

# Kansas Law Review

## CLOSE CORPORATIONS AND THE KANSAS GENERAL CORPORATION CODE OF 1972

*Edwin W. Hecker, Jr.\**

### TABLE OF CONTENTS

	PAGE
I. CONTROL OVER SHAREHOLDER ACTION .....	490
A. Shareholder Voting Agreements .....	490
B. Voting Trusts .....	499
C. Shareholder Veto Provisions .....	502
D. Different Classes of Stock .....	506
II. CONTROL OVER DIRECTOR ACTION .....	510
A. Direct Restriction of Discretion .....	510
B. Director Veto Provisions .....	517
C. Employment Contracts .....	520
III. DISSENSION, DEADLOCK, AND DISSOLUTION .....	521
A. Voluntary Dissolution .....	522
B. Involuntary Dissolution .....	525
IV. RESTRICTIONS ON TRANSFER .....	530
A. Prior Law .....	531
B. The Code .....	533
V. STATUTORY CLOSE CORPORATIONS .....	546
A. Acquisition and Maintenance of Close Corporation Status .....	546
B. Management of the Business .....	553
C. Dissension and Deadlock .....	557
VI. CONCLUSION .....	563

It has become a truism that within the genus of "corporation" there are at least two species—the publicly-held corporation and the closely-held corporation—and that the characteristics and requirements of a close corporation often are more akin to those of a partnership than to those of a public corporation. It is also common knowledge that in the past corporate legislation was drafted solely with the public corporation in mind and thus failed to take account of the peculiar characteristics and needs of the close corporation. As a result, the close corporation became a square peg sought to be forced into a round hole. A free and independent board of directors, necessary for the protection of inactive investors in a public corporation, was an anathema to the close corporation in which all of the shareholders were engaged in active conduct of the business. Free transferability of shares, again necessary for inactive investors in the public corporation, was the bane of shareholders

\* Associate Professor of Law, University of Kansas. B.A. 1966, Oakland University; J.D. 1969, Wayne State University; LL.M. 1970, Harvard University.

of a close corporation who wanted to be free to pick and choose their associates. Severe restrictions on dissolution, necessary not only for the protection of shareholders of a public corporation but also for its employees and, indeed, the public itself, often made no sense in the context of an incorporated partnership.

In 1972 Kansas adopted a new General Corporation Code<sup>1</sup> (Code). While prior Kansas law, both legislative and decisional, was not particularly anti-pathetic to the plight of the close corporation, the Code makes significant innovations. The most striking of these is a special article expressly recognizing close corporations and devoted solely to their problems. In addition, the Code contains numerous provisions of general applicability that are particularly suited to the needs of close corporations.

The author will attempt to identify the problems most commonly encountered by participants in a close corporation and to analyze those problems and their solutions in light of both prior law and the Code. The analysis will focus primarily on the situation of a minority shareholder in such a venture. In order to keep the scope of the discussion manageable, it is confined principally to an examination of Kansas law, although most of the problems discussed will apply to close corporations organized in any jurisdiction.

## I. CONTROL OVER SHAREHOLDER ACTION

### A. *Shareholder Voting Agreements*

Traditionally, control over the management and business policies of a corporation has been vested in its board of directors. The Code continues this general rule in section 17-6301(a) with the following language: "The business and affairs of every corporation shall be managed by a board of directors, except as may be otherwise provided in this act or in its articles of incorporation." The importance and utility of the exception contained in section 17-6301(a) will be discussed subsequently.<sup>2</sup>

Assuming, however, that the parties choose to operate within the traditional corporate framework, the first concern of a minority shareholder must be to secure representation on the board. If the minority shareholder owns a sufficiently large percentage of the shares outstanding, the requirement of cumulative voting, continued by the Code,<sup>3</sup> may provide him such representation.<sup>4</sup> However, mere representation on the board of directors often will not

<sup>1</sup>KAN. STAT. ANN. §§ 17-6001 to -7404 (1974) (unless otherwise indicated, section references in the text refer to the Code).

<sup>2</sup>See text at notes 141-56 *infra*.

<sup>3</sup>KAN. STAT. ANN. § 17-6504 (1974).

<sup>4</sup>Cumulative voting is a method of voting that entitles each shareholder to as many votes as he has shares, multiplied by the number of directors to be elected. Each shareholder may distribute these votes among the nominees in whatever manner he desires. The purpose is to provide a minority shareholder the opportunity for representation on the board of directors. Thus, if a corporation has 100 shares issued and outstanding, 76 shares held by *A* and 24 shares held by *B*, and four directors are to be elected, *A* will have 304 votes and *B* will have 96 votes. There is no way that *A* can distribute his votes to elect more than three of the four directors. *B* will be assured of a seat on the board. However,

be sufficient to further his interests since the board generally acts by the vote of a majority of a quorum.<sup>5</sup> Thus, representation on the board through a minority director may be effective only to the extent that he can persuade the other directors that his view is the correct one. Often this will not be enough.

If no shareholder owns a majority of shares and if a number of minority shareholders have common goals with respect to the business of the corporation, the natural inclination is to form a majority coalition, combining their voting power to elect a majority of the directors. In such a case a binding contractual arrangement is necessary to prevent a future defection by one or more of the coalition members. These shareholder voting agreements, also called pooling agreements, are usually constructed so that each shareholder retains both title to his shares and the right to vote them, thus distinguishing the arrangement from a voting trust.<sup>6</sup> Unlike the Delaware General Corporation Law<sup>7</sup> (Delaware Law) the Code contains no specific provisions regulating the validity or use of pooling agreements. The Code merely states that the section governing voting trusts "shall not be deemed to invalidate or otherwise affect any voting or other agreement among stockholders or any irrevocable proxy which is not otherwise illegal."<sup>8</sup> Therefore, in order to determine the validity and effect of pooling agreements, one must refer to prior case law.

It is generally recognized in the great majority of jurisdictions that shareholders may agree to combine their voting power if their purpose is not illegal or fraudulent. The purpose of electing a majority of directors and thereby securing control of the corporation is not, of itself, considered an illegal or fraudulent purpose.<sup>9</sup> This view is supported in Kansas by *Wallace v. Southwestern Sanitarium Co.*,<sup>10</sup> which upheld the validity of a pooling

---

cumulative voting is not a guarantee of minority representation. If, in the above example, only three directors were to be elected, *A* would have 228 votes and *B* would have 72 votes. In such a case *A* would elect all three directors.

<sup>5</sup> KAN. STAT. ANN. § 17-6301(b) (1974). The majority of the total number of directors constitutes a quorum unless the articles of incorporation or the by-laws require a greater number. Moreover, the by-laws may provide that less than a majority shall constitute a quorum (but in no event less than one-third of the total number of directors) unless such a by-law would contravene a provision in the articles of incorporation. The vote of a majority of a quorum is necessary to transact business, but the articles of incorporation or by-laws may provide that the vote of a greater number is required. If the quorum and vote requirements are set high enough they may give a minority director an effective veto over corporate action. This method of control is discussed in the text at notes 157-70 *infra*.

<sup>6</sup> For a discussion of voting trusts see text at notes 60-78 *infra*.

<sup>7</sup> DEL. CODE ANN. tit. 8, §§ 218(c), (d) (Supp. 1970).

<sup>8</sup> KAN. STAT. ANN. § 17-6508(c) (1974).

<sup>9</sup> *E.g.*, *Weil v. Beresth*, 154 Conn. 12, 220 A.2d 456 (1966); *Galler v. Galler*, 32 Ill. 2d 16, 203 N.E.2d 577 (1964); *Tschirgi v. Merchants Nat'l Bank*, 253 Iowa 682, 113 N.W.2d 226 (1962); *Royster v. Baker*, 365 S.W.2d 496 (Mo. 1963); *Lieberman v. Lieberman*, 23 App. Div. 2d 545, 256 N.Y.S.2d 145, *appeal dismissed*, 16 N.Y.2d 613, 209 N.E.2d 109, 261 N.Y.S.2d 64 (1965); *Irwin v. Prestressed Structures, Inc.*, 420 S.W.2d 491 (Tex. Civ. App. 1967); *Annot.*, 45 A.L.R.2d 799 (1956).

<sup>10</sup> 160 Kan. 331, 161 P.2d 129 (1945). *Wallace* involved an agreement among the holders of 66% of a corporation's voting bonds to pool their bonds and vote them as the parties unanimously agreed, for the purpose of assuring the continued maintenance and operation of the corporation. The bonds were deposited with an escrow agent for the 15 year duration of the agreement, and it was provided that no party could sell his bonds to a nonparty or withdraw them from escrow without the unanimous consent of the other parties. One of the parties to the agreement brought suit to recover payment on his bonds,

agreement among the holders of corporate bonds with voting rights. The purpose of the agreement was to insure continued maintenance and operation of the corporation. The fact that less than all the bondholders were parties to the agreement did not affect its validity.

It would seem that mutual promises of the parties as to voting would be sufficient consideration to sustain a pooling agreement under contract law, and some courts have so stated.<sup>11</sup> However, there is authority to the effect that such an agreement is revocable at will unless some additional consideration is given.<sup>12</sup> Apparently, these courts have confused the consideration necessary to support a bilateral contract with the type of interest necessary to sustain the irrevocability of a proxy under the law of agency.<sup>13</sup> Significantly, in the cases requiring additional consideration not all shareholders were parties to the pooling agreement. Present Kansas law is unclear on this point. In *Wallace*, as previously stated, not all bondholders were parties to the pooling agreement. The court noted that the consideration for the agreement was the mutual promises of the parties<sup>14</sup> and went on to hold that a recalcitrant party could not, in effect, withdraw his bonds from the pool. As a result, *Wallace* could be read as implying that mutual promises are sufficient consideration. However, in *Wallace* an additional "interest" was present in the form of a restriction on the transfer of bonds to persons not party to the agreement. Because of the *Wallace* court's reliance on these transfer restrictions elsewhere in its opinion,<sup>15</sup> it is not clear what result would have been reached in their absence. In practice, this point should not be very significant because free transferability of shares is nearly always highly undesirable in the close corporation context. Therefore, the prudent draftsman will usually include transfer restrictions for reasons independent of the question of consideration.<sup>16</sup>

---

and the corporation and the other parties to the agreement raised the pooling agreement as a defense. The plaintiff demurred to the defense, but the supreme court affirmed the trial court's overruling of the demurrer, holding that the essence of the agreement was joint control of the corporation. Since a party to the agreement could not unilaterally withdraw his bonds from escrow, he could not achieve the same result indirectly by suing to enforce payment of them. In answer to the plaintiff's contention that the agreement constituted a voting trust and therefore was illegal because it exceeded the maximum statutory duration of 10 years, the court held that the agreement was not a voting trust because there was no transfer of voting rights to the escrow agent. The court went on to state that even assuming the voting trust statute applied, the consensual restriction on sales of bonds to nonparties constituted a sufficient interest to bring the arrangement within an exception that sanctioned a greater than 10 year grant of voting rights when coupled with an interest in the security involved.

<sup>11</sup> Ringling Bros.-Barnum & Bailey Combined Shows, Inc. v. Ringling, 29 Del. Ch. 610, 53 A.2d 441 (Sup. Ct. 1947), *aff'g* 29 Del. Ch. 318, 49 A.2d 603 (Ch. 1946); Carnegie Trust Co. v. Security Life Ins. Co., 111 Va. 1, 68 S.E. 412 (1910).

<sup>12</sup> Simpson v. Neilson, 77 Cal. App. 297, 246 P. 342 (1926); Roberts v. Whitson, 188 S.W.2d 875 (Tex. Civ. App. 1945).

<sup>13</sup> In order to sustain the irrevocability of a proxy, the holder of the proxy must have some property right in the underlying shares or a security interest in the shares given as protection for money loaned or obligations incurred. 1 F. O'NEAL, CLOSE CORPORATIONS § 5.36, at 124 (2d ed. 1971) [hereinafter cited as O'NEAL]. The Code provision governing irrevocability of proxies is discussed in the text at notes 38-48 *infra*.

<sup>14</sup> 160 Kan. at 334, 161 P.2d at 131.

<sup>15</sup> See note 53 and accompanying text *infra*.

<sup>16</sup> The two most obvious reasons for imposing restrictions on the transfer of shares are to prevent a shift in control among existing shareholders and to prevent the intrusion of unwanted outsiders. For a general discussion of permissible transfer restrictions under the Code see text at notes 241-300 *infra*.



Absent a statutory provision, the duration of a pooling agreement, standing alone, should not affect its validity.<sup>17</sup> In *E.K. Buck Retail Stores v. Harkert*,<sup>18</sup> the Nebraska Supreme Court found unobjectionable an agreement that was to continue so long as one of the parties remained a shareholder. Even agreements that were silent as to their duration have been upheld, the courts implying a reasonable term, which may be for the life of the parties.<sup>19</sup> One commentator has found only two cases, both decided in Georgia prior to 1920, that used the excessive duration of a pooling agreement as the primary ground for a finding of invalidity.<sup>20</sup> Again, the only Kansas case on point is *Wallace*, which upheld an agreement with a term of 15 years. The Comment to section 17-6508 also seems pertinent. In explaining why the Delaware ten year initial limitation on pooling agreements<sup>21</sup> was not adopted in Kansas, the Comment states: "Subsection (c) and (d) of the Delaware section were rejected. . . . It was determined that the new code should not prescribe limitations on the ability of stockholders to enter into voting agreements, or other agreements, as long as any such agreement did not constitute a voting trust." It appears, then, that pooling agreements will not be subject to an arbitrary time limit, but will be enforced to the extent that their duration is reasonable in light of the purposes sought to be accomplished. Caution would demand, however, that some term be expressly stated in the agreement. This will obviate the necessity of judicial implication of a term that might be different than that originally anticipated by the parties. In addition, depending upon the circumstances of a given case, it may be wise to provide a method for early termination, such as by a vote of the majority of the parties.<sup>22</sup>

Finally, it should be noted that a party seeking to avoid his obligations under a pooling agreement might contend that provisions requiring him to vote his shares in a prescribed manner abridge his statutory cumulative voting rights,<sup>23</sup> and that therefore the agreement is invalid. Such a claim was made in *E.K. Buck Retail Stores v. Harkert*.<sup>24</sup> In response, the *Buck* court stated:

It is clear to us that the purpose of the constitutional provision and statute enacted pursuant thereto was to provide for cumulative voting in the election of directors or managers of incorporated companies in order to secure to minority stockholders a greater representation in the management of the corporation's business. In order to do this it was necessary that the law state the number of votes to which each

<sup>17</sup> 1 O'NEAL, *supra* note 13, § 5.09.

<sup>18</sup> 157 Neb. 867, 62 N.W.2d 288 (1954).

<sup>19</sup> *Glazer v. Glazer*, 374 F.2d 390 (5th Cir. 1967); *Galler v. Galler*, 32 Ill. 2d 16, 203 N.E.2d 577 (1965).

<sup>20</sup> Logan, *Methods to Control the Closely Held Kansas Corporation*, 7 KAN. L. REV. 405, 418-19 (1959) [hereinafter cited as Logan].

<sup>21</sup> DEL. CODE ANN. tit. 8, §§ 218(c), (d) (Supp. 1970).

<sup>22</sup> A provision for early termination by a majority could be disastrous for a minority shareholder who invested heavily in reliance on continued operation of the agreement. If such a provision is used, it is imperative to clearly specify whether "majority" means a majority in number or a majority in interest.

<sup>23</sup> KAN. STAT. ANN. § 17-6504 (1974).

<sup>24</sup> 157 Neb. 867, 62 N.W.2d 288 (1954).

stockholder was entitled and to insure against an *involuntary loss* of the right conferred. . . . But such provision does not purport to limit the right of the stockholder to *contract* with reference to his stock. It grants him a right or privilege which he may or may not exercise as he sees fit . . . .<sup>25</sup>

It is submitted that the distinction made in *Buck* between voluntary and involuntary restrictions on the right to cumulate votes is sound and finds support in the waiver theory underlying the decision in the leading Kansas case of *Peck v. Horst*.<sup>26</sup> Such a conclusion is reinforced by Code provisions permitting voting trusts,<sup>27</sup> classification of the board of directors,<sup>28</sup> and executive committees,<sup>29</sup> all of which could be said to undermine the statutory right of cumulative voting.

Given the validity of a shareholders' pooling agreement, the most important question becomes its enforcement. Although some older cases have denied specific performance, holding that an action at law is the only appropriate remedy,<sup>30</sup> most modern cases have recognized the availability of equitable remedies such as injunction and specific performance.<sup>31</sup> Such a result clearly seems appropriate because of the highly speculative nature of any damage award and the irreparable injury that may be suffered by a nonbreaching shareholder. It may be inferred from *Wallace v. Southwestern Sanitarium Co.*,<sup>32</sup> that specific performance or injunctive relief would be granted in a proper case in Kansas.<sup>33</sup>

However, it would not be prudent for a draftsman to rely upon the possibility that a court at some future date might be willing to grant specific performance. The pitfalls of such an approach are illustrated by *Ringling*

<sup>25</sup> *Id.* at 873, 62 N.W.2d at 294 (emphasis added).

<sup>26</sup> 175 Kan. 479, 264 P.2d 888 (1953), *aff'd on rehearing*, 176 Kan. 581, 272 P.2d 1061 (1954). See text at note 128 *infra*.

<sup>27</sup> KAN. STAT. ANN. § 17-6508 (1974).

<sup>28</sup> *Id.* § 17-6301(d).

<sup>29</sup> *Id.* § 17-6301(c).

<sup>30</sup> *E.g.*, *Rosenkrantz v. Chattahoochee Brick Co.*, 147 Ga. 730, 95 S.E. 225 (1918) (unwillingness to engage in continuing judicial supervision of elections); *Haldeman v. Haldeman*, 176 Ky. 635, 197 S.W. 376 (1917) (dictum: no judicial power to require continuing association between those with irreconcilable views); *Gage v. Fisher*, 5 N.D. 297, 65 N.W. 809 (1895) (conscience of equity not moved by one seeking to control stock without purchasing it).

<sup>31</sup> *E.g.*, *Weil v. Beresth*, 154 Conn. 12, 220 A.2d 456 (1966) (injunction); *Galler v. Galler*, 32 Ill. 2d 16, 203 N.E.2d 577 (1964) (specific performance); *Katcher v. Ohmsman*, 26 N.J. Super. 28, 97 A.2d 180 (Ch. 1953) (specific performance); *Samuelson v. Starr*, 28 Misc. 2d 479, 213 N.Y.S.2d 889 (Sup. Ct. 1961) (specific performance).

<sup>32</sup> 160 Kan. 331, 161 P.2d 129 (1945).

