compensation for the performance of directorial duties and provide that officers' compensation will be equal or in fixed proportions.

6. Restrict the board's authority to have the corporation make loans or incur obligations with regard to matters outside the usual and regular course of business.

The bylaws may absolutely deny the board authority to engage in these transactions or the bylaws may only authorize transactions below a set dollar amount. Transactions within the prohibition may be authorized by a high vote of the board of directors if that device will give the minority shareholder veto power. In the alternative, the bylaws may require shareholder approval for these extraordinary transactions. Similar restrictions should be placed on the board's authority to have the corporation mortgage or pledge its assets in transactions not in the usual and regular course of the corporation's business.[181]

7. Prescribe qualifications for directors.

The authority[182] to prescribe qualifications for directors is exercised very infrequently. In a close corporation, the bylaws could require that directors be shareholders or, if the enterprise is a family business, that they be members of the family. If the corporation intends to act as a contractor for the United States Department of Defense, directors may be required to be U.S. citizens, hold appropriate security clearances, or meet other special requirements.[183]

8. Require that the corporation have certain officers and that particular officers be holders of a specified class of shares.

Such a requirement allows minority shareholders to have control over

180. If expanded preemptive rights have been granted to the shareholders, this method of diluting minority shareholder interest will not work. *See supra* notes 136-90 and accompanying text.

181. *See* MODEL ACT, *supra* note 3, at § 12.01(a)(2).

182. *Id.* at § 8.02.

183. *See* Finkelstein, *Stock Transfer Restrictions on Alien Ownership under Section 202 of the Delaware General Corporation Law*, 38 BUS. LAW. 573 (1983).

certain aspects of the corporation's operations.[184] It operates in a manner similar to classified directorships provided in the articles.

9. Define the officers' powers and duties, terms of office, circumstances of removal, and limit the authority to delegate power.

If the bylaws fix the authority and duties of certain corporate officers and the minority shareholder is assured of holding a particular office, the shareholder may acquire substantial control over day-to-day operations.[185] The bylaws should, of course, further protect the shareholder from removal by the directors without cause.[186] Additional limitations may be provided in the bylaws, such as: requiring several corporate officers, including the shareholder who wants veto power, to execute checks, notes and substantial contracts; or limiting the authority of corporate officers with respect to usual and regular course of business transactions by providing low dollar limitations unless another officer (the shareholder) or the board (if a high vote is required for action) approves the transactions.[187] The bylaws can also require special approval before the corporation can employ "highly compensated" persons.[188]

10. Provide that any shareholder may call a special meeting of the shareholders.

If significant power has been lodged in the shareholders, any shareholder should be able to call the shareholders together to consider whether action should be taken.[189] In the absence of such a provision, a shareholder or shareholders will need to hold 10 percent of the voting power in order to demand a meeting.[190] The bylaws should further pro-

184. MODEL ACT, *supra* note 3, at § 8.40(a).

185. *Id.* at § 8.41.

186. *Id.* at § 8.43. In the alternative, the officer may be given contract rights to employment for a specified term. Such contract rights will not prevent removal from office, however, the former officers will be entitled to damages for breach of contract. *See id.* at § 8.44. A fair price buy-out of the former officer's shares is appropriate. *See supra* note 162.

187. *See* O'Neal, *Close Corporation Control Agreements,* BENCH AND BAR OF MINN. 19, 23 (Sept. 1973).

188. It will be necessary to define "highly compensated" in the bylaws. The definition could, for example, refer to a specific dollar amount or determine highly compensated status by reference to the salaries of current personnel (average salary of vice presidents or some similar formula).

189. *See* MODEL ACT, *supra* note 3, at § 7.02(a)(1). *See also supra* note 11, (granting shareholders power to propose matters for shareholder vote).

190. *Id.* at § 7.02(a)(2).

vide that if the meeting is adjourned a new notice must be sent to all shareholders before another meeting can be held, unless all the shareholders were present at the adjourned meeting.[191] An adjourned meeting is an unusual occurrence and a shareholder who may have been willing to miss the original meeting may well desire to attend any continuation of that shareholders meeting. The usual rule for shareholder meetings is that shareholders may leave the meeting, thus destroying the presence of a quorum and preventing further action.[192] The Model Act's rule for directors is the opposite[193] and consideration should be given to specifying a rule in the bylaws governing the corporation's shareholders meetings.

11. Require shareholder approval for loans to directors, transactions involving director conflict of interest, and claims for indemnification.

These transactions should be subject to shareholder approval because they are likely to be of questionable benefit to the corporation, and the director's judgment is likely to be clouded. Such transactions are isolated events of an extraordinary nature with respect to which a requirement of shareholder approval will not cause inconvenience. Only disinterested shareholders should be counted for a quorum or allowed to vote with regard to these transactions.[194] Counsel may wish to consider whether the Model Act's definition of a conflict of interest transaction[195] is sufficiently broad with respect to the activities of the corporation in question. Furthermore, extension of these restrictions to transactions involving non-director officers of the corporation will often be appropriate.