<sup>33</sup> In *Wallace*, a party to a bondholders' pooling agreement sued to enforce payment of his bonds that had been deposited in escrow. The court upheld the defense that the agreement provided that bonds so deposited could be withdrawn only by unanimous consent of the parties to the agreement. The court stated:

The contract does provide a plan for the control of the deposited bonds as a unit, and limits the rights of the parties. . . . The contract makes it clear that the parties intended to pool their interests, and that none could withdraw without the consent of the others. . . . If one be permitted to reduce his bonds to judgment, his status passes from that of bondholder, with accompanying voting rights, to that of creditor with rights pertaining to that status, and the plan for joint control is frustrated. . . . We are of the opinion the interveners had a right to insist upon performance of the contract, and that under its terms one of the parties may not, without consent of the others, bring an action on bonds deposited by him, and thus by indirection, accomplish his withdrawal from the obligations of the contract.

*Id.* at 338-39, 161 P.2d at 133.

*Brothers-Barnum & Bailey Combined Shows, Inc. v. Ringling*.<sup>34</sup> In that case, Ringling and Haley each owned 315 shares and agreed to vote them jointly. If they failed to agree, the matter was to be arbitrated and the decision of the arbitrator as to how the votes were to be cast would be binding. The purpose of the agreement was to keep control out of the hands of the third shareholder, North, who owned 370 shares. Because of cumulative voting, by pooling their votes Ringling and Haley could elect five of the seven directors. Inevitably, a dispute arose between Ringling and Haley, and the matter was submitted to arbitration. However, Haley refused to abide by the arbitrator's decision and voted the shares in another manner. The trial court held the agreement valid and granted specific performance.<sup>35</sup> The Delaware Supreme Court, while affirming the validity of the agreement, felt that the proper remedy was to discount the Haley votes.<sup>36</sup> The result of this decision was that Ringling elected three directors and North elected three—a result which seriously undermined Ringling's position.<sup>37</sup> The clear lesson of *Ringling Brothers* is that pooling agreements should be made self-executing wherever possible.

One of the most common and perhaps best ways to make an agreement self-executing is for the parties to give each other irrevocable proxies so that a recalcitrant party cannot vote his shares except in accordance with the agreement. Three major problems may arise in regard to irrevocable proxies: (1) how a proxy may be made irrevocable; (2) whether there is a statutory time limit on the duration of proxies; and (3) whether the entire arrangement will be held invalid as an attempt to create a voting trust while not complying with the statutory requirements.

The Code provides, in section 17-6502(c), that

A duly executed proxy shall be irrevocable if it states that it is irrevocable and if, and only so long as, it is coupled with an interest sufficient in law to support an irrevocable power. A proxy may be made irrevocable regardless of whether the interest with which it is coupled is an interest in the stock itself or an interest in the corporation generally.

Thus the Code, in large part, carries over the perplexing agency law problem of the type of interest the holder of a power must have in order to fall within the exception to the general rule that all powers are revocable. The cases are widely divergent on this point.<sup>38</sup> In a noncorporate context Kansas has adopted the rule that the power holder must have an interest or estate in the subject matter of the power itself rather than simply an interest in the execution of the power,<sup>39</sup> and it is possible that this rule could carry over to corpo-

<sup>34</sup> 29 Del. Ch. 610, 53 A.2d 441 (Sup. Ct. 1947), *aff'g* 29 Del. Ch. 318, 49 A.2d 603 (Ch. 1946).

<sup>35</sup> 29 Del. Ch. 318, 328-30, 335, 49 A.2d 603, 608, 611 (Ch. 1946).

<sup>36</sup> 29 Del. Ch. 610, 623, 53 A.2d 441, 448 (Sup. Ct. 1947).

<sup>37</sup> Moreover, if at the next annual meeting North knew that the Haley votes would again be discounted, he could distribute his votes in such a way as to be able to elect 4 of the 7 directors.

<sup>38</sup> See Annot., 28 A.L.R.2d 1243 (1953).

<sup>39</sup> *Chase v. Chapman*, 89 Kan. 196, 131 P. 615 (1913).

rate proxies. Such a result would appear to be in accord with the conventional view that to sustain irrevocability the proxy holder must have either some property right in the underlying shares or a security interest in such shares given as protection for money loaned or obligations incurred.<sup>40</sup> It is clear that under such a rule the interest of a shareholder in securing and maintaining control of the corporation would not suffice.

Two factors alleviate the severity of this problem. First, a body of case law developed in other states continues to pay lip service to the conventional requirement of an "interest" but has broadened the definition of that term "to such an extent that it is hardly recognizable."<sup>41</sup> Secondly, the definition of "interest" in the Code itself includes either an interest in the underlying stock *or* an interest in the corporation generally.<sup>42</sup> The latter phrase evidences a clear intent on the part of the draftsmen to broaden the common-law rule, but the precise meaning of the phrase is uncertain.<sup>43</sup> Section 17-6502(c) is a verbatim copy of section 212(c) of the Delaware Law.<sup>44</sup> With respect to section 212(c) the Reporter of the Delaware revision committee has commented that "[i]t is likely that, under the new statute, the stockholder willing to abide by the voting agreement would be deemed to have a sufficient 'interest in the corporation generally' to sustain an irrevocable proxy . . . ."<sup>45</sup> The issue has not been decided in either Kansas or Delaware, but it is submitted that this is the approach the courts should take. If, as *Wallace v. Southwestern Sanitarium Co.*<sup>46</sup> suggests, a Kansas court would grant specific performance of a pooling agreement that does not include cross proxies, it makes little sense to say that where the parties have attempted to make the agreement self-executing by including proxies such an attempt must fail because the proxy holder does not have a sufficient interest to make the proxy irrevocable. It should also be noted that Kansas, in dictum at least,<sup>47</sup> recognized that a "consent" type transfer restraint was a sufficient interest to uphold the irrevocability of a voting trust for a period of greater than ten years under the old voting trust statute.<sup>48</sup>

<sup>40</sup> I O'NEAL, *supra* note 13, § 5.36, at 124.

<sup>41</sup> *Id.* at 125. A first option to purchase the shares under the proxy or a power to sell the shares may be adequate interests. "Language in the decisions suggests that an irrevocable proxy may be sustained 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 protect the interests of the proxy holder." *Id.* at 126.

<sup>42</sup> KAN. STAT. ANN. § 17-6502(c) (1974).

<sup>43</sup> This approach is in contrast to that taken by the New York statute, which specifically provides that a proxy is irrevocable if stated to be so and given to: (1) a pledgee; (2) a person who has purchased or agreed to purchase the shares; (3) a person extending credit in consideration of the proxy; (4) a person contracting to perform services in consideration of the proxy; and (5) a party to a shareholder voting agreement. N.Y. BUS. CORP. LAW § 609(f) (McKinney 1963).

<sup>44</sup> DEL. CODE ANN. tit. 8, § 212(c) (Cum. Supp. 1968).

<sup>45</sup> E. FOLK, THE DELAWARE GENERAL CORPORATION LAW 241-42 (1972) [hereinafter cited as FOLK].

<sup>46</sup> 160 Kan. 331, 161 P.2d 129 (1945) (*see* note 33 and accompanying text *supra*).

<sup>47</sup> *Id.* at 337, 161 P.2d at 132.

<sup>48</sup> Law of April 3, 1939, ch. 152, § 66, [1939] Kan. Sess. Laws 241-42, (repealed 1972) (formerly codified at KAN. STAT. ANN. § 17-3307 (1964)). This statute specified that the voting rights granted under a voting trust would be deemed coupled with an interest if granted in connection with: (1) an option or contract to buy or sell the underlying shares; (2) a pledge of the shares; or (3) a guarantee of corporate obligations.

Section 17-6502(b) provides, with respect to the duration of proxies, that, "no such proxy shall be voted or acted upon after three (3) years from its date, unless the proxy provides for a longer period." This clearly suggests that irrevocable cross proxies may be granted to endure for the life of a pooling agreement if the proxies expressly so indicate. Such an interpretation is in accord with the underlying philosophy of the Code that legislative limitations should not be imposed upon shareholder voting agreements as long as such agreements do not constitute voting trusts.<sup>49</sup>

The primary characteristic of a voting trust is separation of voting rights from beneficial ownership of the stock for a continuous period of time. Is it possible that a pooling agreement which employs irrevocable proxies might be held to be, in substance, a voting trust and therefore invalid for want of compliance with the statutory voting trust requirements? This issue was raised in *Abercrombie v. Davies*,<sup>50</sup> where a majority of the shareholders delivered their stock endorsed in blank to eight agents. The agents were given irrevocable proxies and the exclusive right to vote the shares for ten years. The Delaware Supreme Court found that the essential elements of a voting trust were present: (1) a divorce of voting rights from beneficial ownership; (2) a transfer of voting rights to third party fiduciaries; (3) the transfer of voting rights was through the medium of irrevocable proxies and was to be effective for ten years; (4) the voting rights were pooled in the agents as a group; and (5) the agreement's principal object was securing voting control of the corporation.<sup>51</sup> The court held that the agreement in substance constituted a voting trust and was invalid because the stock had not been transferred to the agents on the corporation's books and a copy of the agreement had not been filed at the corporation's principal office.

No case similar to *Abercrombie* has arisen in Kansas. However, in *Wallace v. Southwestern Sanitarium Co.*<sup>52</sup> it was argued that the bondholders' pooling agreement constituted a voting trust and was illegal because it had a duration in excess of ten years. The court held that since the right to vote had not been transferred to the escrow agent with whom the bonds were deposited the agreement did not constitute a voting trust. However, the court stated that even assuming that the voting rights had been transferred and the voting trust statute then would be applicable, a restriction on the transfer of bonds to persons not party to the agreement was a sufficient interest to sustain irrevocability for a period greater than ten years.<sup>53</sup> The court's willingness to assume that if voting rights had been transferred the voting trust statute would apply suggests that *Abercrombie* might have been decided the same way had it arisen in Kansas.

<sup>49</sup> KAN. STAT. ANN. § 17-6508, Comment (1974).

<sup>50</sup> 36 Del. Ch. 371, 130 A.2d 338 (Sup. Ct. 1957).

<sup>51</sup> *Id.* at 383, 130 A.2d at 344-45.

<sup>52</sup> 160 Kan. 331, 161 P.2d 129 (1945).

<sup>53</sup> *Id.* at 337, 161 P.2d at 132.

The draftsmen of the Delaware Law, apparently in response to *Abercrombie*, included a subsection in the voting trust statute which provides: "This section shall not be deemed to invalidate any voting or other agreement among stockholders or any irrevocable proxy which is not otherwise illegal."<sup>54</sup> Kansas has adopted a substantially identical subsection.<sup>55</sup> The Delaware Reporter has commented that "[t]he holding of *Abercrombie v. Davies* that a voting agreement coupled with an explicit irrevocable proxy would fail as a voting trust for nonconformity with the then voting trust statute . . . is in effect overruled by new § 218(e) . . ."<sup>56</sup> Similarly, the Kansas Comment states:

It was determined that the new code should not prescribe limitations on the ability of stockholders to enter into voting agreements, or other agreements, as long as any such agreement did not constitute a voting trust. Thus, subsection (c) of the new section provides that it is not to be construed as invalidating or otherwise affecting any other stockholders' agreements or irrevocable proxies which are otherwise legal.<sup>57</sup>

While this may be the purpose of the statutory language, it is not clear that the phrase "not otherwise illegal" is sufficient to accomplish the purpose. On its face, "otherwise illegal" is broad enough to encompass *any* external ground for illegality, including similarity to a voting trust under the *Abercrombie* rationale. Thus the phrase could be interpreted to mean that the voting trust statute will not invalidate a shareholder agreement if the agreement is not otherwise illegal, but that if the agreement is sufficiently similar to a voting trust it will be "otherwise illegal." The situation is not clarified by the Kansas commentary. Certainly legislative restrictions were not intended to be placed upon shareholder agreements which do not constitute voting trusts, but in what sense is the term "voting trust" used? Does it refer only to formal voting trusts nominated as such, or does it also include a *de facto* voting trust such as was present in *Abercrombie*? It is submitted that the statute should not be interpreted to carry forward the *Abercrombie* rationale. In light of the potential danger in which all pooling agreements with irrevocable proxies were placed by the *Abercrombie* holding and the clear intent of the Delaware draftsmen to overrule that case, "otherwise illegal" should be interpreted as limited to traditional common-law grounds for illegality, such as a purpose to secure a private benefit or work a fraud on nonparty shareholders.<sup>58</sup>

However, even if *Abercrombie* remains viable, that decision should not cause undue restriction upon counsel seeking to tailor an agreement to his client's needs. If each party to the agreement gives irrevocable proxies to the other parties there will be no transfer of voting rights to third party fiduciaries as there was in *Abercrombie*. More importantly, each shareholder will retain

<sup>54</sup> DEL. CODE ANN. tit. 8, § 218(e) (Supp. 1970).

<sup>55</sup> KAN. STAT. ANN. § 17-6508(c) (1974).

<sup>56</sup> FOLK, *supra* note 45, at 242 (footnote omitted).

<sup>57</sup> KAN. STAT. ANN. § 17-6508, Comment (1974).

<sup>58</sup> E.g., *Palmbaum v. Magulsky*, 217 Mass. 306, 194 N.E. 746 (1914).

the right to vote his own shares, excepting only cases of disagreement. That is, any separation of voting rights from beneficial ownership will usually be only intermittent rather than continuous over a protracted period of time. Moreover, this will be true even if an arbitration clause with proxies running to the arbitrator is included. Although the arbitrator might be termed a third party fiduciary, he will not exercise voting rights on a regular basis. Therefore, there seems to be considerable latitude in drafting self-executing shareholder pooling agreements in Kansas.

Finally, there is the matter of enforcement of the agreement against transferees of the stock. Since most pooling agreements will also be coupled with one or more restrictions on free transferability, this subject will be discussed subsequently in connection with such transfer restrictions.<sup>59</sup>

### B. Voting Trusts

The voting trust is another popular method for allocating control in a close corporation. Almost all states now have specific statutory provisions regulating voting trusts, and the Code has continued this practice in section 17-6508. A voting trust is created by a written trust agreement pursuant to which one or more shareholders transfer their stock to voting trustees and receive in return voting trust certificates issued by the trustees. The voting trustees thereafter have the exclusive right to vote the stock for the duration of the agreement.

It is settled that a voting trust, to be legal, must comply with all terms of the statute.<sup>60</sup> However, the question remains whether the statutory requirements constitute a "safe harbor" or whether there may be judicial inquiry into the purpose for which the voting trust was created. Although the question has not often arisen, there is some indication that courts may be willing to inquire into the purpose for which the trust was created and to declare the trust invalid if an improper purpose, such as fraud, is found.<sup>61</sup> Cases antedating voting trust statutes may serve as guides to the propriety of particular purposes. Purposes that have been found proper include: securing control,<sup>62</sup> maintaining control in the original promoters,<sup>63</sup> preventing deadlock,<sup>64</sup> and assuring continuity of management.<sup>65</sup>

Compliance with the statutory requirements should not be difficult in most cases. The scheme of section 17-6508(a) may be summarized as follows:

<sup>59</sup> See text at notes 242-49 *infra*.

<sup>60</sup> *Abercrombie v. Davies*, 36 Del. Ch. 371, 130 A.2d 338 (Sup. Ct. 1957); *In re Morse*, 247 N.Y. 290, 160 N.E. 374 (1928).

<sup>61</sup> *In re Morse*, 247 N.Y. 290, 160 N.E. 374 (1928) (dictum); *Redman v. Minnis*, 43 Ohio App. 371, 183 N.E. 299 (1932) (dictum).

<sup>62</sup> *Gumbiner v. Alden Inn, Inc.*, 389 Ill. 273, 59 N.E.2d 648 (1945).

<sup>63</sup> *Gray v. Bloomington & Norm. Ry.*, 120 Ill. App. 159 (1905); *Frost v. Carse*, 91 N.J. Eq. 124, 108 A. 642 (Ct. Err. & App. 1919).

<sup>64</sup> See *Day v. Hecla Mining Co.*, 126 Wash. 50, 217 P. 1 (1923).

<sup>65</sup> *Mackin v. Nicollet Hotel, Inc.*, 25 F.2d 783 (8th Cir.), *cert. denied*, 278 U.S. 618 (1928). For a further discussion of proper and improper purposes see Ballantine, *Voting Trusts, Their Abuses and Regulations*, 21 Tex. L. Rev. 139, 152-53 (1942).

(1) a voting trust may be formed by one or more shareholders; (2) the trust agreement must be reduced to writing; (3) any person or corporation, including a beneficiary of the voting trust, may be trustee; (4) the original term of the trust may not exceed ten years; (5) the agreement may contain any lawful provisions not inconsistent with the purpose of vesting voting rights in the trustee or trustees; (6) a copy of the agreement must be filed at the registered office of the corporation and be open to inspection by any stockholder or beneficiary of the trust;<sup>66</sup> (7) the shares transferred to the trustee or trustees must be surrendered to the corporation for cancellation and new shares issued in the name of the trustee or trustees; and (8) such new shares must state that they are issued pursuant to the voting trust agreement and a notation to that effect must be made in the corporate stock ledger.

The section also addresses the question of the validity of a voting trust with a term in excess of that permitted by the statute. This issue was raised in the Delaware case of *Perry v. Missouri-Kansas Pipeline Co.*,<sup>67</sup> where the court held that a voting trust with an express term of 11 years (the statutory limit being ten years) was not invalid as to the eleventh year only, but was completely void. Such a result would be impossible under the new statute, which provides: "The validity of a voting trust agreement, otherwise lawful, shall not be affected during a period of ten (10) years from the date when it was created or last extended, as provided in subsection (b), by the fact that under its terms it will or may last beyond such ten-year period."<sup>68</sup>

As previously stated, the original duration of a voting trust may not exceed ten years. There is no exception, as there was under the prior statute,<sup>69</sup> for a longer duration where the voting rights conferred on the trustee are coupled with an interest. However, subsection (b) of the new statute<sup>70</sup> provides for extensions of the voting trust. Such extensions may be accomplished by one or more of the beneficiaries within two years prior to expiration of the agreement. Extensions bind only those beneficiaries who consent thereto. The beneficiaries must execute a written extension agreement, secure the written consent of the voting trustee or trustees, and cause the trustee or trustees to file both instruments at the corporation's registered office prior to expiration of the original term of the agreement. The extension, like the original term, is limited to a maximum duration of ten years, but there is no limitation on the number of successive extensions. Apparently, the legislative intent is not to impose an absolute limitation upon the length of time

---

<sup>66</sup> The mandatory language of § 17-6508 with respect to filing resolves a problem of interpretation created by the permissive language of the prior statute. Law of April 3, 1939, ch. 152, § 67, [1939] Kan. Sess. Laws 242 (repealed 1972) (formerly codified at KAN. STAT. ANN. § 17-3308 (1964)); Logan, *supra* note 20, at 411-12.

<sup>67</sup> 22 Del. Ch. 33, 191 A. 823 (Ch. 1937).

<sup>68</sup> KAN. STAT. ANN. § 17-6508(a) (1974).

<sup>69</sup> Law of April 3, 1939, ch. 152, § 66, [1939] Kan. Sess. Laws 241-42, (repealed 1972) (formerly codified at KAN. STAT. ANN. § 17-3307 (1964)).

<sup>70</sup> KAN. STAT. ANN. § 17-6508(b) (1974).



a voting trust may endure, but to provide for forced periodic review of the continued desirability and efficacy of the arrangement.

If the voting trust is to be successful as a control device the method of determining how the shares will be voted must be stated expressly. The statute provides that if there are two or more voting trustees and the agreement does not specify the method for voting the shares, they will be voted as the majority of trustees determines. If the trustees are equally divided as to how the shares should be voted, the votes are to be divided equally between the factions.<sup>71</sup> Certain problems may make it unwise to rely on this statutory method of determining voting. First, the statute does not seem to contemplate a situation where the voting trustees are split into three or more unequal factions, none of which constitutes a majority in number. It is possible that in such a case the votes would be apportioned among the factions on a pro rata basis. It should be noted, however, that any division of votes among divergent groups of trustees may undermine one of the major purposes of the voting trust—the unified voting of a substantial block of stock. Moreover, majority determination of how the shares are to be voted may not afford sufficient protection to a minority beneficiary. In such a case counsel for the minority beneficiary may want to include a provision requiring unanimity among the trustees with an arbitration clause as a safeguard against the increased potential for deadlock.

Another problem inherent in a voting trust is possible loss of the beneficiary's status as a "stockholder" for purposes other than voting. For example, suppose the voting trustees vote to approve a merger of which one of the beneficiaries disapproves. Section 17-6712 provides that stockholders who dissent from a vote approving a merger may have their shares appraised and receive cash payments in exchange therefor.<sup>72</sup> However, a "stockholder" is defined as "a holder of record of stock in a stock corporation."<sup>73</sup> Since the voting trustees rather than the beneficiaries of the trust are holders of record, a dissenting beneficiary may be denied appraisal and payment rights.<sup>74</sup> Another common problem relates to the statutory right of a stockholder to inspect corporate books and records. This right is granted by section 17-6510, but again, "stockholder" is defined as "a stockholder of record."<sup>75</sup> Here too the beneficiary may be deprived of rights which he otherwise would have.<sup>76</sup>

An additional disadvantage of the voting trust as a control device is its ten year maximum duration. In certain situations, a control device with a longer lifespan may be desirable or even imperative. The provision permitting

<sup>71</sup> *Id.* § 17-6508(a).

<sup>72</sup> *Id.* § 17-6712(b).

<sup>73</sup> *Id.* § 17-6712(a).

<sup>74</sup> *Scott v. Arden Farms Co.*, 26 Del. Ch. 283, 28 A.2d 81 (Ch. 1942). *But see* Application of Bacon, 287 N.Y. 1, 38 N.E.2d 105 (1941).

<sup>75</sup> KAN. STAT. ANN. § 17-6510(a) (1974).

<sup>76</sup> *State ex rel. Crowder v. Sperry Corp.*, 41 Del. 84, 15 A.2d 661 (Super. Ct. 1940). The Kansas and Delaware statutes are in sharp contrast to that of New York, which expressly grants inspection rights to beneficiaries of voting trusts. N.Y. BUS. CORP. LAW § 624(b) (McKinney 1963).

successive ten year extensions is no answer because any beneficiary can withdraw from the trust at any expiration date,<sup>77</sup> possibly making continuation of the trust pointless. In short, the effectiveness of the voting trust cannot be depended upon beyond any given ten year period. A pooling agreement, which has no maximum time limit in Kansas, seems preferable from this standpoint.

Finally, the presence of a voting trust may prevent a corporation from electing or maintaining special tax status as a "small business corporation" under Subchapter S of the *Internal Revenue Code*.<sup>78</sup>

### C. Shareholder Veto Provisions

Another method of securing minority control over the election of directors and other matters subject to shareholder action is the use of greater than normal quorum and vote requirements, commonly known as veto provisions. Thus, if unanimity is required for the election of directors a minority shareholder will have power to prevent the election of directors and can use this power to secure favorable representation on the board. While veto provisions have been held invalid in some states on public policy grounds because they were thought to violate the corporate norm of majority rule and because of the increased potential for deadlock,<sup>79</sup> the Code, continuing prior law,<sup>80</sup> has granted authority for such provisions in fairly broad terms.<sup>81</sup> Section 17-6002(b)(4) states that the articles of incorporation may contain provisions requiring that shareholder action be taken by the vote of a larger portion of stock than is otherwise required by the Code. Section 17-6506 provides that, subject to Code provisions stating the vote requirement for specified matters, the articles of incorporation or by-laws may specify the number of shares necessary to constitute a quorum and the number of votes necessary for the transaction of shareholder business.

The first question that arises regarding veto provisions is how high the vote requirement should be set; that is, should unanimity be required expressly or should the requirement be stated in percentage terms high enough

<sup>77</sup> KAN. STAT. ANN. § 17-6508(b) (1974) provides that "no such extension agreement shall affect the rights or obligations of persons not parties thereto."

<sup>78</sup> INT. REV. CODE OF 1954, §§ 1371-79 permit certain close corporations to elect a special tax status under which, in general, the corporation is not subject to tax and its income and losses are deemed to be the income and losses of its shareholders. To qualify for this special tax status the corporation must: (1) be a domestic corporation that is not a member of an affiliated group of corporations; (2) not have more than 10 shareholders; (3) not have as shareholders persons other than individuals or estates; (4) not have nonresident aliens as shareholders; and (5) not have more than one class of stock. *Id.* § 1371(a). The Treasury Regulations have interpreted requirement (3) as disqualifying any corporation whose shares are held by a trust, including a voting trust. Treas. Reg. § 1.1371-1(e) (1959). However, at least one court has refused to follow the Regulation to the extent that it fails to distinguish between "normal" trusts and voting trusts. *A & N Furniture & Appliance Co. v. United States*, 271 F. Supp. 40 (S.D. Ohio 1967).

<sup>79</sup> *E.g.*, *Benintendi v. Kenton Hotel*, 294 N.Y. 112, 60 N.E.2d 829 (1945). The increased potential for deadlock caused by veto provisions appears to be a very real danger. It has been suggested that the veto power be limited to the specific areas where it is essential to protect a legitimate business interest. 1 O'NEAL, *supra* note 13, § 4.24.

<sup>80</sup> Law of April 3, 1939, ch. 152, §§ 12G & 64, [1939] Kan. Sess. Laws 223, 241 (repealed 1972) (formerly codified at KAN. STAT. ANN. §§ 17-2803G, -3305 (1964)).

<sup>81</sup> KAN. STAT. ANN. §§ 17-6002(b)(4), -6506 (1974).

to give a minority shareholder the desired veto?<sup>82</sup> It is the opinion of one authority that a hostile court might declare a unanimity provision invalid under a statute authorizing requirements for the vote of a greater *proportion* of shares than otherwise required by law,<sup>83</sup> apparently on the ground that "proportion" means some percentage less than one hundred. While section 17-6506 speaks in terms of "the number of shares," section 17-6002(b)(4) authorizes "the vote of a larger *portion* of the stock" than normally required.<sup>84</sup> It therefore seems possible that unanimity provisions based on section 17-6002(b)(4) could be held invalid in Kansas. However, the Reporter for the Delaware revision committee has commented concerning section 102(b)(4) of the Delaware Law, which is virtually identical to section 17-6002(b)(4), that although the section does not speak directly to the issue of unanimity requirements, "the fact that the legislature has reaffirmed high vote requirements as a matter of policy should induce today's courts to cast aside the doubts expressed some 30 years ago and sustain a unanimous vote requirement."<sup>85</sup>

Against the possible invalidity of a unanimity provision one must balance possible dilution of the effectiveness of a high percentage vote requirement. For example, if a shareholder owns 30 percent of the issued and outstanding stock and the articles of incorporation require an affirmative vote of 75 percent of the shares for shareholder action, it may be possible for the corporation to issue enough additional shares so that the shareholder's position is diluted to 25 percent or less. To frustrate such a circumvention of a veto provision certain safeguards must be placed in the articles of incorporation. First, shareholders must be expressly given a preemptive right to subscribe to any additional issue of stock.<sup>86</sup> If there is authorized but unissued stock or treasury stock, preemptive rights alone will not afford sufficient protection both because of the many exceptions thereto<sup>87</sup> and because the shareholder may not possess sufficient liquid assets to exercise his rights. In such a case it may be necessary to include a clause in the articles of incorporation requiring shareholder consent to the issuance of any such stock and, of course, extending the veto provision to such shareholder action.<sup>88</sup> If all authorized shares are

<sup>82</sup> As a simple example, it is clear that a 75% vote requirement in effect would be a requirement for unanimity if the stock of a corporation were equally divided among three shareholders.

<sup>83</sup> I O'NEAL, *supra* note 13, § 4.27.

<sup>84</sup> Emphasis added.

<sup>85</sup> FOLK, *supra* note 45, at 13. For the doubts expressed "some 30 years ago" see *Sellers v. Joseph Bancroft & Sons Co.*, 23 Del. Ch. 13, 26, 2 A.2d 108, 114 (Ch. 1938).

<sup>86</sup> KAN. STAT. ANN. § 17-6002(b)(3) (1974) provides that no preemptive rights shall exist unless they are expressly granted in the articles of incorporation (this section is not retroactive). This is a change from prior law, which provided that preemptive rights existed unless they were limited or denied by the articles of incorporation. Law of April 3, 1939, ch. 152, § 12D, [1939] Kan. Sess. Laws 223 (repealed 1972) (formerly codified at KAN. STAT. ANN. § 17-2803D (1964)).

<sup>87</sup> Preemptive rights do not apply, for example, to stock issued for property, for personal services, in payment of a corporate debt, or in a merger or consolidation. See I O'NEAL, *supra* note 13, § 3.39.

<sup>88</sup> While the issuance of stock ordinarily is a function reserved to the directors, KAN. STAT. ANN. § 17-6411 (1974), presumably such a clause would be authorized by § 17-6301(a) which provides: "The business and affairs of every corporation shall be managed by a board of directors, except as may be otherwise provided in this act or in its articles of incorporation." See *id.* § 17-6002(b)(1). For a more detailed discussion of these sections see text at notes 141-56 *infra*.

issued and outstanding and the veto provision covers all shareholder action, the problem should not be as great because a shareholder vote would be necessary to amend the articles to increase the number of shares authorized.<sup>89</sup> The possibility of unavoidable absence from a meeting should also be recognized, and a high vote requirement should be reinforced by either a high quorum requirement or by explicitly providing that the high vote requirement refers to all issued and outstanding stock and not just that present or represented at a meeting.

Once a veto provision has been included in the articles of incorporation, a minority shareholder need not fear that the majority might later amend the articles to remove it. Section 17-6602(c)(4) states that when the articles provide for action by a greater than normal vote such provision may not be altered, amended, or repealed except by such greater vote. If the veto provision is included in only the by-laws pursuant to section 17-6506, it will be necessary to draft and include a provision similar to section 17-6602(c)(4). Obviously, it also is imperative that the articles not confer upon the directors power to make, alter, or repeal by-laws, unless a veto provision is operative at the board level.<sup>90</sup>

A vacancy in a directorship caused by death, resignation, or removal of a director creates additional hazards. Section 17-6513(a) states that unless the articles of incorporation provide otherwise, vacancies on the board and newly created directorships may be filled by a majority of the directors then in office.<sup>91</sup> Thus unless the power to fill vacancies is reserved to the shareholders by the articles of incorporation and the veto provision is made applicable to such shareholder action, minority representation on the board may be frustrated by a premature death or resignation. One may also wish to include a charter provision prohibiting board action until the vacancy has been filled.<sup>92</sup> The possibility of removal of a minority director by a majority shareholder

<sup>89</sup> KAN. STAT. ANN. §§ 17-6602(a)(3), (c)(1) (1974).

<sup>90</sup> Section 17-6009(a) provides that, after the original by-laws have been adopted, the power to make, alter, or repeal by-laws is vested in the shareholders unless the articles of incorporation confer that power on the directors. Again, this is the converse of the presumption created by prior law. See Law of April 9, 1941, ch. 182, § 7, [1941] Kan. Sess. Laws 273-74 (repealed 1972) (formerly codified at KAN. STAT. ANN. § 17-3107 (1964)). Note, however, that while the directors were given primary authority over by-laws by former § 17-3107, a concurrent authority was conferred upon shareholders to make, alter, or repeal by-laws or to override the action of the board. Since no such language is included in § 17-6009(a) it might be argued that if the articles of incorporation confer authority over by-laws upon the directors, such authority is *exclusive*, leaving no residual or concurrent authority in the shareholders. This difficult question appears to remain unresolved. See *Rogers v. Hill*, 289 U.S. 582 (1933); *Auer v. Dressel*, 306 N.Y. 427, 118 N.E.2d 590 (1954); *FOLK*, *supra* note 45, at 25-26; *cf.* *SEC v. Transamerica Corp.*, 163 F.2d 511 (3d Cir. 1947). *But see* *Somers v. AAA Temporary Servs., Inc.*, 5 Ill. App. 3d 931, 284 N.E.2d 462 (1972). It is submitted that shareholders should be held to have inherent authority over internal corporate guidelines, and that the legislature should have expressly recognized such inherent authority in § 17-6009(a) as it did in former § 17-3107. In the absence of such recognition, if the articles are to confer authority on the directors it would be prudent to expressly retain concurrent authority in the shareholders. For a discussion of director veto provisions see text at notes 157-70 *infra*.

<sup>91</sup> The same problem of exclusivity raised in note 90, *supra*, with respect to by-laws is also presented in § 17-6513(a). However, one Delaware case has held that use of the permissive term "may" in a similar statute does not deprive the shareholders of their inherent right to fill vacancies and newly created directorships. *Campbell v. Loew's, Inc.*, 36 Del. Ch. 563, 571, 134 A.2d 852, 857 (Ch. 1957).

<sup>92</sup> 1 O'NEAL, *supra* note 13, § 4.12.

vote presents similar problems. Such an eventuality may be guarded against by expressly extending the veto provision to removal actions.<sup>93</sup>

Some question may arise as to whether a shareholder veto provision is legally applicable to certain fundamental corporate acts such as amendment of the articles of incorporation,<sup>94</sup> merger or consolidation,<sup>95</sup> lease or transfer of all or substantially all the corporate assets,<sup>96</sup> or voluntary dissolution.<sup>97</sup> It will be noted that all these sections require a majority shareholder vote, and section 17-6506 provides that, "[s]ubject to the provisions of this act with respect to the vote that shall be required for a specified action," the articles of incorporation or by-laws may specify the requirements for quorums and voting.<sup>98</sup> However, section 17-6002(b)(4) permits the articles of incorporation to include "[p]rovisions requiring for any corporate action, the vote of a larger portion of the stock . . . than is required by this act."<sup>99</sup> While the question has not been authoritatively resolved in Kansas,<sup>100</sup> it is submitted that section 17-6002(b)(4) should control. The critical distinction between the two provisions is that section 17-6002(b)(4) authorizes *only* higher than normal vote requirements while section 17-6506 permits higher *or* lower than normal vote requirements. It appears that the "subject to" language in the latter section is directed principally to the problem of a merger, dissolution, or other fundamental corporate change being authorized by less than a majority of shares. In addition, these matters offer great potential for the "squeeze out" of a minority shareholder, and as a result are of vital importance to such a shareholder. Because of the clear language of section 17-6002(b)(4), a veto power over such matters should not be denied on the basis of section 17-6506.

It may also be possible to increase the effectiveness of a shareholder veto provision as a control device by extending it to some matters not ordinarily within the province of shareholder action. For example, under the Code a mortgage or pledge of corporate assets does not require shareholder approval unless the articles of incorporation so provide.<sup>101</sup> If desired, a shareholder veto over any such mortgage or pledge may be acquired simply by including in the articles a provision requiring shareholder approval and by drafting the veto provision broadly enough to cover such action. A more important concern of the minority shareholder may be selection of the officers who will carry on the day to day business of the corporation. Although selection of

<sup>93</sup> Application of Burkin, 1 N.Y.2d 570, 136 N.E.2d 862, 154 N.Y.S.2d 898 (1956). *But cf.* Campbell v. Loew's, Inc., 36 Del. Ch. 563, 573, 134 A.2d 852, 858 (Ch. 1957) (permitting removal for cause by majority vote of a director elected through cumulative voting).

<sup>94</sup> KAN. STAT. ANN. § 17-6602(c)(1) (1974).

<sup>95</sup> *Id.* § 17-6701(c).

<sup>96</sup> *Id.* § 17-6801(a).

<sup>97</sup> *Id.* § 17-6804(b).

<sup>98</sup> Emphasis added.

<sup>99</sup> Emphasis added.

<sup>100</sup> For the Delaware view see *Sellers v. Joseph Bancroft & Sons Co.*, 25 Del. Ch. 268, 17 A.2d 831 (Ch. 1941), 23 Del. Ch. 13, 2 A.2d 108 (Ch. 1938) (upholding a 75% vote requirement for certain amendments to the articles of incorporation).

<sup>101</sup> KAN. STAT. ANN. § 17-6802 (1974).

officers traditionally has been regarded as a director function, the Code provides that "[e]very corporation . . . shall have a president, secretary and treasurer, who shall be chosen as the bylaws may direct."<sup>102</sup> By the simple expedient of a by-law provision, officer selection thus may be transformed into a shareholder function to which a shareholder veto could apply.

Finally, it would be good practice to state, or at least conspicuously note the existence of, any shareholder veto provision on all stock certificates. While this is not expressly required by the Code, veto provisions are unusual, and a court might be unwilling to charge a good faith purchaser for value with constructive notice of their existence merely because they appear in the articles of incorporation or the by-laws.

#### D. *Different Classes of Stock*

A final major method for allocating control among shareholders, authorized by section 17-6401(a), is the use of two or more classes of stock with such voting rights—full, limited, or none—as may be provided in the articles of incorporation or in the resolution of the board of directors providing for the issuance of such stock (if such power is expressly conferred upon the board by the articles of incorporation).<sup>103</sup> This provision permits the draftsman considerable flexibility in the use of different classes of stock as a control device.

It is not uncommon for parties to want control over election of directors to be allocated in a manner disproportionate to their capital contributions. For example, two parties may each desire an equal voice in director elections, but one may have a significantly larger amount of capital to invest in the business than the other. Their desires can be accommodated by creating two classes of common stock identical in all respects except that each class is given the right to elect one of the two directors. The number of shares allocated to each party will be based upon his investment so that each will share proportionately in earnings and assets, yet each will have an equal voice in the election of directors. The permissibility of class voting for directors seems implicit in the broad language of section 17-6401(a),<sup>104</sup> and has been upheld

<sup>102</sup> *Id.* § 17-6302(a).

<sup>103</sup> Prior law expressly permitted a method of allocating voting control within a single class of stock by allowing a corporation's articles to include "[a] provision to the effect that no stockholder of the corporation shall ever own, or vote as owner or by proxy, or both, to exceed a certain percent of the capital stock of such corporation." Law of April 3, 1939, ch. 152, § 12E, [1939] Kan. Sess. Laws 223 (repealed 1972) (formerly codified at KAN. STAT. ANN. § 17-2803E (1964)). Thus, a minority shareholder might have been able to equalize his voting power with that of a majority shareholder by insisting that such a provision be included in the articles. However, this section has not been carried over into the new Code, and, accordingly, the continued validity of such provisions may be in doubt. Moreover, the efficacy of such a device depended upon an effective restriction on transfer of the majority shareholder's stock. Otherwise, a restriction on the percentage of outstanding stock that could be voted by one person could be circumvented by transfers of portions of his stock to family members or others who would vote sympathetically. Logan, *supra* note 20, at 409-10.