12. Expand dissenter's rights to cover all shares whether or not entitled to vote and include more corporate activities.

Even when major changes in the fundamental structure of the corporation are undertaken, the Model Act restricts dissenter's rights to shareholders who are entitled to vote on the matter.[196] If the shareholders investment takes the form of a minority holding of voting shares com-

191. *See id.* at § 7.05(e).
192. Levisa Oil Corp. v. Quigley, 217 Va. 898, 234 S.E.2d 257 (1977).
193. *See* MODEL ACT, *supra* note 3, at § 8.24.
194. *See id.* at §§ 8.31, 8.32, 8.55.
195. *Id.* at § 8.31.
196. *Id.* at § 13.02(a).

bined with nonvoting preferred shares, a fundamental change may substantially impair the shareholder's investment, unless he is entitled to dissent and receive fair value for *all* of his shares. The Model Act further restricts dissenters' rights to instances where an amendment to the articles "materially and adversely" affects certain rights of that shareholder.[197] The bylaws, however, may extend dissenters' rights to all shareholders and to any corporate action, provided a shareholder vote is required for approval of that action.[198]

13. Provide that all shareholders have an absolute right to examine the corporation's books and records at any time and to receive free copies of those records.

The Model Act places substantial limitations on the ability of shareholders to inspect and copy corporate records.[199] In nonpublic corporations, shareholder access to information about the corporation depends on the shareholder's right of inspection. Few legitimate reasons exist for limiting shareholder access to books and records in the close corporation context. Shareholders will have significant investment in the business, substantial interest in its management and control, and powers which are best exercised in the light of full and complete information. It may be desireable to put limited practical restrictions on access, such as, examination during normal business hours and a cost-based fee after some free copying allowance has been used. While providing an absolute right of access, the bylaws may restrict the shareholder's ability to use that information in a manner which is likely to injure the corporation.[200]

The bylaws may also specify the type of financial information which the corporation is required to provide to its shareholders.[201] The Model Act does not require the corporation to keep its financial records in accordance with generally accepted accounting practices. Only "appropriate" records are required.[202] Venture capitalists and other astute investors always insist on proper accounting records and minority shareholders should do the same.

197. *Id.* at § 13.02(a)(4).

198. *Id.* at § 13.02(a)(5). *See supra* notes 123-24 and accompanying text. There is no apparent reason for the Model Act's restriction on the voluntary extension of dissenter's rights to corporate actions only when taken pursuant to a shareholder vote.

199. *See* MODEL ACT, *supra* note 3, at § 16.02.

200. *See, e.g.*, MINN. STAT. § 302A.461 subds. 4a and 4b (1985).

201. *See* MODEL ACT, *supra* note 3, at § 16.01(b).

202. *Id.* at § 16.01(b).

14. Define significant terms such as "substantially all" and "oppressive" as they apply to this corporation.

Many key terms used in the Model Act are not defined. These terms may be defined in the articles[203] or in the bylaws.

15. Provide a procedure for exercising cumulative voting rights.

Unless the bylaws provide a different procedure, the board of directors can prevent a shareholder from exercising cumulative voting rights by failing to conspicuously state in the meeting notice that cumulative voting is authorized.[204] In addition, if no shareholder gives forty-eight hours notice of his intention to vote cumulatively, the shareholders cannot do so.[205] If cumulative voting is the chosen device for ensuring a shareholder's voice at the board of director level, steps must be taken to guarantee that the shareholder can vote effectively.[206]

16. Provide for arbitration or other nonjudicial dispute resolution.

No dispute, other than certain divorce actions, brings out the strong emotions that occur in a fullblown dispute among participants in a close corporation. The shareholders will frequently want to avoid the publicity of a public trial and secure the expertise of chosen arbitrators, to reap the benefits of speed and reduced cost available in arbitration. Arbitration may be elected in the bylaws by including a simple one paragraph statement provided by the American Arbitration Association.[207] Alternatively, counsel may choose a more detailed arbitration provision designed to ensure that arbitrators will deal effectively with all matters involving the corporation and its shareholders.[208]

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203. *See supra* note 151.

204. MODEL ACT, *supra* note 3, at § 7.28(d)(1).

205. *Id.* at § 7.28(d)(2).

206. *See* MINN. STAT. § 302A.215 subd. 1 (1984) (requires no statement regarding cumulative voting in the notice and allowing a shareholder to cumulate votes so long as notice is given to any officer of the corporation before the meeting or to the presiding officer at the meeting at any time before the election).

207. The American Arbitration Association's standard arbitration clause provides:

> Any controversy or claim arising out of or relating to this contract, or the breach thereof, shall be settled by arbitration in accordance with the Commercial Arbitration Rules of the American Arbitration Association, and judgment upon the award rendered by the Arbitrator(s) may be entered in any Court having jurisdiction thereof.

COMMERCIAL ARBITRATION RULES 2 (1982).

208. OLSON & SPENCER, SHAREHOLDER PLANNING 204-05 (Minnesota CLE 1984).

IV. PLANNING OPPORTUNITIES USING SHAREHOLDERS' AGREEMENTS

Shareholder[209] agreements[210] in the close corporation context may be divided into two types: the shareholder voting agreement and the shareholder control agreement.[211] The shareholder voting agreement operates only at the shareholder level through the traditional shareholder prerogative of voting for directors and upon fundamental changes to the corporate structure. Shareholder control agreements, on the other hand, operate at the board of directors or corporation level by directly affecting the management of the business and affairs of the corporation. The distinction between the two types of agreements is not always clear in the case law[212] nor in corporation statutes.[213]

The Official Comment to the 1969 Model Act's version of what is now section 7.31 described a voting agreement as one which is "devised primarily as a means of effecting a specific allocation of representation on the Board of Directors."[214] The Official Comment to section 7.31 states that mere voting agreements are "universally upheld" while "more recent cases have relaxed the strict rule that all shareholder agreements