<sup>104</sup> KAN. STAT. ANN. § 17-6401(a) (1974) provides that different classes of stock may be given "such designations, preferences and relative, participating, optional or other special rights, and qualifications, limitations or restrictions thereof, as shall be stated and expressed in the articles of incorporation . . . ."

in Delaware under a similarly worded statute.<sup>105</sup> It might be argued that section 17-6301(d), which provides for classification of directors into not more than three classes with staggered terms, constitutes the exclusive method of classifying directors since it is the only section of the Code that expressly refers to classification. It is submitted, however, that such an interpretation would be incorrect, because there is no reason why a particular class of stock should not be given the exclusive right to elect a certain number of directors.<sup>106</sup> Actually, such class voting seems entirely consistent with the legislative purpose of providing for minority representation on the board of directors.

The possibility that the holders of a majority of the aggregate amount of stock outstanding might amend the articles of incorporation to eliminate class voting for directors must be contemplated. The Code provides that a corporation's articles may be amended by the affirmative vote of a majority of the outstanding stock entitled to vote thereon and a majority of the outstanding stock of each class entitled to vote thereon as a class.<sup>107</sup> The question whether stock is entitled to vote, or vote as a class, ordinarily is determined by reference to the articles of incorporation. However, the Code further provides that, whether or not the holders of a particular class of stock would be entitled to vote as a class under the articles, they shall be so entitled "if the amendment would increase or decrease the aggregate number of authorized shares of such class, increase or decrease the par value of the shares of such class, or alter or change the powers, preferences or special rights of the shares of such class so as to affect them adversely."<sup>108</sup> Thus class voting would be required in amending the articles to eliminate class voting for directors. For additional protection it may be desirable to expressly make any amendment of the articles of incorporation the subject of class voting. Finally, the articles should not contain a clause permitting an increase in the number of authorized shares of a particular class by a simple majority vote.<sup>109</sup> Under such a clause the holders of a majority of the aggregate amount of shares outstanding could nullify the minority's representation on the board by increasing the number of authorized shares of the class held by the minority and causing a sufficient number of such additional shares to be issued to themselves to give them a majority position within that class of stock.<sup>110</sup>

The same danger may be present if there exists previously authorized but unissued stock in the class that has been allocated to the minority. In such a case it may be necessary to make the issuance of stock subject to share-

---

<sup>105</sup> See *Lehrman v. Cohen*, 43 Del. Ch. 222, 222 A.2d 800 (Sup. Ct. 1966).

<sup>106</sup> See 1 O'NEAL, *supra* note 13, § 3.23 n.2.

<sup>107</sup> KAN. STAT. ANN. § 17-6602(c)(1) (1974).

<sup>108</sup> *Id.* § 17-6602(c)(2).

<sup>109</sup> *Id.* Such a provision may be included in the original articles of incorporation. If not so included, it may be inserted thereafter only by the affirmative vote of a majority of shares of the class or classes that would be affected.

<sup>110</sup> Preemptive rights may not afford sufficient protection against such a scheme. See notes 86, 87 and accompanying text *supra*.

holder consent and to extend class voting to such shareholder action.<sup>111</sup> The simplest way to avoid this problem is to make certain at the outset that no more stock is authorized than will be issued.

Another possible method to circumvent or frustrate minority representation is to increase the size of the board of directors. The Code provides that the number of directors shall be fixed by, or as provided in, the by-laws, unless the number of directors is fixed by the articles of incorporation, in which event any change in the number of directors can be made only by amending the articles.<sup>112</sup> The danger that the size of the board will be increased is magnified if the directors have been given authority to make, alter, or repeal by-laws.<sup>113</sup> One solution to this problem would be to fix the number of directors in the articles and to extend class voting to all amendments of the articles. Another approach would be to specify the representation of each class in terms of a fractional portion of the entire board (such as "one-half") rather than in absolute numbers (such as "two").

It should be recognized that class voting for directors may not protect a minority shareholder from certain slightly more sophisticated "squeeze outs" that may be accomplished by means of a merger, consolidation, sale of assets, or dissolution followed by reincorporation.<sup>114</sup> The Code does not seem to recognize class voting in the context of such fundamental corporate changes; the shareholder vote requirement is consistently phrased as "a majority of the outstanding stock of the corporation entitled to vote thereon."<sup>115</sup> The best solutions would probably be either a high vote requirement<sup>116</sup> or a limitation or denial of the majority's voting rights.<sup>117</sup>

As previously noted, the Code authorizes stock with full, limited, or no voting rights. Theoretically, limited voting or nonvoting stock may be either common or preferred. However, if common is used, subsequent sales to outsiders may not be permitted by the State securities commissioner, presumably on the ground that such stock would not have the protection of preferential rights as to earnings and assets.<sup>118</sup> Therefore, if future public issues are rea-

<sup>111</sup> See note 88 and accompanying text *supra* and text at notes 141-56 *infra*.

<sup>112</sup> KAN. STAT. ANN. § 17-6301(b) (1974).

<sup>113</sup> See *id.* § 17-6009(a).

<sup>114</sup> See F. O'NEAL & J. DERWIN, EXPULSION OR OPPRESSION OF BUSINESS ASSOCIATES—"SQUEEZE-OUTS" IN SMALL ENTERPRISES §§ 4.05-.11 (1961).

<sup>115</sup> KAN. STAT. ANN. §§ 17-6701(c), -6801(a), -6804(b), (1974).

<sup>116</sup> See text at notes 79-102 *supra*.

<sup>117</sup> While this latter method theoretically may be possible, it seems unlikely that majority shareholders would be willing to place the absolute power of decision with respect to such fundamental corporate changes in the hands of the minority. A high vote requirement, on the other hand, would not give the minority an affirmative power to effectuate a change against the wishes of the majority, but rather, only a negative power to block changes which the minority felt were undesirable. The difference between an affirmative and a negative power in the hands of the minority would appear to be significant from the viewpoint of the majority.

<sup>118</sup> The Regulations under the Kansas Securities Act provide:

The securities commissioner will look with disfavor upon any application for registration of securities as not being in the public interest and tending to work a fraud on investors, or resulting in unreasonable or inequitable underwriters' or promoters' profits or participation, unless the following requirements are met, or good cause is shown for an exception:

(K) *Nonvoting Common Stock*:



sonably foreseeable, control allocation may have to be accomplished on the basis of voting common and nonvoting or limited voting preferred.

Aside from this problem, seemingly the only limit upon allocation of control through the use of limited voting stock or nonvoting stock is the draftsman's imagination. For example, if one party is to contribute capital but is not to be active in the business and another has little capital but will contribute services, and the parties agree that the latter, because of his experience, should have control over normal operations of the business, their desires can be accommodated by means of a capital structure consisting of both common and preferred stock. Common stock with a low par value could be issued to the party primarily contributing services, and cumulative preferred stock could be issued to the inactive party contributing capital.<sup>119</sup> Each will reap a return on his investment, the former probably by way of salary and the latter by way of dividends. A liquidation preference for the latter also seems warranted because of his greater capital investment. If the preferred shareholder desires additional protection, he could be given limited voting rights. It has become common to provide that if preferred dividends are in arrears for a specified number of years, the preferred stock will have voting rights on an equal basis with, or sometimes to the exclusion of, the common stock. It might also be provided that while preferred stock normally will not have the right to vote for directors, it will have voting rights with respect to fundamental corporate changes. Where control will lie in regard to such matters can be determined by the respective par values of the two classes of stock and, accordingly, the number of shares that will be issued for a given consideration.

Another common situation is for parties making unequal capital contributions to desire an equal voice in matters properly the subject of shareholder action. Again, their needs may be accommodated by use of voting and nonvoting stock. One class of voting stock with relatively few authorized shares and low par value can be allocated equally among the parties. A second class of nonvoting stock, which will represent the bulk of each party's investment, can be allocated among them in accordance with the capital contribution of each. The total of each shareholder's voting and nonvoting stock will then equal the amount of his capital contribution. Thus an arrangement roughly approximating a partnership will be created under which each party will have an equal voice in the election of directors and other shareholder matters but will share in corporate assets in proportion to his capital investment.

All these arrangements are permissible under the Code and represent no change from prior law. The chief advantage of using different classes of

---

Securities of an issuer having more than one class of common stock must ordinarily provide equal voting rights upon all matters, including the election of members to the board of directors.

KAN. ADMIN. REG. art. 81-7-1(K) (Supp. 1972).

<sup>119</sup> For a scholarly and detailed discussion of this type of situation see Herwitz, *Allocation of Stock Between Services and Capital in the Organization of a Close Corporation*, 75 HARV. L. REV. 1098, 1118-24 (1962).

stock as a shareholder control device is that it creates a relatively permanent arrangement, an advantage that often cannot be attained by shareholder pooling agreements and voting trusts. The primary disadvantage is that eligibility to be taxed under Subchapter S usually will be lost.<sup>120</sup> Furthermore, as a practical matter, the stock classification probably must be imposed either upon incorporation, or thereafter only by unanimous consent.<sup>121</sup> Finally, it should be noted that if the corporation is authorized to issue more than one class of stock, the Code requires that each stock certificate state or summarize the rights, privileges, and restrictions of the class to which it belongs, or, in lieu thereof, state that the corporation will furnish the same free of charge to any shareholder who so requests.<sup>122</sup>

## II. CONTROL OVER DIRECTOR ACTION

Although control over shareholder action is important, it usually will not be sufficient to meet the needs of active participants in a closely-held corporation. Their ultimate goal in most cases is to secure a salaried position with the corporation and to maintain control over management of its everyday business. To attain these objectives it is usually desirable to employ one or more devices that limit the freedom of action of the majority of the board of directors, since the power to manage the corporation's business is vested primarily in the board.<sup>123</sup> Without limits on the majority, minority representation on the board may be relegated to the status of perennial dissent from policies adopted by the majority.

### A. Direct Restriction of Discretion

The simplest and most direct way to control action by the board of directors is to provide in the articles of incorporation, by-laws, or shareholders' agreement, specific restrictions on action taken by the board. Such direct restrictions, however, have been viewed with hostility by many courts in the past.<sup>124</sup> Perhaps the best known example of hostile judicial treatment is the case of *McQuade v. Stoneham*,<sup>125</sup> which involved an agreement among three shareholders who together owned 1,306 of the 2,500 shares of a corporation's issued and outstanding stock. The agreement provided: (1) that each party would use his best efforts to continue the others as both directors and officers

<sup>120</sup> INT. REV. CODE OF 1954, § 1371(a)(4) (requiring not more than one class of stock). An exception to the single class of stock requirement that may apply in certain cases of class voting for directors is contained in Treas. Reg. § 1.1371-1(g) (1959), which provides: "[I]f two or more groups of shares are identical in every respect except that each group has the right to elect members of the board of directors in a number proportionate to the number of shares in each group, they are considered one class of stock."

<sup>121</sup> See Logan, *supra* note 20, at 409, for a discussion of the fiduciary obligations of majority shareholders in this context.

<sup>122</sup> KAN. STAT. ANN. § 17-6401(f) (1974).

<sup>123</sup> *Id.* § 17-6301(a).

<sup>124</sup> *E.g.*, West v. Camden, 135 U.S. 507 (1890); Teich v. Kaufman, 174 Ill. App. 306 (1912); Odman v. Oleson, 319 Mass. 24, 64 N.E.2d 439 (1946); Jackson v. Hooper, 76 N.J. Eq. 592, 75 A. 568 (Ct. Err. & App. 1910); Dubbs v. Kramer, 302 Pa. 455, 153 A. 733 (1931).

<sup>125</sup> 263 N.Y. 323, 189 N.E. 234 (1934).

of the corporation; (2) that no salaries would be paid to any of the parties except as specified in the agreement; and (3) that there would be no change in salaries, amount of capital, number of shares, by-laws, or any matters regarding business policy except upon the unanimous consent of the parties to the agreement. The agreement worked smoothly for nine years, but then one of the parties was ousted from his positions as director and treasurer. Upon his suit to enforce the agreement, the New York Court of Appeals held that it was illegal and void because it violated the statutory corporate norm that the business and affairs of a corporation are to be managed by its board of directors. The court stated that "stockholders may not, by agreement among themselves, control the directors in the exercise of the judgment vested in them by virtue of their office to elect officers and fix salaries."<sup>126</sup> While recognizing that shareholders may unite in exercising their voting power, the court felt, "The power to unite is, however, limited to the election of directors and is not extended to contracts whereby limitations are placed on the power of directors to manage the business of the corporation by the selection of agents at defined salaries."<sup>127</sup> Since the possibility of personal liability for breach of such an agreement would tend to inhibit the free exercise of directorial discretion on behalf of all shareholders, the agreement was held null and void.

Kansas, however, has not adopted the restrictive approach illustrated by *McQuade*. The leading case of *Peck v. Horst*<sup>128</sup> involved a voting trust and management agreement entered into by the two holders of all the corporation's issued and outstanding stock. The agreement provided, among other things, that the trustees were to elect directors and officers, determine corporate policies, hire and discharge employees and fix their salaries, declare dividends, amend by-laws, enter into contracts, and, in general, do all things necessary for the operation of the corporation. One of the parties sued to set the agreement aside, contending, among other things, that it violated the statutory norm of corporate management by the board of directors. The court upheld the agreement, basing its decision upon the principle of waiver. In answer to the plaintiff's contention that an agreement that contravened the express provisions of the corporation code violated public policy, the court noted that statutes may be divided into two categories—those that seek to protect the rights of the public generally and those that seek to protect the rights of certain individuals. If a statute is of the latter variety, an individual in the class sought to be protected may voluntarily waive his rights. After noting that the parties to the agreement owned all the stock of the corporation, the court concluded:

---

<sup>126</sup> *Id.* at 328, 189 N.E. at 236.

<sup>127</sup> *Id.*

<sup>128</sup> 175 Kan. 479, 264 P.2d 888 (1953), *aff'd on rehearing*, 176 Kan. 581, 272 P.2d 1061 (1954) (two judges dissenting).

We have examined the various statutes plaintiff argues this contract violated. They are all statutes providing the manner in which the business of a corporation should be carried on. They are designed to regulate the internal affairs of corporations. We find no particular in which the interest of the public is jeopardized by this contract. There is no change in liability of the corporation to third parties. . . . [The] parties to this contract when they entered into it waived the application of the statutes relied on by plaintiff.<sup>129</sup>

The most troubling question about *Peck* is the extent to which unanimous shareholder participation in the agreement influenced the result. This point was stressed repeatedly in the defendant-appellee's brief,<sup>130</sup> but was mentioned only in passing by the court.<sup>131</sup> Because *Peck* was decided on the basis of waiver, as opposed to a finding by the court that the agreement was "legal,"<sup>132</sup> the answer may depend upon the identity of the party attacking the agreement. That is, if the litigant seeking to avoid the agreement is a party to it, he may be held to have waived the statutory norm of management by the board regardless of whether there are shareholders who are not parties to the agreement. The existence of nonparticipating shareholders is irrelevant to the theory of waiver, and the possibility of injury or harm to such shareholders should not be infused into the case since they are not complaining.<sup>133</sup> If the agreement is attacked by a shareholder who is not a party to it, the waiver theory is inapplicable, and to this extent unanimous participation is important.

The theory of unrestricted directional discretion may be both valid and necessary in the context of a public corporation, but it is often a myth in the context of a close corporation. By means of a pooling agreement or voting trust the holders of a majority of the outstanding shares can elect a majority of the directors, and such directors will be either the majority shareholders themselves or persons dominated by them. An agreement that restricts their discretion as directors often will be no different in practical effect *with respect to minority shareholders* than informal concerted action.<sup>134</sup> The chief practical difference between a formal agreement and informal concerted action relates only to the parties to the agreement, for if it is enforceable they may not avoid the obligations of their bargain at will. If the agreement works a fraud or oppression on nonparty minority shareholders, it should be invalidated at their behest, but, under the evolving fiduciary obligations of controlling shareholders, the same result should be reached even absent a formal agreement.<sup>135</sup> Nevertheless, because of the absence of any Kansas authority directly in point, the draftsman must continue to be wary of agreements that restrict the discretion of directors when there is less than unanimous shareholder participation.

<sup>129</sup> 175 Kan. at 487, 264 P.2d at 894.

<sup>130</sup> Brief for Appellee at 7, 11, 30-32, 35, *Peck v. Horst*, 175 Kan. 479, 264 P.2d 888 (1953).

<sup>131</sup> 175 Kan. at 487, 264 P.2d at 893-94.

<sup>132</sup> See *Galler v. Galler*, 32 Ill. 2d 16, 203 N.E.2d 577 (1964).

<sup>133</sup> *Faulds v. Yates*, 57 Ill. 416, 421 (1870); *Ringuet v. Bergeron*, 24 D.L.R.2d 449, 459 (1960).

<sup>134</sup> See *Meck, Employment of Corporate Executives by Majority Stockholders*, 47 YALE L.J. 1079, 1083 (1938); cf. *Thisted v. Tower Management Corp.*, 147 Mont. 1, 14, 409 P.2d 813, 820 (1966).

<sup>135</sup> See *Zahn v. Transamerica Corp.*, 162 F.2d 36 (3d Cir. 1947); *Jones v. H.F. Ahmanson & Co.*, 1 Cal. 2d 93, 460 P.2d 464, 81 Cal. Rptr. 592 (1969).

A question may be raised regarding the extent to which *Peck* remains viable under the new Code. The first provision that could raise such a question is section 17-6301(a), which provides that: "The business and affairs of every corporation shall be managed by a board of directors, except as may be otherwise provided in this act or in its articles of incorporation." It might be argued that any deviation from the strict norm of free and unrestricted management by the board must be accomplished by a provision in the articles and not by a private agreement. While this argument may appeal to logic when viewed in the abstract, it loses much of its force when it is recognized that a statute with substantially similar language was in effect at the time *Peck* was decided.<sup>136</sup> The issue was not briefed in *Peck*, but the statute was quoted to the court.<sup>137</sup>

A second argument relates to sections 17-7210 and 17-7211. These sections authorize not only agreements that restrict the discretion of directors but even complete abolition of the board pursuant to a provision in the articles of incorporation. They apply only to corporations that meet special statutory qualifications and elect to be treated as "close corporations." Therefore, it could be argued that these sections evidence a legislative intent to preempt the field, leaving no room for *Peck* type agreements with respect to corporations that either do not qualify or do not elect to be treated as statutory close corporations. This argument should be rejected on the basis of section 17-7216 which states: "The provisions of K.S.A. 1972 Supp. 17-7201 to 17-7215, inclusive, and any amendments thereto shall not be deemed to repeal any statute or rule of law which is or would be applicable to any corporation which is organized under the provisions of this act, but which is not a close corporation."<sup>138</sup> The Reporter for the Delaware Law has commented, regarding a substantially similar provision contained therein,<sup>139</sup> that this savings clause was intended to negate the possible implication that the special close corporation article renders inapplicable prior permissive case law with respect to corporations not governed thereunder.<sup>140</sup> Therefore, it should be concluded that *Peck v. Horst* retains its vitality in spite of the special provisions for statutory close corporations.

As previously noted, section 17-6301(a) provides for management of a corporation by its board of directors "except as may be otherwise provided in [the] act or in its articles of incorporation." On its face, this broad language seems to authorize a provision in the articles substantially restricting director discretion or, indeed, even completely abolishing the board, unless such a

---

<sup>136</sup> Law of April 9, 1941, ch. 182, § 5, [1941] Kan. Sess. Laws 272-73 (repealed 1972) (formerly codified at KAN. STAT. ANN. § 17-3101 (1964)).

<sup>137</sup> Brief for Appellee at 13-14, *Peck v. Horst*, 175 Kan. 479, 264 P.2d 888 (1953).

<sup>138</sup> Emphasis added.

<sup>139</sup> DEL. CODE ANN. tit. 8, § 356 (Cum. Supp. 1968).

<sup>140</sup> FOLK, *supra* note 45, at 528.

clause would not be properly includible in the articles.<sup>141</sup> Section 17-6002 (b)(1) provides that the articles may include: "Any provision for the management of the business and for the conduct of the affairs of the corporation, and any provision creating, defining, limiting and regulating . . . the powers of the corporation, the directors and the stockholders . . . if such provisions are not contrary to the laws of this state." Although these sections of the Code are substantially similar to prior law,<sup>142</sup> there is no Kansas case law construing them with respect to the issue considered here.

The Delaware Law (both prior and present) is virtually identical to the corresponding sections of the Kansas statute (both prior and present).<sup>143</sup> Unfortunately, the Delaware cases are inconclusive. Many involve the extent to which corporate common-law rules that had not been codified could be altered under the prior Delaware equivalent to section 17-6002(b)(1).<sup>144</sup> The general Delaware rule that emerges seems to be that optional provisions in the articles will be upheld unless they "transgress a statutory enactment or a public policy settled by the common law or implicit in the *General Corporation Law* itself."<sup>145</sup> However, none of these cases involved clauses which attempted to restrict board discretion.

Two Delaware cases merit consideration because they involved the prior Delaware counterpart to the section 17-6301(a) exception to management by the board of directors. In *Lehrman v. Cohen*,<sup>146</sup> each of two families owned a class of stock, each class being entitled to elect two of the four directors. In order to avoid deadlocks at the board level the families unanimously agreed to create a third class of stock having only one share, which would be held by their corporate counsel and be entitled to elect a fifth director. Later, one faction challenged the device on the ground, among others, that it illegally permitted the four original directors to delegate their discretion to the fifth director, who acted as an arbitrator. The court, after finding a proper purpose, upheld the third class of stock, stating: "The . . . arrangement was created by the unanimous action of the stockholders of

<sup>141</sup> Section 35 of the Model Business Corporation Act, as amended in 1969, contains language substantially identical to that of § 17-6301(a). According to the American Bar Association's Committee on Corporate Laws the exception was added to: "permit close corporations to do under the law what they have been commonly doing in practice. The generality of the provision permits almost complete flexibility in patterns of management that can be tailored to specific needs, with imposition of such controls as may be desired in individual cases." ABA-ALI MODEL BUS. CORP. ACT § 35, Comment (1969).

<sup>142</sup> Law of April 3, 1939, ch. 152, § 12B, [1939] Kan. Sess. Laws 222-23 and Law of April 9, 1941, ch. 182, § 5, [1941] Kan. Sess. Laws 272-73 (repealed 1972) (formerly codified at KAN. STAT. ANN. §§ 17-2803B, -3101 (1964)).

<sup>143</sup> DEL. CODE ANN. tit. 8, §§ 102(b)(1), 141(a) (Cum. Supp. 1968); DEL. CODE OF 1953 tit. 8, §§ 102(b)(1), 141(a) (repealed 1967).

<sup>144</sup> State *ex rel.* Cochran v. Penn-Beaver Oil Co., 34 Del. 81, 143 A. 257 (1926); Kaufman v. Shoenberg, 33 Del. Ch. 211, 91 A.2d 786 (Ch. 1952); Martin Foundation, Inc., v. North American Rayon Corp., 31 Del. Ch. 195, 68 A.2d 313 (Ch. 1949); Butler v. New Keystone Copper Co., 10 Del. Ch. 371, 93 A. 380 (Ch. 1915).

<sup>145</sup> Sterling v. Mayflower Hotel Corp., 33 Del. Ch. 293, 314, 93 A.2d 107, 118 (Sup. Ct. 1952); *accord*, Frankel v. Donovan, 35 Del. Ch. 433, 120 A.2d 311 (Ch. 1956). In passing upon a provision that limited inspection rights to shareholders holding 25% or more of a class of stock, a Delaware court has stated that "a charter provision which seeks to waive a statutory right or requirement is unenforceable." Loew's Theatres, Inc. v. Commercial Credit Co., 243 A.2d 78, 81 (Del. Ch. 1968).

<sup>146</sup> 43 Del. Ch. 222, 222 A.2d 800 (Sup. Ct. 1966).

the Company by amendment to the certificate of incorporation. The stockholders thereby provided how the business of the corporation is to be managed, as is their privilege and right under § 141(a)."<sup>147</sup> Although the device challenged in *Lehrman* did not involve great deviation from the norm of management by the board, the case has been interpreted by one commentator as recognizing "the power of stockholders to establish any type of internal corporate structure they desire so long as it does not violate some other statutory provision or public policy."<sup>148</sup> Moreover, dictum in *Mayer v. Adams*<sup>149</sup> implies that the articles of incorporation may vest managerial powers in the shareholders or even completely abolish the board of directors.

The paucity of case law interpreting the scope of permissible restrictions on director discretion under section 17-6301(a) and its predecessors may be the result of a vicious circle—draftsmen have been wary of utilizing the exception granted by the statute in the absence of interpretive decisions, and because the exception has not been utilized to any great extent, its scope has not been litigated. Much of the hesitancy in this area seems unfounded. *Peck v. Horst* established that the public has no great interest that will be infringed if corporate directors are given less than unrestricted freedom of action. It cannot be argued that restrictions contained in the articles of incorporation violate the express requirements of the Code, because the Code itself establishes the exception. Moreover, the language of section 17-6301(a) seems to contemplate restrictions on the discretion of directors or transfer of at least some of their functions to others.<sup>150</sup>

The most serious problem appears to relate to the time when the provision is inserted in the articles and the circumstances attendant upon the insertion. If the articles of incorporation constitute a contract between the corporation and the shareholders and among the shareholders *inter se*,<sup>151</sup> and if the provision is included in the original articles, there should be no problem with respect to the original shareholders. All would be parties to the "contract," and the waiver principles of *Peck* would apply. The provision should also bind persons who subsequently become shareholders, since new shareholders are presumed to enter the "contract" with knowledge of its terms and are bound by them.<sup>152</sup> However, as a restriction on director discretion would be an exception to the general rule of management by an unrestricted board of directors, it is conceivable that a court might not impute knowledge of

<sup>147</sup> *Id.* at 234, 222 A.2d at 808.

<sup>148</sup> *FOLK*, *supra* note 45, at 54.

<sup>149</sup> 36 Del. Ch. 466, 470, 133 A.2d 138, 140 (Ch. 1957).

<sup>150</sup> The last sentence of § 17-6301(a) states: "If any such provision [restricting or removing the management powers of directors] is made in the articles of incorporation, the powers and duties conferred or imposed upon the board of directors, by this act shall be exercised or performed to such extent and by such person or persons as shall be provided in the articles of incorporation."

<sup>151</sup> H. HENN, *HANDBOOK OF THE LAW OF CORPORATIONS AND OTHER BUSINESS ENTERPRISES* § 340, at 696 (2d ed. 1970).

<sup>152</sup> *E.g.*, *Rogers v. Mountain States Royalties, Inc.*, 116 Colo. 455, 182 P.2d 142 (1947); *Kreicker v. Naylor Pipe Co.*, 374 Ill. 364, 29 N.E.2d 502 (1940), *aff'd*, 312 U.S. 659 (1941).

the restriction to new shareholders and hold them bound merely because the restriction was contained in the articles. Therefore, it would be prudent to clearly state or summarize the provision on all stock certificates. This would give added force to the argument that new shareholders purchased their stock with notice of the restriction and thus waived the general rule.

Whether a simple majority could amend the articles to include such a provision over the objection of the minority and effectively bind the minority to such a scheme of operation is unclear. The waiver principles of *Peck* would not apply to a dissenting minority shareholder unless it could be argued that by becoming a shareholder he agreed to be bound by amendments to the articles adopted by the majority.<sup>153</sup> The extent to which courts will give the exception in section 17-6301(a) force and effect independent of the waiver theory remains an open question. Two sections of the special article on statutory close corporations may provide assistance by way of analogy. Section 17-7210 provides that an agreement among the holders of a majority of the outstanding stock of a corporation will not be invalid, *as between the parties*, on the ground that it restricts the discretion of the board of directors. It seems clear that this section leaves the agreement open to attack by nonparties, and, it is submitted, merely represents a codification of *Peck* applicable in a special context. Section 17-7211 states that the articles of incorporation may, in effect, abolish the board of directors and provide for direct management of the corporation by the shareholders. An amendment to the articles to include such a provision, however, must be adopted by a *unanimous* vote of all stock, including nonvoting stock.<sup>154</sup> The unanimous vote requirement presumably was included to protect minority interests that otherwise would be bound by the amendment, and, it is submitted, the same principle should apply to provisions limiting board discretion under section 17-6301(a). On the other hand, it could be argued that in the absence of limiting language in section 17-6301(a) itself, the general rule that a majority may amend the articles of incorporation<sup>155</sup> should apply. Such a view would give unwarranted and perhaps unrealistic weight to a supposed purposeful legislative determination underlying the absence of a unanimity requirement in section 17-6301(a). It is submitted that counsel should be aware of a real danger of successful attack by a dissenting minority shareholder if an amendment to the articles limiting board discretion is adopted by less than a unanimous vote.

As with all control devices, the possibility of circumvention by the other parties must be recognized. If it is carefully drafted, a provision in the articles of incorporation restricting director action should be immune from most methods of circumvention. Additionally, a high vote requirement for amend-

<sup>153</sup> *Cf.* *Tu-Vu Drive-In Corp. v. Ashkins*, 61 Cal. 2d 283, 391 P.2d 828, 38 Cal. Rptr. 348 (1964).

<sup>154</sup> KAN. STAT. ANN. § 17-7211 (1974).

<sup>155</sup> *Id.* § 17-6602(c)(1).



ments to the articles or some other shareholder voting control device should be included to prevent a direct attack in the form of a resolution to repeal.<sup>156</sup>

### B. *Director Veto Provisions*

A more indirect method of restricting director action, and the counterpart of the shareholder veto provision, is the director veto provision. In general, section 17-6301(b) of the Code provides that a majority of the total number of directors will constitute a quorum and that action may be taken by the vote of a majority at a meeting at which a quorum is present. However, that section also states that either the articles of incorporation or the by-laws may provide for greater-than-majority quorum and vote requirements.<sup>157</sup> Section 17-6002(b)(4) states that the articles of incorporation may require the vote of a larger number of directors than otherwise is required by the Code. There thus appears to be clear statutory authority for provisions that would give a minority representative on the board a veto over director action. Of course, for such provisions to be effective they must be coupled with a control device operative at the shareholder level to insure representation on the board.

The problems involved here are similar to those encountered in connection with shareholder veto provisions. A high vote requirement either should be buttressed by a high quorum requirement or should be drafted to state unambiguously that the specified high vote relates to the total number of directors rather than merely those present at a given meeting. The latter may be preferable in light of the New York case of *Gearing v. Kelly*,<sup>158</sup> which held that a shareholder was estopped from complaining of the validity of action taken at a board meeting intentionally boycotted by her nominee solely to prevent the presence of a quorum. In addition, it is obvious that a director veto provision will protect minority interests only so long as the minority representative continues on the board. It is necessary, therefore, to make adequate provision for the contingencies of removal, resignation, or death of the minority director. As noted previously, such contingencies may be provided for by reserving to shareholders the power to fill vacancies and coupling the reservation with a shareholder control device.<sup>159</sup>

An increase in the size of the board of directors may cause a related problem. For example, a veto provision, rather than being drafted in terms of unanimity, may be stated as a fraction of the total number of directors large enough to give a minority director a veto power in practical effect. In such a case the veto power may be rendered nugatory if the total number of

---

<sup>156</sup> See text at notes 79-102 *supra*. But cf. KAN. STAT. ANN. § 17-7211 (1974), which expressly provides that an amendment to delete a clause providing for direct shareholder management is to be adopted by the vote of a majority of the outstanding stock, including nonvoting stock.

<sup>157</sup> Section 17-6301(b) also states that, absent a contrary provision in the articles, the by-laws may provide that less than a majority, but not less than one-third of the total number of directors, will constitute a quorum.

<sup>158</sup> 11 N.Y.2d 201, 182 N.E.2d 391, 227 N.Y.S.2d 897 (1962). But see *Campbell v. Loew's, Inc.*, 36 Del. Ch. 563, 134 A.2d 852 (Ch. 1957).

<sup>159</sup> See text at notes 79-102 *supra*.

directors is increased. Section 17-6301(b) provides that the number of directors shall be fixed by, or in the manner provided in, the by-laws, unless the number of directors is fixed by the articles of incorporation, in which case a change in number may be accomplished only by amending the articles. The Code thus gives rise to three different possible situations.

First, if the number of directors is fixed in the by-laws, a change in number may be made only by amending the by-laws. If the articles of incorporation do not vest power to amend by-laws in the directors, it remains in the shareholders,<sup>160</sup> and it will be necessary to utilize some form of shareholder control device to prevent an unwanted increase in board size. If the articles of incorporation do grant power to amend by-laws to the directors, the veto provision itself, if properly drafted, should prevent an increase in the number of directors. However, because of the unresolved question of the extent to which shareholders retain concurrent power over by-laws,<sup>161</sup> it would be prudent to include a shareholder control device applicable to by-law amendments even in this case.

Secondly, the number of directors may be fixed in the manner provided in the by-laws. This provision of the Code seems to contemplate a by-law provision granting the right to determine the number of directors to some person or group other than the shareholders or whole board of directors. Such a provision would be extremely dangerous because it would create the possibility of an increase in board size that could not be blocked by the minority. It should never be used where minority protection is sought by means of a director veto provision.

Thirdly, if the number of directors is fixed by the articles of incorporation, a change in the number of directors may be made only by an amendment to the articles. Since the Code provides that the first step in amending the articles is an affirmative resolution of the board of directors,<sup>162</sup> a veto provision operative at the director level may be sufficient to block such a change at its initial stage. However, amendments to the articles of incorporation may be thought to be primarily a shareholder function. To guard against the possibility that a court might hold a director veto provision, in this context, an overly nice procedural technicality that would thwart shareholder democracy,<sup>163</sup> a shareholder control device should be used in this case too.

A direct attack on the veto provision in the form of an amendment to repeal it must also be contemplated. The issues involved and the solutions are substantially similar to those just discussed with respect to amendments to increase the number of directors. Section 17-6602(c)(4) provides additional protection if the veto provision is included in the articles of incorporation. It states that if "the articles of incorporation shall require for action by the

<sup>160</sup> KAN. STAT. ANN. § 17-6009(a) (1974).

<sup>161</sup> See note 90 *supra*.

<sup>162</sup> KAN. STAT. ANN. § 17-6602(c)(1) (1974).

<sup>163</sup> *Cf. SEC v. Transamerica Corp.*, 163 F.2d 511 (3d Cir. 1947).

board of directors . . . the vote of a greater number . . . than is required by any section of this act, the provision of the articles of incorporation requiring such greater vote shall not be altered, amended or repealed except by such greater vote.”

As with shareholder veto provisions, it should be possible to extend a director veto to virtually all phases of director action, including fundamental corporate changes. The Code provisions governing amendment of the articles of incorporation,<sup>164</sup> merger,<sup>165</sup> and sale of all or substantially all the corporate assets<sup>166</sup> do not require approval by a specified percentage of the directors, but rather speak only in terms of a resolution adopted by the board of directors. Although the section governing voluntary dissolution specifies the vote of a “majority of the whole board,”<sup>167</sup> the permission granted by section 17-6002 (b)(4) to include in the articles of incorporation higher voting provisions than those required by the Code should be held controlling.<sup>168</sup> Thus a director veto provision should be included in the articles as well as the by-laws.

Section 17-6301(c) provides that a majority of the whole board may appoint one or more directors to committees, and that, with certain exceptions, such committees may be given the complete authority of the board to manage the corporation.<sup>169</sup> By removing director functions from the realm of the board as a whole, such a committee could severely undercut the effectiveness of a director veto provision. To guard against this possibility, the veto provision must be made applicable to resolutions creating such a committee and appointing its members. Since this will involve altering the statutory majority vote requirement in section 17-6301(c), the veto provision again must be contained in the articles of incorporation.

The draftsman must consider carefully before giving a blanket veto over all director action to a single director. Such a veto could result in total and prolonged deadlock under which all interests would suffer. The wiser course may be to limit the veto to certain areas where it is felt to be imperative; for example, the selection of executive officers and fundamental corporate changes. One commentator has suggested that another approach would be to set the vote requirement low enough so that it would be necessary for two or more directors to combine to veto proposed corporate action.<sup>170</sup> For example, if there are five directors, the vote requirement might be set at four. The point to remember is that giving a veto to one director necessarily also gives it to all other directors.

---

<sup>164</sup> KAN. STAT. ANN. § 17-6602(c)(1) (1974).

<sup>165</sup> *Id.* § 17-6701(b).

<sup>166</sup> *Id.* § 17-6801(a).

<sup>167</sup> *Id.* § 17-6804(a).

<sup>168</sup> See text at notes 99, 100 *supra*.

<sup>169</sup> The exceptions relate to amendment of the articles of incorporation, merger or consolidation, sale of all or substantially all the corporate assets, voluntary dissolution, and amendment of the by-laws. Such a committee may be given the power, by either the board resolution, the by-laws, or the articles of incorporation, to declare dividends and to issue stock.

<sup>170</sup> 1 O'NEAL, *supra* note 13, § 4.24.

For the reasons previously discussed with respect to direct restraints on board action, it would probably be best to have a director veto provision adopted unanimously.

### C. *Employment Contracts*

The ultimate goal of an investor in a close corporation often will be to secure a salaried position with the enterprise. A long-term employment contract may be a useful device to insure his tenure and salary. An exhaustive description of the legal and practical problems involved in such contracts is beyond the scope of this discussion, and these matters have been discussed admirably in other works.<sup>171</sup> The discussion here will merely point out certain changes made by the Code that may affect employment contracts in the close corporate context.