209. The holder of a convertible debenture may be considered an "inchoate shareholder" for purposes of validating, as a shareholder' agreement, a debenture indenture which contains a survival clause. Westland Capital Corp. v. Lucht Eng'g., Inc., 308 N.W.2d 709 (Minn. 1981). The Minnesota Act was amended in 1982 to exclude agreements including, as parties, persons who are not at the time they enter the agreement actual "shareholders" by adding the word "solely"to the shareholder agreement provisions. MINN. STAT. §§ 302A.455; 302A.457, subds. 1 and 2 (1984). Thus a debenture holder, such as those in *Westland Capital*, will not be able to claim the security of the safe harbor provided in the act. This is a trap for the unwary, however, because any debenture holder with sufficient bargaining power to cause the corporation to enter into a restrictive debtenture agreement containing a survival clause will have sufficient power to demand one share of stock (nonvoting and callable if no conversion occurs) in addition to the debenture. Furthermore, *Westland Capital* continues as good law because the statutory safe harbors are nonexclusive. *See* MINN. STAT. § 302A.457 subd. 4 (1984). The Model Act, sensibly, does not attempt to alter the bargaining power between the corporation and investors in this fashion.

210. While the agreement should always be in a signed writing, oral agreements are enforceable. Wasserman v. Rosengarden, 405 N.E.2d 131 (Ill. App. 1980).

211. The Minnesota Business Corporation Act is the only statute to explicitly distinguish between these two types of agreements. If the agreement is operative only at the shareholder level, the agreement need not be unanimous and it is called a "shareholder voting agreement". MINN. STAT. § 302A.455 (1984). An agreement which is operative on any other level in the corporate structure, usually the board of directors level, must be unanimous, filed with the corporation, and noted on the share certificates and is referred to as a "shareholder control agreement." *Id.* at § 302A.457.

212. *See, e.g.*, Hart v. Bell, 222 Minn. 69, 23 N.W.2d 375 (1946).

213. *Compare* MODEL ACT, *supra* note 3, at § 7.31 *with* CLOSE CORP. SUPP., *supra* note 8, at § 20.

214. MODEL ACT ANNOT., *supra* note 2, at 732.

restricting the discretion of directors are invalid."[215] The case law validates agreements that one or more shareholders enter into which name the persons who will be the corporation's directors.[216] In addition, the courts validate agreements among all or almost all shareholders which name the persons who will be the corporation's officers, specify the salaries to be paid to those officers, or specify a policy governing distributions to shareholders.[217]

A. Shareholder Voting Agreements

The Model Act provides specific authority for written "voting agreements"[218] in which two or more shareholders specify the manner in which they will vote their shares.[219] The Model Act provision is a "safe harbor" providing nonexclusive statutory validation of shareholder contracts, and does not apply to, limit or restrict agreements otherwise valid under the common law of corporations.[220] The voting agreement can directly affect the parties to it only in their capacity as shareholders. It is a non-unanimous agreement among shareholders which is operative only at the shareholder level through the mechanism of voting shares. Such an agreement, therefore, *is* subject to the "corporate norm" and may not usurp the prerogatives of the board. The agreement may control who is elected to the board, but it cannot control what that person does as a director with respect to his duties owed to all shareholders. The agreement may, however, cover other matters for which shareholder voting is required, such as amendments to the articles or bylaws, or fundamental changes in the corporation.[221]

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215. *Id.* at 713. *See also supra* notes 15-27 and accompanying text. *See generally* Morganstern, *Agreements for Small Corporation Control,* 17 CLEVE.-MAR. L. REV. 324 (1968); Comment, *Shareholder Pooling Agreements,* 24 ARK. L. REV. 501 (1971).

216. *See, e.g.,* Ringling Bros-Barnum and Bailey Combined Shows v. Ringling, 29 Del. Ch. 610, 53 A.2d 441 (1947).

217. *See, e.g.,* Glazer v. Glazer, 374 F.2d 390 (5th Cir.), *cert. denied,* 389 U.S. 831 (1967); Galler v. Galler, 32 Ill.2d 16, 203 N.E.2d 577 (1965); Westland Capital Corp. v. Lucht Eng'g, Inc., 308 N.W.2d 709 (Minn. 1981); Clark v. Dodge, 269 N.Y. 410, 199 N.E. 641 (1936). *See also* Bulloch, *Shareholder Agreements in Closely-Held Corporations Is Sterilization an Issue?,* 59 TEMPLE L.Q. 61, 82 (1986).

218. Voting agreements are often referred to as "pooling agreements" in the literature.

219. MODEL ACT, *supra* note 3, at § 7.31(a). The agreement is binding on those shareholders who have signed it.

220. *See supra* notes 216-17. *Compare* CLOSE CORP. SUPP., *supra* note 8, at § 20(h) *with* MINN. STAT. § 302A.457 subd. 4 (1984).

221. Examples of such changes include mergers, share exchanges, sales of all or substantially all assets, or dissolution of the corporation.

The shareholder voting agreement must be contained in a signed writing. Although the Model Act places no durational limits on shareholder agreements, the writing itself should provide a specific time limit to preclude judicial imposition of a limitation, such as, a reasonable time. A number of alternatives are available for the duration provision. A clause could be inserted which would provide, in the alternative: the agreement continues so long as any two parties, or original parties, own stock in the corporation; the agreement continues so long as the aggregate voting power of the shares the parties, or original parties, own exceeds a specified percentage; or the agreement continues until vote of a specified number of shares or number of parties terminate it. The agreement could also provide that the entire agreement, or certain portions of it, terminate upon the public offering of the corporation's shares.[222] Stock transfer restrictions will be necessary to ensure that the transfer of shares to persons who are not bound by the agreement does not render the agreement ineffective. Because a shareholder voting agreement depends for its effectiveness upon the percentage of outstanding shares held by the parties to it, transfer of shares subject to the agreement must be restricted to transferees who consent to the agreement.[223]

A shareholder voting agreement is not subject to the limitations placed on voting trusts.[224] A voting trust is an alternative mechanism for achieving the results of a shareholder voting agreement.[225] The voting trust is limited to a ten year duration[226] and can be cumbersome to draft and implement.[227] The voting trust, however, has the advantage of being self-effectuating.