One of the main problems in the past was employment in a so-called elective position such as president. Under prior law a corporation president was required to also be a director, and the president, secretary, treasurer, and vice-presidents, if any, were chosen by the board of directors.<sup>172</sup> A long-term contract purporting to employ a person as president ran the risk of invalidity under prior law because the corporation would be incapable of promising that a particular person would continue to be elected as a director.<sup>173</sup> Moreover, since the statute required selection of the above officers by the board of directors, a contract to employ a person in one of these capacities arguably might have constituted an illegal usurpation or delegation of the directors' duties.

Under the Code, the president, secretary, and treasurer of a corporation are to be chosen as the by-laws direct, and there is no requirement that the president be a member of the board of directors.<sup>174</sup> These changes seem to remove some of the possible statutory grounds for striking down contracts seeking to bind the corporation to employ a person as an executive officer. As has been said with respect to a similar provision of the Delaware Law, "The conclusion is that the officers may be chosen in any way and by any person or body if the by-laws . . . so [specify]."<sup>175</sup>

However, the wording of the Code may cause some problems. Section 17-6302(a) provides that the president, secretary, and treasurer shall be chosen as the by-laws direct. It says nothing regarding their term of office but merely states that they shall serve until their successors are *elected* and qualified or until their earlier resignation or removal. Section 17-6302(b) provides that the corporation may have other officers, who are to be chosen

<sup>171</sup> *Id.* §§ 6.01-.16; Logan, *supra* note 20, at 435-39.

<sup>172</sup> Law of April 9, 1941, ch. 182, § 6, [1941] Kan. Sess. Laws 273 and Law of April 3, 1939, ch. 152, § 32, [1939] Kan. Sess. Laws 230 (repealed 1972) (formerly codified at KAN. STAT. ANN. §§ 17-3105, -3106 (1964)).

<sup>173</sup> See *Koppitz-Melchers, Inc. v. Koppitz*, 315 Mich. 582, 24 N.W.2d 220 (1946) (dictum).

<sup>174</sup> KAN. STAT. ANN. § 17-6302(a) (1974).

<sup>175</sup> FOLK, *supra* note 45, at 71.

in such manner and hold their offices for such terms as are prescribed by the by-laws or determined by the board of directors or other governing body. The difference in language in the two sections is unfortunate. A hostile court could seize upon the word "elected" in section 17-6302(a) and the absence of any affirmatively permissive language with respect to the term of office as indicative of a legislative intent that the president, secretary, and treasurer in fact be elected at some fixed periodic interval. This finding could in turn lead a court to hold a long-term employment contract for one of these "elective" positions invalid. Such a holding probably would be contrary to actual legislative intent. The broad permission that such officers shall be chosen as the by-laws direct, coupled with the absence of a statutory provision expressly requiring periodic election, should lead a court to the opposite conclusion. That is, the board of directors, acting pursuant to authority contained in the by-laws, should be able to cause the corporation to enter into employment contracts for executive officer positions even though the terms of such contracts extend beyond the tenure of the present board, provided that the terms are of reasonable duration.<sup>176</sup> To avoid any possibility of question, cautious counsel may continue to draft such employment contracts in terms of traditionally "nonelective" positions such as general manager.

Section 17-6302(e) provides that any vacancy in any office arising by death, resignation, removal, or otherwise is to be filled as directed in the by-laws, or absent any by-law provision, by the board of directors or other governing body. This section impliedly authorizes removal of officers,<sup>177</sup> presumably in the manner provided in the by-laws. It is important that the by-laws do not provide that the directors may remove officers at will. It is possible that such a by-law would be construed to be part of the employment contract with the result that premature dismissal without cause might not give rise to a cause of action for damages on behalf of the officers.<sup>178</sup> Absent such a by-law, section 17-6302(e) presumably would be interpreted not to abrogate the rule that an employee removed without cause and in violation of a contract of employment for a term may recover damages for breach of contract.<sup>179</sup>

In summary, it can be said that the Code makes no drastic changes in the area of long-term employment contracts, and that the changes that have been made are permissive rather than restrictive.

### III. DISSENSION, DEADLOCK, AND DISSOLUTION

Because their shares are held by relatively few participants, sometimes in

<sup>176</sup> *Id.* With reference to the question of reasonable duration, *see* *Fulton v. Tennessee Walking Horse Breeders' Ass'n*, 63 Tenn. App. 569, 476 S.W.2d 644 (1971) (10 years valid); *Miller v. Angelina & N.R.R.R.*, 476 S.W.2d 389 (Tex. Civ. App. 1972) (12 years valid); 1 O'NEAL, *supra* note 13, § 6.06.

<sup>177</sup> FOLK, *supra* note 45, at 73.

<sup>178</sup> *See* *Hunter v. Sun Mut. Life Ins. Co.*, 26 La. 13 (1874); *Rundell v. Farmers' Co-op. Elevator Co.*, 210 Mich. 642, 178 N.W. 21 (1920); *Walker v. Maas & Waldstein Co.*, 104 N.J.L. 341, 140 A. 286 (Ct. Err. & App. 1928). *But see* *Realty Acceptance Corp. v. Montgomery*, 51 F.2d 636 (3d Cir. 1930); *Cuppy v. Stollwerck Bros.*, 216 N.Y. 591, 111 N.E. 249 (1916).

<sup>179</sup> *Hess v. Kismet State Bank*, 106 Kan. 701, 189 P. 919 (1920).

equal amounts, close corporations seem to have a greater potential for dissension or deadlock than their publicly-held counterparts. This potential is increased if the shares of an active participant pass, through a transfer at death or otherwise, into the hands of an inactive or incapable participant. The use of shareholder and director veto provisions further increases the chance of a crippling stalemate. Lack of advance planning in the form of contingent buy-out or arbitration agreements<sup>180</sup> often leaves dissolution or a similar remedy as the only available alternative.

Corporate dissolutions may be classified into two types, voluntary and involuntary. The former refers to the statutory procedure whereby the holders of a specified percentage of shares, usually either a simple majority or a two-thirds majority, vote in favor of a resolution to dissolve the corporation. The latter refers to a suit by a shareholder who is unable to muster sufficient votes to achieve voluntary dissolution to put an end to the corporate existence against the wishes of the majority.

#### A. *Voluntary Dissolution*

Under prior Kansas law, if the board of directors deemed dissolution to be advisable and beneficial to the corporation, a resolution to that effect was required to be adopted by a majority of the whole board. The board was required to send notice of such resolution and of a special shareholders' meeting to each shareholder and to publish a similar notice for two weeks. If at the special meeting the holders of two-thirds of the shares having voting power approved a resolution to dissolve, the corporation would be dissolved upon compliance with certain filing requirements.<sup>181</sup> Under an alternate procedure, the unanimous written consent of voting shareholders would suffice in lieu of an actual shareholders' meeting, but apparently a formal board meeting still was necessary.<sup>182</sup>

While the Code has retained this basic framework, it has made the following changes: (1) in line with the lowered voting requirements for sales of assets and mergers, the requisite shareholder vote has been reduced from two-thirds to a simple majority; (2) publication of a dissolution notice is no longer required; and (3) the scope of the unanimous written shareholder consent provision has been enlarged to eliminate the necessity of both the shareholders' and directors' meetings.<sup>183</sup> The Code has also added a special provision, which will be discussed subsequently in connection with involuntary dissolution, applicable to corporations whose stock is held equally by only two shareholders.<sup>184</sup> Thus, it will be seen that the only major substantive change with respect to voluntary dissolution is the lowering of the share-

<sup>180</sup> See 2 O'NEAL, *supra* note 13, §§ 9.04-25.

<sup>181</sup> Law of April 9, 1941, ch. 182, § 10, [1941] Kan. Sess. Laws 274-75 (repealed 1972) (formerly codified at KAN. STAT. ANN. § 17-3602 (1964)).

<sup>182</sup> Law of March 20, 1943, Ch. 131, § 1, [1943] Kan. Sess. Laws 206 (repealed 1972) (formerly codified at KAN. STAT. ANN. § 17-3603 (1964)).

<sup>183</sup> KAN. STAT. ANN. §§ 17-6804(a), (b), (c) (1974).

<sup>184</sup> *Id.* § 17-6804(d). See text at note 216 *infra*.

holder vote requirement from two-thirds to a simple majority. Most of the problems under prior law remain.

Most important among such problems is the question of the extent to which the statutory vote requirements may be altered by private parties to make voluntary dissolution either harder or easier to achieve. That the vote requirements can be made higher than those specified in the statute, making dissolution harder to achieve, seems clear.<sup>185</sup> The more troublesome problem is whether the statutory vote requirements may be lowered, either by provisions in the articles of incorporation or by-laws or by shareholder agreement. That is, can a minority shareholder be given the ultimate weapon—the power to single-handedly cause dissolution of the corporation?

Section 17-6002(b)(1) states that the articles of incorporation may contain any provision creating, defining, limiting, and regulating the powers of the corporation, the directors, and the shareholders if such provision is not contrary to the laws of the State. If the majority vote requirements of section 17-6804 are regarded as mandatory, then a provision permitting dissolution upon the vote of less than a majority of directors and shareholders would be contrary to the laws of the State and would not properly be includible in a corporation's articles. Section 17-6002(b)(4) states that the articles may include provisions requiring a larger vote of either directors or shareholders than otherwise would be required under the Code. This section clearly does not grant permission for the inclusion of a provision which would lower the specific vote requirements of the Code. Section 17-6301(b) states that unless the articles of incorporation provide otherwise, the by-laws may provide that less than a majority of directors, but in no event less than one-third of the entire board, shall constitute a quorum. This section further states that the vote of a majority of directors present at a meeting at which a quorum is present is sufficient for action unless the articles or by-laws require the vote of a greater number. Section 17-6301(b) could be construed to permit the approval of a resolution to dissolve by less than a majority of the whole board. For example, if a corporation had three directors, the by-laws conceivably could set the quorum requirement at one, and that one director could approve a resolution to dissolve. The more likely construction, however, would be that section 17-6301(b) applies only in the absence of a specific vote requirement and that the phrase "majority of the whole board" in section 17-6804(a) precludes reliance on section 17-6301(b).<sup>186</sup> Moreover, statutory authority for a less-

<sup>185</sup> See discussion of shareholder and director veto provisions in the text at notes 94-100 and 164-68 *supra*.

<sup>186</sup> A comparison of § 17-6301(b) with its predecessor may yield the conclusion that such a construction was not intended by the legislature. Section 17-6301(b) provides, in part, as follows: "The vote of the majority of the directors present at a meeting at which a quorum is present shall be the act of the board of directors, unless the articles of incorporation or the bylaws shall require the vote of a greater number." The corresponding provision of prior law contained certain significant additional wording: "The act of a majority of the directors at a meeting at which a quorum is present shall be the act of the board of directors unless a greater number is required by the articles of incorporation, the bylaws, or by provisions of law." Law of April 9, 1941, Ch. 182, § 5, [1941] Kan. Sess. Laws 272-73 (repealed 1972) (formerly codified at KAN. STAT. ANN. § 17-3101 (1964)) (emphasis added).

than-majority director vote is meaningless unless similar authority can be found for a shareholder vote. Such authority cannot be found in the Code. The final section relating to shareholder voting requirements is section 17-6506, which provides that "[s]ubject to the provisions of this act with respect to the vote that shall be required for a specified action," the articles of incorporation or by-laws may set shareholder quorum and vote requirements at any level desired. Since the broad permission of section 17-6506 is made subject to the specific vote requirements imposed by the Code, and since section 17-6804 contains such a specific vote requirement, it must be concluded that the Code does not provide authority for a less-than-majority shareholder vote on voluntary dissolution.

The question remains whether such a result could be accomplished by a shareholder agreement. More specifically, the question is whether the holders of a majority of the outstanding shares could agree to vote their shares for dissolution of the corporation if one or more of their number so desired. The answer under general principles of corporate law permitting shareholders to pool their votes and cast them in a predetermined manner, seems to be that they may, if the agreement does not oppress or defraud the nonparticipating shareholders.<sup>187</sup> There should be no question in regard to the shareholder majority vote requirement of section 17-6804 because, if the agreement functions properly, a majority of shares *will* be voted in favor of dissolution.

However, some problems may be encountered with respect to the director vote that initiates the dissolution procedure. Section 17-6804(a) begins with the phrase, "If it should be deemed advisable in the judgment of the board of directors of any corporation that it should be dissolved . . ." This phrase seems to require the exercise of business discretion by the directors on behalf of all shareholders, and any agreement by which shareholders seek to bind themselves to vote in favor of dissolution in their capacity as directors would be open to the objection that it infringes upon the free exercise of such discretion. If all shareholders are parties to the agreement, this objection should have no force. First, if all shareholders are parties, unanimous written consent to dissolution would be possible and there would not have to be a directors' meeting.<sup>188</sup> Secondly, the theory of *Peck v. Horst*,<sup>189</sup> under which a shareholder may waive strict compliance with statutory norms by entering into an agreement which varies those norms, should be held applicable. If not all shareholders are parties to the agreement, the proper result becomes less clear. It is submitted that the analysis previously discussed with respect to controlling director discretion in general should apply.<sup>190</sup> If the only shareholders who

<sup>187</sup> See text at notes 2-59 *supra* for a general discussion of shareholder pooling agreements. It seems vital in this instance for the participating shareholders who desire power to cause dissolution to make the agreement self-executing, as by the use of irrevocable proxies. For cases dealing with shareholder agreements in the context of dissolution, see *Wolf v. Arant*, 88 Ga. App. 568, 77 S.E.2d 116 (1953); *Leventhal v. Atlantic Fin. Corp.*, 316 Mass. 194, 55 N.E.2d 20 (1944).

<sup>188</sup> KAN. STAT. ANN. § 17-6804(c) (1974).

<sup>189</sup> 175 Kan. 479, 264 P.2d 888 (1953), *aff'd on rehearing*, 176 Kan. 581, 272 P.2d 1061 (1954).

<sup>190</sup> See text at notes 130-35 *supra*.



oppose dissolution are parties to the agreement, the *Peck* theory of waiver should control. Such persons should not be permitted to avoid their bargain by asserting the rights of others. If some of the shareholders who oppose dissolution are not parties to the agreement, they cannot be held to have waived their rights under section 17-6804(a). In such a case, because of the drastic effect of dissolution, perhaps a presumption of harm should be raised and dissolution denied.<sup>191</sup>

Providing a method whereby a minority shareholder may cause dissolution of the corporation gives that shareholder an extremely potent bargaining weapon and also a quick, if drastic, remedy in case of oppression by the other shareholders. However, because of its potency it also is quite dangerous. Unless it is drafted in terms that are personal to a particular shareholder, which may not be practical, it necessarily must be given to others who are parties to the agreement. As the number of shareholders who possess such power increases, so does the possibility that one or more may employ it in bad faith to extract undue concessions from the others. Therefore, this device should be utilized by the draftsman only as a last resort.

### B. *Involuntary Dissolution*

Prior to 1967 Kansas had no statute expressly permitting involuntary dissolution at the request of a minority shareholder. The issue under prior law was whether a minority shareholder could obtain appointment of a receiver for the corporation, and there was no specific statutory authority governing this question either.<sup>192</sup> In viewing the cases involving appointment of a receiver, it is helpful to distinguish between those in which the receiver, if appointed, was to continue operation of the corporation's business and those in which the receiver was to wind up the business, liquidate the corporation's assets, and distribute them to creditors and shareholders.

It was generally held that a receiver would not be appointed to take over and continue operation of the corporate business if the minority shareholder could show only unwise business decisions on the part of the majority and there was no imminent danger that the corporation would become insolvent.<sup>193</sup> That is, mere unwise business decisions and irregularities in conduct short of fraud, actual bad faith, or breaches of fiduciary duty would not justify the appointment of a receiver if the interests of the corporation and shareholders were not jeopardized. The rationale of these decisions appears to be that the appointment of a receiver to take over and continue operation of the business in the absence of serious misconduct would undercut the concept of majority

<sup>191</sup> Note that the problem will not arise unless some of the parties to the agreement join with the nonparty shareholder in opposing dissolution. If the holders of a majority of shares are parties to the agreement and all desire dissolution, it can be achieved under § 17-6804 with or without the agreement.

<sup>192</sup> The only statute in force prior to 1963 permitted the appointment of receivers according to the general usages of courts of equity. Law of March 12, 1909, ch. 182, § 266, [1909] Kan. Sess. Laws 377 (repealed 1963). The present law may be found in KAN. STAT. ANN. § 60-1301 (Supp. 1974).

<sup>193</sup> *Inscho v. Mid-Continent Dev. Co.*, 94 Kan. 370, 146 P. 1014 (1915); *Fluker v. Emporia City Ry.*, 48 Kan. 577, 30 P. 18 (1892).

rule. However, a receiver would be appointed if the board of directors completely failed to function, because of deadlock or otherwise, so that the corporate interests were left without protection.<sup>194</sup> This type of decision seems to be based upon the view that failure of the board to function, for whatever reason, will make attainment of corporate objectives impossible, and that it is therefore necessary to appoint a receiver to prevent total atrophy.

The question of appointment of a receiver to wind up a corporation's business and liquidate and distribute its assets has undergone gradual evolution. The early attitude of the Kansas courts with respect to this drastic remedy is exemplified by *Feess v. Mechanics' State Bank*,<sup>195</sup> where the court stated:

There is nothing in the [general equity] statute which authorizes a court of equity to dissolve a corporation, or wind up its affairs, at the instance of a minority stockholder, and in the absence of express statutory authority it cannot be done. . . . [A] court of equity can not interpose its authority to forfeit the franchise of a corporation, wind up its affairs or otherwise end its corporate existence at the instance of a stockholder.<sup>196</sup>

The *Feess* decision was based on jurisdictional grounds. In effect, the court said that appointing a receiver to wind up a corporation's affairs and distribute its assets was the practical equivalent of dissolution, and courts lack the power to do either, absent express statutory authority. Practical necessity doomed the *Feess* rule to a short life. In *Bowen v. Bowen-Romer Flour Mills Corp.*,<sup>197</sup> the court avoided the impact of *Feess* by reading it to apply only to actual dissolution and not to the appointment of a receiver to liquidate the business.<sup>198</sup> After *Bowen*, the issue was not whether a court had jurisdiction or power to appoint a receiver to liquidate a corporation but rather whether a court would exercise its power on the facts of a particular case.<sup>199</sup>

In *Bowen*, there was deadlock at both the shareholder and director levels so that it was impossible for the corporation to function. The court held that this was sufficient ground to appoint a receiver to liquidate the corporation, even though it was solvent and not in imminent danger of becoming insolvent. Two other cases have held that a receiver may be appointed at the instance of a minority shareholder upon a showing of severe dissension, though short of actual deadlock, coupled with fraud or breach of fiduciary duty and imminent danger of insolvency.<sup>200</sup>

In 1967 the Kansas legislature passed a statute authorizing district courts to entertain proceedings for involuntary dissolution on the petition of either

<sup>194</sup> *Jordan v. Austin Sec. Co.*, 142 Kan. 631, 51 P.2d 38 (1935) (also involving colorable breaches of fiduciary duty by the directors).

<sup>195</sup> 84 Kan. 828, 115 P. 563 (1911).

<sup>196</sup> *Id.* at 835, 115 P. at 565. The court also held that since the plaintiff had shown merely improper or unwise management there were not even sufficient grounds to appoint a receiver to continue the business as opposed to winding it up.

<sup>197</sup> 114 Kan. 95, 217 P. 301 (1923).

<sup>198</sup> *Id.* at 98-100, 217 P. at 302-03.

<sup>199</sup> 2 O'NEAL, *supra* note 13, § 9.27, at 97.

<sup>200</sup> *Geiman-Herthel Furniture Co. v. Geiman*, 160 Kan. 346, 161 P.2d 504 (1945); *Nelson v. United Elevators Co.*, 115 Kan. 567, 223 P. 814 (1924).

a shareholder or director when: (1) the corporation had an even number of directors who were equally divided and could not agree as to management of its affairs so that its business could no longer be conducted to advantage or so that its property and business would be impaired and lost; and (2) the voting shareholders were so divided into factions that they could not agree upon or elect a board of directors of an uneven number.<sup>201</sup> Although this statute was never interpreted by the courts and is no longer in force, a few comments about it will be helpful in comparing it to present procedure under the Code.

The most perplexing thing about the statute is its use of the conjunctive "and" between the two grounds for dissolution. This suggests that both grounds must be present before a court could entertain proceedings for dissolution. Yet the two statutory grounds seem to contemplate different circumstances, one in which there is a board consisting of an even number of directors and one in which the board consists of an uneven number. If both grounds were necessary, the statute would require: (1) an even number of directors who were deadlocked; (2) a deadlock among shareholders such that they could not amend the articles of incorporation to change the number of directors to an uneven number;<sup>202</sup> or (3) if the shareholders could so amend the articles, a subsequent deadlock such that they could not elect the new board consisting of an uneven number of directors. Moreover, under such a construction, the statute would not apply to a corporation that originally had an uneven number of directors. Finally, the California statute after which the Kansas provision apparently was modeled uses the disjunctive "or" rather than "and."<sup>203</sup> Although the Kansas provision was never construed, it probably should be concluded that the legislature intended either ground standing alone to be sufficient to confer jurisdiction on the district courts.

It should also be noted that the first ground required an equal division among directors. Thus, a director deadlock caused by a veto provision would not be sufficient, although apparently a shareholder deadlock caused by a veto provision would be sufficient to meet the second ground. Also, use of the word "may" in the introductory provision makes it clear that the courts were given discretion in decreeing involuntary dissolution even if the statutory grounds were met. Giving the courts such discretion seems wise in view of the possible harsh results of terminating a going enterprise against the wishes of the majority. Finally, the statute gave standing to sue to either a director

---

<sup>201</sup> Law of April 13, 1967, ch. 126, § 1, [1967] Kan. Sess. Laws 277-78 (repealed 1972) (formerly codified at KAN. STAT. ANN. § 17-3611 (Supp. 1971)).

<sup>202</sup> Under prior law the number of directors was fixed by the articles of incorporation. Law of April 9, 1941, ch. 182, § 5, [1941] Kan. Sess. Laws 272-73 (repealed 1972) (formerly codified at KAN. STAT. ANN. § 17-3101 (1964)). There is also the problem that as a matter of strictly proper corporate procedure, amendments to the articles of incorporation should originate with the board of directors. See Law of March 28, 1951, ch. 205, § 1, [1951] Kan. Sess. Laws 286 (repealed 1972) (formerly codified at KAN. STAT. ANN. § 17-4204 (1964)).

<sup>203</sup> CAL. CORP. CODE §§ 4651(b), (c) (West 1955) (the court may grant a petition to dissolve upon a showing of "any one or more" of the grounds enumerated).

or a shareholder. Since directors generally own at least some shares, this point often would not be significant. However, directors were not, and are not, required to own shares,<sup>204</sup> and the wisdom of conferring standing to sue for dissolution upon someone with no proprietary stake in the business may be questioned.

The Code does not provide for involuntary dissolution *per se*. Rather, it introduces the new concept of a custodian, whose charge, in most cases, will be to continue the business rather than liquidate it. This is a commendable approach since it allows the corporation to continue functioning and gives the parties an opportunity to resolve their differences short of dissolution. In the words of one commentator, "[D]issolution irrevocably ends a formerly viable concern, which might have been revived if the corporation's life had continued and the deadlock broken. . . . Hence, those states which have in one way or another provided alternative remedies have made a considerable advance over those which give courts (and counsel) only the choice between dissolution or no dissolution."<sup>205</sup>

Section 17-6516(a) provides three alternative grounds upon which a district court may appoint a custodian: (1) "[a]t any meeting held for the election of directors the [shareholders] are so divided that they have failed to elect successors to the directors whose terms have, or would have expired"; (2) the directors are so divided with respect to the management of the corporation that the required vote for action cannot be obtained, the shareholders are unable to terminate the director deadlock, and as a result the business of the corporation is suffering or is threatened with irreparable injury; or (3) "[t]he corporation has abandoned its business and has failed within a reasonable time to take steps to dissolve, liquidate or distribute its assets."

Although the Code elsewhere provides that failure of the shareholders to elect directors will not cause an involuntary dissolution,<sup>206</sup> section 17-6516 makes it clear that such a failure may be sufficient cause, in the discretion of the court, for appointment of a custodian. Unlike some dissolution statutes, there is no set period of time during which the shareholder deadlock must continue.<sup>207</sup> Presumably the absence of a set time period reflects the facts that appointment of a custodian is much less drastic than dissolution and that the remedy is not automatic but rests in the sound discretion of the district court. In addition, it is clear from the wording of the section that the deadlock need not be the result of an equal division of voting power between two factions. Deadlock caused by a veto provision will qualify as ground for appointment of a custodian.

The second ground for appointment of a custodian—director deadlock—

<sup>204</sup> KAN. STAT. ANN. § 17-6301(b) (1974); Law of April 9, 1941, ch. 182, § 5, [1941] Kan. Sess. Laws 272-73 (repealed 1972) (formerly codified at KAN. STAT. ANN. § 17-3101 (1964)).

<sup>206</sup> Folk, *Corporation Statutes: 1959-1966*, 1966 DUKE L.J. 875, 952-53.

<sup>207</sup> KAN. STAT. ANN. § 17-6501(c) (1974).

<sup>207</sup> See, e.g., ILL. ANN. STAT. § 157.86(a)(2) (Smith-Hurd Supp. 1974); ABA-ALI MODEL BUS. CORP. ACT § 97(a)(3) (1969).

can also be met by deadlock caused by a veto provision. Two more conditions are necessary under the second ground, however: inability of the shareholders to break the deadlock and actual or threatened irreparable injury. The requirement that the shareholders be unable to break the director deadlock appears designed to prevent precipitous resort to custodianship when the problem conceivably could be solved at the next shareholders' meeting.<sup>208</sup> The additional requirement of irreparable injury seems to be for the same purpose and ordinarily should not bar appointment of a custodian if both director and shareholder deadlocks are present. The main problem with the irreparable injury requirement is that courts may tend toward a restrictive reading, equating it with actual or imminent insolvency.<sup>209</sup> It is submitted that such a view would be unwarranted, particularly in light of prior Kansas case law on the question of appointment of a receiver to continue the business.<sup>210</sup> Moreover, if the shareholders were unable to break the director deadlock by electing a new board, it seems that the first ground for appointment of a custodian—shareholder deadlock—would be satisfied even without a showing of irreparable injury.

The final ground for appointment of a custodian—abandonment of the corporate business without taking steps to dissolve, liquidate, or distribute assets—seems self-explanatory. In such a case the custodian becomes a receiver charged with liquidating the corporate assets and distributing them to creditors and shareholders as their interests appear.<sup>211</sup> Under these circumstances the attorney general could even bring a quo warranto proceeding for revocation of the articles of incorporation based upon nonuse of the corporate franchise.<sup>212</sup>

The custodian will also have the liquidation powers of a receiver if the corporation is insolvent,<sup>213</sup> in special cases involving electing statutory close corporations,<sup>214</sup> and in other cases where the district court so orders.<sup>215</sup> This last provision appears to be a catchall designed to give the district courts discretion to order liquidation in egregious circumstances not involving electing close corporations, insolvency, or abandonment of business. One such case might be that of flagrant breaches of fiduciary duty by those in physical control. It seems, however, that appointing a custodian to assume control of the business would be sufficient to put an end to such abuses. It appears likely that this power will be used most often when, after a custodian has been appointed and a "cooling off" period has passed, the parties remain unwilling

<sup>208</sup> FOLK, *supra* note 45, at 272.

<sup>209</sup> *Cf. In re Radom & Neidorff, Inc.*, 307 N.Y. 1, 119 N.E.2d 563 (1954).

<sup>210</sup> *Jordan v. Austin Sec. Co.*, 142 Kan. 631, 51 P.2d 38 (1935) (holding appointment of a receiver appropriate when the board of directors failed to function, leaving the corporate interests without protection). *Cf. Bowen v. Bowen-Romer Flour Mills Corp.*, 114 Kan. 95, 217 P. 301 (1923), discussed in text at notes 197-200 *supra*.

<sup>211</sup> KAN. STAT. ANN. § 17-6516(b) (1974).

<sup>212</sup> *Id.* § 17-6812(a).

<sup>213</sup> *Id.* § 17-6516(a).

<sup>214</sup> *Id.* §§ 17-6516(b), -7212(a)(2), -7215. See text at notes 366-67 *infra*.

<sup>215</sup> *Id.* § 17-6516(b).

or unable to resolve their differences. Under such circumstances liquidation would be the most desirable result for all concerned.

Before moving to a consideration of a special dissolution provision, it should finally be noted that standing to petition under section 17-6516 has been limited to shareholders, thus eliminating the anomaly introduced by former section 17-3611.

Section 17-6804(d) contains a special, narrow, quasi-involuntary dissolution provision. It applies only to corporations owned by two shareholders, each of whom holds 50 percent of its stock. If the shareholders can not agree upon the desirability of dissolution, either may petition the district court for dissolution and distribution of the corporate assets in accordance with a proposed plan, which must be filed with the petition. Unless the proposed plan or some modification thereof is agreed upon and carried out by the shareholders within specified time periods, the court may dissolve the corporation and appoint a receiver or trustee to wind up its affairs and distribute its assets.<sup>216</sup> This section is designed to provide relief in an all too common situation: one 50 percent shareholder, possibly a successor to a former active shareholder's interest, wishes to withdraw his investment from the business; because he possesses only 50 percent voting power, he can not achieve a voluntary dissolution; because of the lack of either a ready outside market or a prearranged buy-out agreement, he is at the mercy of the other shareholder with respect to the price at which his shares can be sold; and there may not be sufficient grounds even for the appointment of a custodian to continue the business much less a receiver to liquidate it. In such a case the shareholder may find a remedy under section 17-6804(d). The section can be termed quasi-involuntary since the non-petitioning shareholder may be forced into dissolution against his wishes. However, it is not truly involuntary because he can avoid court-ordered dissolution by agreeing to the proposed plan, which in most cases would probably consist of purchase of the petitioning shareholder's stock at a fair price. Hopefully, the discretion vested in the district court with respect to granting dissolution will prevent the petitioner from attempting to extract undue concessions.

#### IV. RESTRICTIONS ON TRANSFER

For a number of reasons, the shareholders of a close corporation usually desire to modify the general corporate norm of free transferability of shares. These reasons stem from the close identity between ownership and management. Most, if not all, of the shareholders will be active in the business and will tend to think of themselves as partners. As a result they will want to be able to choose their associates or at least be able to prevent undesirable persons from gaining an interest in the business. Such undesirable persons may be those who merely lack integrity or business acumen, or they may be com-

<sup>216</sup> *Id.* § 17-6804(d).

petitors who seek to undermine from within or at least gain access to the corporate books and records.<sup>217</sup> Secondly, the shareholders may wish to preserve the status quo in terms of control by preventing transfers of stock among existing shareholders that would result in a shift of control.<sup>218</sup>

### A. Prior Law

Prior to adoption of the Code, Kansas law was in rather a confused state regarding three important questions: what types of transfer restrictions were permissible; in what documents the restrictions could be placed; and whether the corporation could be designated as the purchaser of shares when a restriction became operative.

The early case of *Steele v. Farmers & Merchants Mutual Telephone Association*<sup>219</sup> set the tone of the law in Kansas. *Steele* involved restrictions contained in the corporation's by-laws providing that no person could become a "member" of the corporation without prior board approval and that any shareholder desiring to sell his stock must first offer it to the corporation at par value. Refusing to accept the argument that such restrictions were necessary to preserve harmony in the business, the court held both restrictions absolutely void on the grounds that stock was personal property alienable at will and that a corporation has no power to impose restraints on its alienation.<sup>220</sup> Additionally, the option provision was void because, absent statutory authority, a corporation was held to have no power to purchase its own stock.<sup>221</sup> The *Steele* court refused to apply the rule recognized by some states that a restriction that is invalid in the form of a by-law may be given effect as a contract between shareholders.<sup>222</sup> This could not be done, the court felt, because the restrictions were imposed by the act of the corporation, and a sale of stock by one of the shareholders was not properly its concern.<sup>223</sup>

The General Corporation Code of 1939 contained several provisions relevant to the legality and operation of transfer restrictions. Section 17-2803B stated that the articles of incorporation could contain any provision, not contrary to the laws of the state, creating, defining, limiting, and regulating the powers of the corporation, the directors, and the stockholders.<sup>224</sup> Section 17-2803F permitted the articles to include a provision reserving to the corporation and shareholders the right to purchase the stock of a selling shareholder before sale to a nonshareholder.<sup>225</sup> Section 17-3004 provided that a corporation could purchase its own shares, *inter alia*, from earned surplus, on

<sup>217</sup> See *id.* § 17-6510.

<sup>218</sup> See 2 O'NEAL, *supra* note 13, §§ 7.02-.03 for a more detailed discussion of the reasons for restrictions on the transfer of stock.

<sup>219</sup> 95 Kan. 580, 148 P. 661 (1915).

<sup>220</sup> *Id.* at 583, 148 P. at 662.

<sup>221</sup> *Id.* at 588-90, 148 P. at 664-65. The only statutory ground recognized by the court was the acquisition by a corporation of its stock as security for a debt owing to the corporation.

<sup>222</sup> See, e.g., *Palmer v. Chamberlin*, 191 F.2d 532 (5th Cir. 1951).

<sup>223</sup> 95 Kan. at 584-85, 148 P. at 663.

<sup>224</sup> Law of April 3, 1939, ch. 152, § 12B, [1939] Kan. Sess. Laws 222-23 (repealed 1972).

<sup>225</sup> Law of April 3, 1939, ch. 152, § 12F, [1939] Kan. Sess. Laws 223 (repealed 1972).

conditions stated in its articles, provided that it was not insolvent and would not be rendered insolvent thereby.<sup>226</sup> It is clear that section 17-2803F allowed a right of first refusal and possibly a first option<sup>227</sup> running to the corporation or the other shareholders, if contained in the articles, with respect to proposed sales of stock to *nonshareholders*. Whether, by virtue of section 17-2803B, restrictions could be imposed on transfers other than sales and on sales or other transfers between existing shareholders remained an open question until 1949. In that year two cases were decided interpreting these sections and section 17-3004.

In dictum in *Talbott v. Nibert*<sup>228</sup> the court said that a restriction in the articles applicable to sales between existing shareholders would be void as an undue restraint on alienation. Such a restriction could not be upheld as an optional charter provision under section 17-2803B<sup>229</sup> because section 17-2803F specifically related to transfer restrictions and validated only restrictions on proposed sales to nonshareholders. The court felt that the specific section controlled the general and that in the absence of express enabling legislation the policy of free alienability enunciated in *Steele* must control.<sup>230</sup> Moreover, the court commented that even if the restriction were not void, it would not be construed to cover sales between existing shareholders because it was not clearly drafted to cover such sales and the purpose of preventing unwanted outsiders from gaining entry to the corporation would not apply in such a case.<sup>231</sup> The court thus apparently ignored the additional purpose of preventing shifts in control among existing shareholders.

*Wentworth v. Russell State Bank*<sup>232</sup> involved restrictions on gratuitous stock transfers contained in the articles of incorporation and by-laws. Suit was brought by a shareholder who had dissented from adoption of the restrictions, and the court declared that no provision of the corporation code authorized a limitation of the rights of "prior existing shareholders."<sup>233</sup> The court also indicated that a provision in the articles that attempted to restrict a shareholder's right to give his stock away or pass it by will or inheritance would be invalid.<sup>234</sup> Regarding a right of first refusal running to the corporation, the court relied upon *Steele* as authority for the proposition that a corporation lacks the power to purchase its own stock absent an enabling

<sup>226</sup> Law of April 3, 1939, ch. 152, § 24, [1939] Kan. Sess. Laws 227-28 (amended 1957) (repealed 1972).

<sup>227</sup> The distinction between a right of first refusal and a first option is discussed in note 265 *infra*.

<sup>228</sup> 167 Kan. 138, 206 P.2d 131 (1949).

<sup>229</sup> See *Weissman v. Lincoln Corp.*, 76 So. 2d 478 (Fla. 1954).

<sup>230</sup> 167 Kan. at 148-50, 206 P.2d at 140.

<sup>231</sup> *Id.* at 148-49, 206 P.2d at 139-40.

<sup>232</sup> 167 Kan. 246, 205 P.2d 972 (1949).

<sup>233</sup> *Id.* at 253, 205 P.2d at 978.

<sup>234</sup> The court said,

[T]here is no provision of the general corporation code which authorizes a limitation on the rights of prior existing stockholders or limiting the title or ownership of their shares passing either by will or inheritance . . . , or that prevents the owner or his heir or legatee from giving away or selling the same, without first making an offer to the board . . . and if that board refuse, to some other person on no better terms.

*Id.*



statute.<sup>235</sup> The court stated that section 17-3004 was inapplicable, apparently limiting its operation to cases falling squarely within section 17-2803F.<sup>236</sup>

The net result of these cases was that strict compliance with section 17-2803F was necessary if transfer restrictions imposed by formal corporate action were to be valid. Such restrictions had to appear in the articles rather than the by-laws, they had to take the form of a right of first refusal or possibly a first option running to the corporation or other shareholders, and they could apply only to proposed sales by a shareholder to a nonshareholder.