A shareholder voting agreement, under the Model Act, may be specifi-

222. Shareholders' agreements in close corporations almost always contain provisions which are not appropriate once the corporation becomes publicly held. The same will often be true of the corporation's articles and bylaws. *See supra* Part III.

223. The issuance of the new share certificate and the transfer of shares on the books of the corporation should be conditioned on delivery to the other parties to the agreement, or the corporate secretary, of a written consent to become a party to the agreement and be bound thereby. An appropriate legend should be placed on each share certificate held by the party to the voting agreement. *See supra* note 90.

224. MODEL ACT, *supra* note 3, at § 7.31(a).

225. *See generally* Woloszyn, *A Practical Guide to Voting Trusts,* 4 U. BALT. L. REV. 245 (1975); Note, *Close Corporations: Voting Trust Legislation and Resolution of Deadlocks,* 67 COLUM. L. REV. 590 (1967).

226. MODEL ACT, *supra* note 3, at § 7.30(b).

227. *See generally* Note, *The Voting Trust: Drafting Suggestions,* 42 N.Y.U.L. REV. 349 (1967).

cally enforced.[228] Specific performance, though, may not always be the most desirable remedy. For example, in the *Ringling Bros.-Barnum and Bailey Combined Shows v. Ringling*,[229] the plaintiff was better off with the court's refusal to count the votes cast in violation of the contract than she would have been had specific performance been decreed.[230] As an alternative to specific performance, the agreement may provide for voiding the votes cast in violation of the agreement. Even so, if a breach cannot be adequately remedied through money damages, injunction or specific performance, an enforcement mechanism should be built into the agreement to ensure the desired result.[231]

The mechanism most commonly used is the irrevocable appointment of a person as the shareholder's proxy to vote the shares in accordance with the agreement. The appointment of a proxy must be contained in a written instrument which is filed with the secretary or other agent of the corporation at or before the shareholder action for which it is to be effective.[232] The appointment is valid for a period of eleven months unless the appointment expressly provides for a longer or shorter period.[233] All appointments are revocable at will in accordance with the consensual nature of the agency relationship.[234] If the proxy is not acting exclusively for the benefit of the shareholder, the nature of the relationship takes on a more complex aspect as it is no longer merely a single-party consensual grant of authority. In such instances, the appointment may be irrevocable.

In order to make an appointment irrevocable, the written instrument must conspicuously state that the appointment is "irrevocable" and the appointment must be "coupled with an interest."[235] The "coupled with an interest" standard for irrevocability is generally defined by case

228. MODEL ACT, *supra* note 3, at § 7.31(b).

229. 29 Del. Ch. 610, 53 A.2d 441 (1947).

230. *See* W. PAINTER, *supra* note 78, at 29-30.

231. The Official Comment to § 7.31 invites the draftsman to provide his own enforcement mechanism in addition to or in lieu of specific performance. MODEL ACT ANNOT., *supra* note 2, at 705.

232. MODEL ACT, *supra* note 3, at § 7.22(b) & (c).

233. The text of the Model Act provides only for specifying a "longer" period. MODEL ACT, *supra* note 3, at § 7.22(c). An appointment which expires by its own terms prior to the passage of 11 months should, nevertheless, be given effect in accordance with that term of the appointment. *See* MODEL ACT ANNOT., *supra* note 2, at 603, Official Comment to § 7.22.

234. MODEL ACT, *supra* note 3, at § 7.22(d).

235. *Id.*

law,[236] although the Model Act specifies five situations in which the appointment is deemed coupled with an interest.[237] In situations which do not fall within those specified in the Model Act, irrevocability may be uncertain.[238]

The shareholder voting agreement provides complete flexibility to achieve the shareholders' goals so long as they can be effectuated by the voting of shares. The parties may agree to vote their shares in accordance with two basic provisions used singly or in conjunction: specific results may be required, or a method of determining how the covered shares will be voted may be provided. Such methods include voting in accordance with the instructions of a third party, voting as the holders of a majority of the covered shares decide, or voting as specified persons direct with respect to specified issues. Flexibility is further provided because the voting agreement may bind the parties for some purposes but not for others. Within the scope of authority accorded shareholder voting agreements, the only limitation is that the agreement cannot be used to defraud, oppress or wrong third parties.[239] A shareholder voting agreement may contain provisions regarding the following matters.

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236. *See* RESTATEMENT (SECOND) OF AGENCY § 138 (1958).

237. Appointments deemed coupled with an interest include the appointment of:

> (1) a pledgee; (2) a person who purchased or agreed to purchase the shares; (3) a creditor of the corporation who extended it credit under terms requiring the appointment; (4) an employee of the corporation whose employment contract requires the appointment; or (5) a party to a voting agreement created under section 7.31.

MODEL ACT, *supra* note 3, at § 7.22(d).

238. Traditionally, the "coupled with an interest" standard is applied very restrictively to include only property interests in the shares the appointment covers. The trend, however, is to sustain the appointment against an attempt to revoke "if it is supported by consideration moving from the proxy holder to the maker, if the proxy holder has changed his position in reliance on the proxy, or if the proxy was given to further or to protect the interests of the proxy holder." F. O'NEAL, *supra* note 6, § 5.36. *Compare* DEL. GEN. CORP. LAW, § 212(c) ("in the shares or in the corporation"); MINN. STAT. § 302A.449 subd. 2 (1984) (same). It is unfortunate that the Model Act continues to base this important determination on an anachronistic analogy to agency law. *See* Calumet Indus., Inc. v. MacClure, 464 F. Supp. 19 (N.D Ill. 1978) (applying a restrictive view of "coupled with an interest" to require that the interest be security for a loan, title to the shares themselves, or an employee's interest with respect to the corporation.). *See generally* Note, *The Irrevocably Proxy and Voting Control of Small Business Corporations,* 98 U. PA. L. REV. 401 (1950); Comment *Irrevocable Proxies,* 43 TEX. L. REV. 733, 738-47 (1965).

239. Wilson v. McClenny, 262 N.C. 121, 128, 136 S.E.2d 569, 575 (1964); Hart v. Bell, 222 Minn. 69, 79, 23 N.W.2d 375, 380-81 (1946); E. FOLK, THE DELAWARE GENERAL CORPORATION LAW; A COMMENTARY AND ANALYSIS 518 (1972).

1. Specified persons will be elected to the board of directors.

The persons specified could include the parties to the agreement or outsiders who can act as the "swing" director should there be disagreement among the shareholder-directors of the corporation. Whenever specific individuals are named for election to the board, provision must be made for selecting successors. If the corporation has not provided a buy-out for the shares of a deceased shareholder, those who succeed to those shares under the shareholder's will should be authorized to name the successor. When predetermined financial goals are not met by the corporation, it may be desirable to provide that a particular shareholder or group of shareholders may specify the persons who shall immediately be elected to the board (by removing the present board if necessary).

2. Incorporate by reference the existing articles and bylaws and provide that no amendments will be adopted except as provided in the agreement.

If the existing articles and bylaws are made a part of the agreement, the parties to the agreement will have contract rights to enforce those provisions. This is especially important as a "backstop" against efforts by those in control of the corporation to evade protections which the non-controlling shareholders have built into the articles or bylaws, such as those suggested earlier in this Article. Any provision which is important to the minority shareholders should be incorporated by reference. The shareholders' agreement should then provide that it can only be amended by mutual agreement or a high vote of the parties to it. In addition, it should provide that no party to the agreement may vote his shares in favor of an amendment to the articles or bylaws unless the parties to the agreement have approved the casting of that vote in the same manner as an amendment to the agreement. Provisions in the statute which are of particular importance to the minority shareholder should, if not already repeated in the articles or bylaws, be placed in the shareholder voting agreement. This will prevent legislative changes to the statute from undercutting the carefully planned "deal" the shareholders have negotiated.[240]

240. *Compare* MINN. STAT. § 301.37 subd. 3(2) (1980) (two-thirds vote required) *with* MINN. STAT. § 302A.135 subd. 4 (1984) (majority vote). On January 1, 1984, all existing Minnesota corporations became governed by chapter 302A and the earlier corporation law, in view of which those corporations were incorporated, was repealed. With one limited exception, shareholders of those corporations *automatically lost* the right to block corporate action by the negative vote of one-third

3. Provide that certain amendments will be made to the articles or bylaws.

When the shareholder voting agreement is negotiated after the corporation has been formed, it will frequently be necessary, as part of the overall "deal", to amend the articles or bylaws to include protective provisions. The shareholder voting agreement, however, is often signed prior to carrying out those changes. In that event, the shareholders should be committed to vote in favor of those changes and they should be set out in full in the agreement.[241] It will also be necessary to cancel the power which the board of directors is given under the Model Act to block shareholder action regarding amendments to the articles and various fundamental changes in the corporate structure.[242]

4. Provide that no votes will be cast with respect to organic changes in the corporate structure, except as provided in the agreement.

The mechanisms provided in the shareholder voting agreement should control shareholder initiation or approval of organic changes to the corporation such as merger, exchange of shares, or sale of all or substantially all assets. Whatever the power the shareholder is given by virtue of the provisions contained in the voting agreement to determine how covered shares will be voted should be brought to bear on these extraordinary matters since they contain strong potential for treating the shareholder contrary to his expectations.

5. Provide that shares will be voted for dissolution of the corporation as provided in the agreement.

The agreement could provide that upon the occurrence of specified events the parties will vote their shares in favor of dissolution.[243] Examples of such events would include modifications of the Model Act's provi-

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of the shareholders. In order to prevent the possibility of this kind of legislative repeal of provisions on which the minority shareholders are depending, those provisions must be included in one of the corporate governance documents drafted for the corporation in question.

241. *See* Beresovski v. Warszawski, 28 N.Y.2d 419, 322 N.Y.S.2d 673, 271 N.E.2d 520 (1971).

242. *See supra* notes 109-11 and accompanying text.

243. MODEL ACT, *supra* note 3, at § 14.02 provides that a majority of shareholders may approve dissolution of the corporation. In order, however, for the shareholders to have this power they must include in the articles a provision cancelling the board's authority to block the shareholder vote. *See supra* note 241.

sions calling for judicial dissolution.[244] The shareholders' voting agreement could provide that all covered shares will be voted in favor of dissolution of the corporation upon a determination (for example, by a court or an arbitrator) that those in control of the corporation have acted, are acting, or will act in a manner that is illegal, oppressive, fraudulent, unfair or prejudicial to any party to the agreement whether in his capacity as shareholder, director, officer, or employee of the corporation.[245] Additionally, the agreement could provide that if the directors are deadlocked in the management of corporate affairs for a period exceeding, for example, three months with respect to any material item, all covered shares will be voted for dissolution.[246] The shareholder voting agreement may also provide that the shares the agreement covers will be voted in favor of dissolution on the nonoccurrence of a specified event, such as, failure to pay dividends equal to a set percentage of net earnings for at least three of the past four years.[247] Alternatively, the covered shares could be voted in favor of dissolution upon the request of a specified percentage of the parties (per capita or by share holdings). The effect of such a provision could be to give a shareholder the option to dissolve the corporation at will without the uncertainty which surrounds a direct grant of that privilege.[248] If a dissolution provision is placed in a shareholder voting agreement, it may be appropriate to give the shareholders who do not favor dissolution an optional right to buy-out at a fair price

244. *See* MODEL ACT, *supra* note 3, at § 14.30(1).

245. *Compare* Close Corp. Supp., *supra* note 8, at § 40(a)(1).

246. This provision does not require further proof that the shareholders are unable to break the deadlock (often unlikely in a close corporation because the shareholders and directors will be the same persons), nor does it require a further showing either that irreparable injury is being threatened to or suffered by the corporation or that the business and affairs of the corporation can no longer be conducted to the advantage of the shareholders generally. *Compare* MODEL ACT, *supra* note 3, at § 14.30(2)(i). Therefore, profitability of the corporation would not be a bar to dissolution. *See* MINN. STAT. § 302A.751 subd. 3 (1984); CLOSE CORP. SUPP., *supra* note 8, at § 43(a).

247. If minority shareholders are inactive and dependent for their financial return on dividends while the majority are active in the business and receive their return in the form of salaries, an economic conflict of interest exists. In this circumstance the minority would be well advised to demand the payment of dividends and enforce that demand through a provision such as that suggested here. A dividend requirement, of course, implicates management control of the corporation and like other provisions limiting the board's management discretion is the subject of a shareholder control agreement. *See infra* Part IV(B)(4). Because of the uncertainty surrounding direct enforcement of such control agreements, *see infra* notes 255-59 and accompanying text, indirect enforcement—through deterrence—by means of a dissolution provision in the shareholders' voting agreement is desirable to make the protections afforded the minority shareholders truly effective.

248. *See supra* note 153.

those who do.[249]

6. Include optional provisions involving other matters arising between the parties.

If a buy-sell agreement does not appear in the bylaws, it is an appropriate candidate for inclusion in a shareholder voting agreement.[250]

7. Include an arbitration clause regarding disputes which arise under the agreement.

Disputes between the shareholders are as likely to occur over the meaning and implementation of a shareholder voting agreement as any other corporate governance document. Thus, the agreement should provide for arbitration and grant the arbitrator an irrevocable proxy from each party to vote that party's shares in accordance with the arbitrator's decision.[251]

8. Include in the agreement a severability provision, a cure provision, and a survival provision.

The agreement should contain a severability provision, providing that the invalidity of one provision of the agreement does not render the remaining provisions inoperative.[252] In using such a provision, counsel should give careful consideration to the relative importance of the various pieces of the parties' "deal." Portions of the shareholders' deal may be so significant that a finding of invalidity with respect to that provision should cancel all agreements and terminate the endeavor. If this is the case, the severability provision will have to be limited and the agreement should expressly provide for the dissolution of the corporation. The shareholder voting agreement should also contain a cure provision providing that the parties will take or cause to be taken all necessary acts to render the agreement valid and enforceable.[253] If the agreement is exe-

249. *See supra* note 155.

250. *See generally supra* note 162 and accompanying text.

251. In *Ringling Bros.*, the Delaware Supreme Court refused to allow this enforcement mechanism. The Model Act is more generous in this regard. *See* MODEL ACT, *supra* note 3, at § 7.31(b); MODEL ACT ANNOT., *supra* note 2, at 705, Official Comment to § 7.21. *See also supra* notes and accompanying text.

252. *See* Beresovski v. Warszawski, 28 N.Y.2d 419, 322 N.Y.S.2d 673, 271 N.E.2d 520 (1971).

253. *See* Zion v. Kurtz, 50 N.Y.2d 92, 428 N.Y.S.2d 199, 405 N.E.2d 681 (1980). In *Zion* the shareholders' agreement contained a provision which, under the applicable law, was enforceable only if contained in the articles of incorporation. The parties to the agreement had the power to amend

cuted as a preincorporation agreement or if the agreement is part of another document, such as a loan agreement involving convertible securities, provision must be made for the agreement to survive the parties' transition to actual shareholder status. Thus, the agreement should provide that its provisions, or specified provisions, survive the incorporation or repayment of the loan so long as the parties have actually become shareholders of the corporation as the agreement contemplates.[254]

B. Shareholder Control Agreements

Control agreements are formed on the shareholder level but are intended to operate on other levels in the corporate structure. They frequently specify corporate policies and name corporate personnel performing functions reserved for the board of directors in the prototypical corporation. Control agreements are essential because shareholder voting agreements merely specify *who* will be directors and do not specify *how* the board will exercise its powers.

The Model Act does not specifically authorize shareholder control agreements,[255] although most modern statutes provide for them.[256] Nevertheless, it is possible under the Model Act to specifically authorize such a shareholders' agreement by including an appropriate provision in the articles of incorporation.[257] Furthermore, the common law of corporations authorizes control agreements where they are entered into by all (or all but an inconsequential, unharmed and uncomplaining group) of the shareholders, and do not adversely affect creditors, do not contravene the statutory "skeleton," and do not impair provisions directed to the courts.[258] This rule is simply another way of stating the normal rule

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the articles and they had agreed to take all necessary acts, although no amendment was ever adopted. Following the maxim of equity that what ought to have been done is deemed to have been done, the court reformed the articles to include the necessary provisions, which were thus valid, and enforced them. In Adler v. Svingos, 436 N.Y.S.2d 719 (App. Div. 1981), the court adopted the *Zion* rationale and enforced a provision contained in the shareholders' agreement but not in the articles of incorporation, where the parties to the agreement had the power to amend the articles although they had *not* expressly agreed that they would take all action necessary to make the agreement valid and enforceable. *But see* Gazda v. Kalinski, 45 N.Y.S.2d 387 (App. Div. 1982) (holding invalid a portion of a shareholders' agreement which did not contain a cure provision without citation to either *Zion* or *Adler*).

254. *See* Westland Capitol Corp. v. Lucht Eng'g, Inc., 308 N.W.2d 709 (Minn. 1981).

255. *See supra* notes 15-27.

256. *See, e.g.*, CAL. CORP. CODE § 3400(b) (Deering 1985); MINN. STAT. § 302A.457 (1984); CLOSE CORP. SUPP., *supra* note 8, at § 20. These statutes require the agreement to be unanimous.

257. *See supra* notes 88-90 and accompanying text.

258. *See* Galler v. Galler, 32 Ill. 2d at 30; Westland Capital Corp. v. Lucht Eng'g, Inc., 308

governing the enforceability of private contracts.[259]

The shareholder control agreement should be contained in a writing signed by all shareholders who are intended to be bound by it.[260] The agreement should specify appropriate durational limits.[261] A stock transfer restriction designed to ensure that transferees of the shares covered by the agreement become bound by the agreement should also be included.[262] The share certificates of parties to the shareholder control agreement should bear a legend disclosing the existence of the agreement and a copy of the agreement should be filed with the corporation so that shareholders and other appropriate persons may inspect it.[263] Although the case law has yet to develop the principle that the shareholders are subject to liabilities otherwise imposed upon directors whenever a control agreement limits the usual discretion of the board, most statutory provisions do impose that liability,[264] and the parties to the agreement should anticipate judicial imposition of such liability. In Model Act jurisdictions which lack recent precedent authorizing control agreements, inclusion of a provision in the shareholder control agreement specifically accepting such liability strengthens the claim that the agreement is valid.[265] Whenever the agreement requires the corporation to take or re-

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N.W.2d at 714; Clark v. Dodge, 269 N.Y. at 417; 1 F. O'NEAL, *supra* note 6 § 5.24. The limitations on a common law control agreement are the same as those governing optional provisions in the articles. *See supra* note 79. Under the modern view, most statutory requirements are imposed for the protection of the shareholders; if those shareholders agree to waive the requirements, the courts do not interfere. *See* Z. CAVITCH, *supra* note 17, at § 114.01[3].

259. Johnson, *supra* note 22, at 216, states:

> The distinction between valid and invalid agreements . . . depends on whether the agreement has caused harm to others. The drafting attorney must fashion the document so that there is no injury, either real or apparent, to the corporation or to third parties. Agreements among shareholders are generally the product of negotiation, and should be construed and enforced like any other contract so as to give effect to the intent of the parties *as expressed in their agreements*, except where they violate a statute; contemplate an illegality; involve fraud, oppression or wrong against others; or are made through self-dealing or duress. Care must be taken to insure that such agreements, like any other contract, do not stray into these prohibited areas.

See also Bulloch, *supra* note 217.

260. Whenever possible, *all* shareholders should be parties to the control agreement. F. O'NEAL, *supra* note 6, at § 5.24.

261. *See supra* note 222.

262. *See supra* note 223.

263. Filing and notice requirements are contained in most statutory safe harbors. *See, e.g.*, MINN. STAT. § 302A.457 subd. 2(b) (1984). *See also supra* note 90.

264. CAL. CORP. CODE § 300(d) (Deering 1985); MINN. STAT. § 302A.45 subd. 3 (1984); MODEL ACT, *supra* note 3, at § 8.01.

265. There appears to be little risk from inclusion of this provision because most liabilities of

frain from taking certain actions, the corporation should become a party to the agreement.[266] A shareholder control agreement can be specifically enforced,[267] corporate actions in derogation of the agreement may be cancelled,[268] or contract damages may be sought as appropriate in the particular case.

As in the case of a shareholder voting agreement, a control agreement may provide for specific results or set forth a mechanism for determining board or corporate action with respect to various issues. A shareholder control agreement may contain provisions dealing with the following matters.

1. No business or activities of the corporation shall be conducted without the unanimous consent of the shareholders or, alternatively, the consent of a specified shareholder.

This provision gives each shareholder veto power over corporate action of all types.[269] It allows the close corporation to operate in the same manner as a partnership, but a potential for causing deadlock among the shareholders also exists. For this reason it may be appropriate to limit the requirement to "material" decisions which are defined in a manner which meets the specific needs of the corporation. An alternative provision might provide that a specified shareholder is to have final authority over certain corporate activities, such as marketing or research and development. Where the entrepreneurs' skills are clearly divided into subject areas and they enter the venture because of these skills, this provision may be appropriate. Although this type of provision is not subject to the deadlock potential of an unaniminity requirement, it presents other problems. For example, the specified shareholder's business skills may diminish over time. Therefore, it is appropriate to consider providing for a high vote override of the shareholder's authority which triggers a fair price buy-out of that shareholder. This would allow the other shareholders to take control but would impose a deterrent to unwarranted action.

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directors *qua* directors run to the shareholders, all of whom ordinarily will be parties to the agreement.

266. *Compare* MINN. STAT. § 302A.457 (1984) (inclusion of a nonshareholder as a party removes the agreement from the statutory safe harbor of subdivision 1 while leaving available the common law of shareholder's agreement pursuant to subdivision 4).

267. Galler v. Galler, 32 Ill.2d 16 (1965).

268. Westland Capital Corp. v. Lucht Eng'g Inc., 308 N.W.2d 709 (Minn. 1981).

269. *See* Zion v. Kurtz, 50 N.Y.2d 92, 428 N.Y.S.2d 199, 405 N.E.2d 681 (1980); Adler v. Svingos, 436 N.Y.S.2d 719 (App. Div. 1981).

2. Designate the individuals who will serve as the officers of the corporation and fix their compensation.

Shareholders inevitably wish to hold positions of power with regard to the corporation and its operations.[270] In many instances corporate titles and relative salaries are the first items the entrepreneurs decide after entering the venture. Salaries may be fixed by specifying a dollar amount or providing a ratio among the various officerships. The shareholder's agreement should provide for periodic review of salaries or the benchmark amount if ratios are used. The shareholder should be expressly required to negotiate in good faith concerning appropriate modifications. The shareholder control agreement may incorporate employment contracts between the shareholder-officers and the corporation.[271] If it is anticipated that those who succeed to a shareholder's stock will also succeed to that shareholder's position with respect to the corporation, a provision should be made for so designating the successor.

3. Restrict corporate expenditures, for example, for capital items or employment of highly compensated persons, and borrowing.

These provisions are always found in venture capital agreements and they should also be included in shareholder control agreements to ensure that corporate funds and credit are properly used for the benefit of all shareholders.[272] With regard to expenditures which are related to the corporation's business and operations, a consent restriction cannot be exercised in an unreasonable manner.[273]

4. Set policy regarding corporate distributions of money or property to shareholders.

When some shareholders are inactive in the business, the required payment of dividends may be necessary to ensure them a fair current return on their investment. Dividends may be determined as a percentage of net earnings or by linking them to the salaries paid to various corporate of-

270. *See supra* note 161. The meaning of a particular corporate "title" in terms of power and responsibility should be clearly spelled out in the bylaws. *See supra* notes 185-88 and accompanying text.

271. *See* F. O'NEAL, *supra* note 6, at § 6.11; Kesler, *Employment Agreements in Close Corporations,* 11 SETON HALL L. REV. 187 (1980).

272. A good example of such an agreement is contained in Westland Capital Corp. v. Lucht Eng'g, Inc., 308 N.W.2d 709 (Minn. 1981).

273. Westland Capital Corp. v. Lucht Eng'g, Inc., 308 N.W.2d at 714.

ficers. Where dividends will not be paid to all shareholders, several classes of common stock may be desirable.

5. Include provisions for arbitration of disputes, severability, cure, and survival.

If a separate shareholder control agreement is prepared, these matters must be included in it as well as any shareholder voting agreement.[274]

V. THE LIMITS OF PLANNING

All planning can fail as the facts change, new parties enter the scene, or relationships break down. Therefore, good draftsmanship does not eliminate the need for judicial intervention. Common law principles and statutory provisions providing relief to shareholders who have been subjected to mistreatment—"oppression" or "unfairly prejudicial conduct"—remain relevant to ensure that good faith and fair and reasonable treatment of shareholders is the standard within the corporation, while the "morals of the marketplace" and ordinary business ethics are the only limitations on the controlling shareholders' actions externally.[275]

Good planning is nevertheless important because the parties' statement of their "deal" will provide direction for judicial analysis when intervention is sought. The shareholders can define their precise expectations under various foreseeable circumstances; specifically delineating their relationship to one another regarding the corporation. They can set their own parameters for honest, fair, and reasonable conduct in their dealings. The more extensive and precise the planning, the more certain the result when the shareholders' agreement is applied to the actual circumstances existing when judicial intervention becomes necessary.

274. *See supra* notes 250-53 and accompanying text.

275. *See supra* notes 31-41 and accompanying text.

APPENDIX

Prior to undertaking representation, we were informed:

(1) that there are potentially differing legal interests among ourselves (as individual participants);

(2) that as a minority party to the proposed transaction, each of us is exposed to possible disagreement with and control by those in the majority;

(3) that the attorney will endeavor, at *each stage* in the negotiations, to point out the advantages and disadvantages of alternate courses of action on *each* of us;

(4) that neither the attorney-client privilege nor the client-lawyer confidentiality duty exists with respect to information acquired by the attorney relating to representation of the group;

(5) that if a severe conflict develops between us, the attorney may be required to withdraw from representation of the group, in which case he may be unable to represent any of us as to that issue; and

(6) that each of us may at any time, without prejudice, seek independent advice or representation, on a specific issue or on our relationship as a whole, from another attorney of our individual choice.

After consideration of the above disclosures, we agree:

(1) that our legal interests vary only slightly and are not in actual conflict;

(2) that our common goals are the predominant factor in our business relationship;

(3) that we desire the attorney's efforts to be directed toward assisting us, as a group, to best adjust our individual interests so as to achieve our common economic goal and we accept any limitations such direction may cause in his representation of each of us.

Therefore, we each consent to multiple representation of all of us, as a group, by the attorney and the firm.

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(*Sample only.* Do not use unless this form meets, in your professional judgment, the needs of your potential clients.)

WASHINGTON UNIVERSITY
LAW QUARTERLY

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