Somewhat greater flexibility was permitted if the transfer restriction was adopted by private agreement of the shareholders. Thus, a provision in a bondholders' pooling agreement requiring unanimous consent of the parties to proposed sales to nonparties was impliedly upheld in *Wallace v. Southwestern Sanitarium Co.*<sup>237</sup> An agreement between two factions of shareholders to maintain equal control by providing that each should share equally in any stock purchased by the other was given effect in *Mitchell v. Beachy*.<sup>238</sup> There also seems to have been authority for the legality of an agreement providing for the purchase of stock upon a shareholder's death.<sup>239</sup> Finally, the statute governing voting trusts impliedly authorized use of certain transfer restrictions in connection therewith.<sup>240</sup>

### B. *The Code*

In contrast to the narrowly restrictive and sometimes hostile attitude of Kansas courts under prior law, section 17-6426 of the Code seems to be based upon the philosophy of stock ownership once expressed by Justice Holmes: "Stock in a corporation is not merely property. It also creates a personal relation analogous otherwise than technically to a partnership. . . . [T]here seems to be no greater objection to retaining the right of choosing one's associates in a corporation than in a firm."<sup>241</sup>

Section 17-6426 is divided into five subsections: (a) a statement of the binding effect of transfer restrictions permitted by the section; (b) a statement as to how the restrictions may be imposed; (c) a categorization of four types of permissible restrictions; (d) a conclusive presumption that a restriction adopted to maintain Subchapter S status under the *Internal Revenue Code* is for a reasonable purpose; and (e) a catchall clause permitting any other "lawful" restrictions. The discussion here will be limited to an analysis of

<sup>235</sup> *Id.*

<sup>236</sup> Section 17-3004 was amended in 1957. See Law of April 8, 1957, ch. 154, § 1, [1956] Kan. Sess. Laws 350-51 (repealed 1972). This amendment has been interpreted to permit a corporation to freely purchase its own stock as long as it has sufficient surplus. Logan, *supra* note 20, at 451.

<sup>237</sup> 160 Kan. 331, 161 P.2d 129 (1945). See note 10 *supra*.

<sup>238</sup> 104 Kan. 445, 179 P. 365 (1919).

<sup>239</sup> *Cf.* Loch v. Paola Farmers Union Co-op. Creamery & Store Ass'n, 130 Kan. 136, 285 P. 523 (1930).

<sup>240</sup> Law of April 3, 1939, ch. 152, § 66, [1939] Kan. Sess. Laws 241-42 (repealed 1972) (formerly codified at KAN. STAT. ANN. § 17-3307 (1964)) (voting rights deemed coupled with an interest if given "in connection with an option, authority or contract to buy or sell such shares or a part thereof"). See *Wallace v. Southwestern Sanitarium Co.*, 160 Kan. 331, 337, 161 P.2d 129, 132 (1945).

<sup>241</sup> Barrett v. King, 181 Mass. 476, 479, 63 N.E. 934, 935 (1902).

section 17-6426 and will not attempt to deal with the many problems inherent in planning and drafting transfer restrictions.<sup>242</sup>

Subsection (a) of section 17-6426 provides:

A written restriction on the transfer or registration of transfer of a security of a corporation, if permitted by this section and noted conspicuously on the security, may be enforced against the holder of the restricted security or any successor or transferee of the holder, including an executor, administrator, trustee, guardian or other fiduciary entrusted with like responsibility for the person or estate of the holder. Unless noted conspicuously on the security, a restriction, even though permitted by this section, is ineffective except against a person with actual knowledge of the restriction.

Two of the most important words of subsection (a) are those providing that the transfer restriction must be "noted conspicuously" on the security to be enforceable, except against a person with actual knowledge. These words were taken from a substantially similar provision of the Uniform Commercial Code (hereinafter referred to as the UCC),<sup>243</sup> and are directed toward the question whether transfer restrictions must be set forth in full on each certificate or whether they may be summarized, with a reference to where the full text may be found. The old Uniform Stock Transfer Act<sup>244</sup> required that restrictions be "stated" on the certificate, and this terminology gave rise to an issue whether a mere summary would suffice.<sup>245</sup> According to the draftsmen of the UCC, the term "noted" was employed to make it clear that the full text need not be set forth on the certificate.<sup>246</sup> "Conspicuous" is defined in the UCC as something "so written that a reasonable person against whom it is to operate ought to have noticed it," such as something written in capital letters or larger or other contrasting type or color.<sup>247</sup> Thus, a "conspicuous" summary of a transfer restriction with a reference to where the full text may be obtained should suffice. A mere notation that the stock is "restricted" may not be enough. Moreover, one commentator has suggested that it is still good practice to set forth the restrictions in full unless they are too numerous or too lengthy.<sup>248</sup> Finally, subsection (a) makes it clear that, contrary to the rule in many states under the Uniform Stock Transfer Act,<sup>249</sup> the restrictions will be enforceable against a person with actual knowledge of them even if they are not noted conspicuously on the certificate.

<sup>242</sup> For an excellent article treating such problems see O'Neal, *Restrictions on Transfer of Stock in Closely Held Corporations: Planning and Drafting*, 65 HARV. L. REV. 773 (1952).

<sup>243</sup> KAN. STAT. ANN. § 84-8-204 (1965).

<sup>244</sup> UNIFORM STOCK TRANSFER ACT § 15.

<sup>245</sup> See *Allen v. Biltmore Tissue Corp.*, 2 N.Y.2d 534, 141 N.E.2d 812, 161 N.Y.S.2d 418 (1957); *Weissman v. Lincoln Corp.*, 76 So. 2d 478 (Fla. 1954).

<sup>246</sup> KAN. STAT. ANN. § 84-8-204, Official UCC Comment (1965).

<sup>247</sup> *Id.* § 84-1-201(10); see *Ling & Co. v. Trinity Sav. & Loan Ass'n*, 482 S.W.2d 841 (Tex. 1972).

<sup>248</sup> 2 O'NEAL, *supra* note 13, § 7.16.

<sup>249</sup> *Age Pub. Co. v. Becker*, 110 Colo. 319, 134 P.2d 205 (1943); *Kintzinger v. Millin*, 254 Iowa 173, 117 N.W.2d 68 (1962); *Goodar Inv. Co. v. Detroit Bank & Trust Co.*, 4 Mich. App. 218, 144 N.W.2d 649 (1966); *Costello v. Farrell*, 234 Minn. 453, 48 N.W.2d 557 (1951); *Hopwood v. Topsham Tel. Co.*, 120 Vt. 97, 132 A.2d 170 (1957); *Larson v. Superior Auto Parts, Inc.*, 270 Wis. 613, 72 N.W.2d 316 (1955) (dictum).

The problems that arise when a shareholder pledges, or attempts to pledge, his stock as security for a loan are among the most troublesome in the area of transfer restrictions. An initial issue, discussed below in connection with subsection (c) of section 17-6426, is whether a restriction can validly prohibit pledges or other encumbrances, and, if so, whether a particular restriction, as drafted, is sufficient to accomplish this purpose. Two further alternative issues also arise. If the restriction covers pledges and a shareholder attempts to pledge his stock, can the corporation or other shareholders require the pledgee to return the stock (under a consent type restriction) or offer it for sale to the corporation or other shareholders (under an option type restriction)? If the restriction does not cover the initial pledge but the pledgee thereafter seeks to foreclose by selling the stock, will the corporation or other shareholders have a voice in determining the identity of the purchaser (under a consent type restriction) or can they require the pledgee to first offer the stock for sale to them (under an option type restriction)? The answer to both of these questions seems to be in the affirmative, provided that the restriction either was noted conspicuously on the stock certificate or the pledgee had actual knowledge of it.

Section 17-6426(a) provides that a transfer restriction may be enforced against the holder of a security or any successor or transferee of the holder. These terms are not defined in the Code, but sections 17-6409 and 17-6425 provide that stock shall be transferable as provided in article eight of the UCC. Article eight in turn refers to section 1-201(20) of the UCC for the definition of "holder" as a person in possession of an investment security drawn, issued or endorsed to him or to his order or to bearer or in blank.<sup>250</sup> In order for a security interest in stock to be enforceable and perfected the secured party must take actual possession of the stock certificate.<sup>251</sup> If, in addition to surrendering possession to the pledgee, the shareholder endorses the stock certificate in blank or attaches a stock power similarly endorsed, the pledgee will become a "holder" and the transfer restriction may be enforced against him. If the pledgee merely takes possession of the certificate, he cannot be a holder as defined in the UCC. However, section 17-6426(a) also applies to transferees of holders. Unless a court applies *ejusdem generis* to limit the term "transferee" to fiduciaries such as executors, administrators, trustees, or guardians, a pledgee in possession of a restricted security should qualify as a transferee.<sup>252</sup> It may therefore be concluded that a transfer restriction permitted by section 17-6426 will be enforceable under subsection (a) thereof against pledgees.<sup>253</sup>

Subsection (b) of section 17-6426 provides:

A restriction on the transfer or registration of transfer of securities of a corpora-

<sup>250</sup> KAN. STAT. ANN. § 84-1-201(20) (1965).

<sup>251</sup> *Id.* § 84-9-203(1)(a) (Supp. 1974); *id.* §§ 84-9-304(1), -305 (1965).

<sup>252</sup> *See id.* § 84-9-311 (1965).

<sup>253</sup> *Cf. Estate Funds, Inc. v. Burton-Fifth Ave. Corp.*, 111 N.Y.S.2d 596 (Sup. Ct. 1952).

tion may be imposed either by the articles of incorporation or by the bylaws or by an agreement among any number of security holders or among such holders and the corporation. No restriction so imposed shall be binding with respect to securities issued prior to the adoption of the restriction unless the holders of the securities are parties to an agreement or voted in favor of the restriction.

The first sentence of subsection (b) grants broad permission as to how transfer restrictions may be imposed and should alleviate the problems that existed under prior law regarding restrictions appearing in corporate by-laws. The second sentence appears to adopt the *Wentworth v. Russell State Bank*<sup>254</sup> rule that a transfer restriction will not be given effect with respect to shareholders who owned stock at the time of its imposition but did not consent thereto.<sup>255</sup> Use of the general term "holders" might be taken to mean that a transferee-holder of securities on which restrictions had been placed subsequent to their issue would not be bound by such restrictions unless he personally assented to them, even though his transferor had so assented. It is submitted that such a reading would be a misinterpretation of the statute. If subsection (b) is read in conjunction with subsection (a), it becomes clear the legislature intended that such transferees be bound if their transferors consented to imposition of the restriction.

Repeal or amendment of a transfer restriction raises a more difficult question because section 17-6426 is silent on this point. In one Kansas case involving a cooperative association, it was stated that a by-law requiring the cooperative to purchase a member's interest upon his death constituted a contract the terms of which could not be abrogated by repealing the by-law by a simple majority vote.<sup>256</sup> It is possible that this vested rights theory could be carried over to corporations under the Code. On the other hand, it could be argued that if the majority of shareholders feel that the restriction no longer serves a useful purpose, they should be free to repeal it, especially since transfer restrictions are an exception to the general rule of free alienability of property. If the articles of incorporation or by-laws are viewed as a contract, one term of the contract might be that the majority may change its provisions.<sup>257</sup>

Amending a transfer restriction also poses a problem. Since an amendment constitutes not only a partial repeal but also an alteration of the original restriction, it could be argued that, in effect, a new restriction is being imposed. If the proposition that a restriction may be repealed by a majority vote is correct, the result under subsection (b) would be that the original restriction would be repealed as to all shareholders and the new, amended restriction would bind only those who voted in favor of it. Because the Code is silent in these areas, the draftsman should provide specifically how transfer restric-

---

<sup>254</sup> 167 Kan. 246, 205 P.2d 972 (1949).

<sup>255</sup> For a contrary view see *Tu-Vu Drive-In Corp. v. Ashkins*, 61 Cal. 2d 283, 391 P.2d 828, 38 Cal. Rptr. 348 (1964).

<sup>256</sup> *Loch v. Paola Farmers Union Co-op. Creamery & Store Ass'n*, 130 Kan. 522, 287 P. 269 (1930).

<sup>257</sup> *Tu-Vu Drive-In Corp. v. Ashkins*, 61 Cal. 2d 283, 391 P.2d 828, 38 Cal. Rptr. 348 (1964).

tions in the articles of incorporation or by-laws may be repealed or amended.<sup>258</sup> Such a specific provision, even if it calls for less than unanimity with respect to amendment or repeal, should be accepted by the courts as part of the shareholders' "contract" under the vested rights theory.

Before considering the specific types of transfer restrictions permitted by the Code, it will be helpful to examine section 17-6410, which governs the power of a corporation to purchase its own stock. This section grants broad authority for a corporation to purchase, hold, and otherwise deal in and with its own stock, provided only that the corporation's capital is not impaired and the purchase itself will not cause an impairment.<sup>259</sup> The phrase "impairment of capital" is not defined in the Code. However, section 17-6404 provides that the capital of a corporation shall be whatever part of the consideration for stock issued by it the board of directors allocates to the capital account. If the corporation has issued only shares having a par value, its capital must be at least equal to the aggregate par value of such shares. If the corporation has issued both par and no par shares, its capital must be some amount in excess of the aggregate par value of the par shares.<sup>260</sup> Under a Delaware statute similar to section 17-6410, it was held that the capital of a corporation was impaired if the value of its assets was less than its capital as that term is used in section 17-6404.<sup>261</sup> Thus, the impairment of capital test of section 17-6410 appears to be another way of saying that a corporation may purchase its own stock only out of surplus.<sup>262</sup> In view of the numerous ways to create or enhance surplus, there should be few cases in which a corporation would be prohibited from purchasing its stock.<sup>263</sup>

Subsection (c) provides that a restriction on the transfer of securities is permitted by section 17-6426 if it falls within one of the four categories specified therein. When this statement is read in conjunction with subsection (a), which makes the restrictions permitted by section 17-6426 enforceable against holders of the securities or their successors or transferees, the result seems to be that the four types of restrictions specified in subsection (c) will be legal per se. That is, it appears that the common law test whereby the necessity for the restraint, in light of the particular factual situation under consideration, is balanced against the policy of free alienability<sup>264</sup> is inapplicable to the four types of restrictions listed in subsection (c).

<sup>258</sup> The problem will not arise if the articles of incorporation contain a veto provision applicable to all matters properly the subject of shareholder action.

<sup>259</sup> KAN. STAT. ANN. § 17-6410 (1974) (also containing a provision permitting a redemption of preferred or special stock out of capital).

<sup>260</sup> *Id.* § 17-6404.

<sup>261</sup> *In re International Radiator Co.*, 10 Del. Ch. 358, 92 A. 255 (Ch. 1914).

<sup>262</sup> "Surplus" is defined as the excess of net assets over capital. "Net assets" is defined as the excess of assets over liabilities, not including capital and surplus as liabilities. KAN. STAT. ANN. § 17-6404 (1974).

<sup>263</sup> Since the primary factor in determining capital is par value, capital can be reduced and surplus created or increased by an amendment to the articles of incorporation that reduces the par value of the stock, followed by a book entry transferring the difference between the old aggregate par value and the new aggregate par value to the surplus account. Of course, the recording and publication procedures required by § 17-6604 must be complied with.

<sup>264</sup> 2 O'NEAL, *supra* note 13, § 7.06.

Subsection (c)(1) provides that a restraint on transfer is permitted if it obligates the holder to offer to the corporation, other security holders, any other person, or any combination thereof a prior opportunity, to be exercised within a reasonable time, to acquire the restricted securities. This subsection authorizes two of the most common types of transfer restrictions—the right of first refusal and the first option.<sup>265</sup> Because of the wording of the section, much broader restrictions may be imposed than were possible under prior law. A “transfer” may include such things as the creation of a security interest,<sup>266</sup> inter vivos gifts either outright or in trust, or bequests made by wills.<sup>267</sup> The absence of limiting language suggests that subsection (c)(1) also permits a right of first refusal or a first option applicable to transfers between existing shareholders as well as transfers to outsiders. However, the courts have construed transfer restrictions narrowly and probably will continue to do so.<sup>268</sup> Therefore, if it is intended that a restriction cover the creation of security interests, gratuitous transfers, or transfers between existing shareholders, it must be drafted to specifically so provide.

One major disadvantage of the type of transfer restriction permitted by subsection (c)(1) is that exercise of the right to acquire the restricted securities may require a substantial outlay of funds. At least with respect to transfers at death this problem can be alleviated by purchasing insurance on the lives of the shareholders. The Code specifically grants corporations the power to purchase such insurance.<sup>269</sup> Alternatively, the corporation may establish a reserve so that it will have sufficient funds for the exercise of a right of first refusal or option.<sup>270</sup> If such a reserve is established, care must be taken to avoid the imposition of an accumulated earnings tax.<sup>271</sup>

<sup>265</sup> These two types of restrictions are similar in that both give the corporation or other shareholders a prior right to acquire securities proposed to be transferred. However, under a first option the price at which the corporation or other shareholders may acquire the securities is specified in, or determined in a manner specified in, the document imposing the restriction. Under a right of first refusal the price is determined by the price offered by the proposed transferee. Because of this feature of the right of first refusal it seems clear that if the parties desire to restrict gratuitous transfers as well as sales it will be necessary to use a first option. If the parties also desire to afford the corporation or other shareholders the benefit of the lowest possible price when the proposed transfer takes the form of a sale, a right of first refusal must be employed in combination with the first option.

<sup>266</sup> Cf. *Monotype Composition Co. v. Kiernan*, 319 Mass. 456, 66 N.E.2d 565 (1946).

<sup>267</sup> In *Ascione v. Antonacci*, 55 N.J. 473, 262 A.2d 866 (1970), the court granted specific performance of a first option which became operative on the death of a shareholder under a statute substantially identical to § 17-6426(c)(1). See N.J. STAT. ANN. § 14A:7-12(3)(a) (1969).

<sup>268</sup> *Thompson v. Anderson*, 209 Kan. 547, 555, 498 P.2d 1, 7-8 (1972); *Talbott v. Nibert*, 167 Kan. 138, 148-49, 206 P.2d 131, 139-40 (1949).

<sup>269</sup> KAN. STAT. ANN. § 17-6102(16) (1974).

<sup>270</sup> *Id.* § 17-6421.

<sup>271</sup> INT. REV. CODE OF 1954, §§ 531-37. The purpose of the accumulated earnings tax is to discourage use of a corporation to accumulate earnings and profits that might be taxed at higher rates if distributed to the shareholders. Section 532(a) imposes the tax on every corporation (except personal holding companies, foreign personal holding companies, and tax exempt corporations) formed or utilized for the purpose of avoiding income tax with respect to its shareholders by permitting earnings and profits to accumulate rather than being distributed. Section 533(a) creates a presumption of a tax avoidance purpose if earnings and profits are allowed to accumulate beyond the reasonable needs of the business. However, § 535(c) in essence provides that any corporation may accumulate up to \$100,000 without risk that the accumulation will be found unreasonable. The net effect of these sections is that to the extent accumulations exceed \$100,000 the corporation must show they were necessitated by reasonable needs of the business. Whether an accumulation to enable a corporation to exercise a first option on a shareholder's stock serves a legitimate business need will depend on the facts of each case. Unfor-

In many cases it would be desirable to require a shareholder to offer his stock to the corporation or other shareholders upon his withdrawal from active participation in the business. However, because of the reference in the introductory language of subsection (c) to a restriction on the *transfer* of securities, it is not clear whether subsection (c)(1) authorizes an option or right of first refusal subject to a contingency other than an attempted transfer. The Delaware case of *Greene v. E. H. Rollins & Sons, Inc.*<sup>272</sup> involved a provision requiring any holder of common stock (with certain exceptions) who was not an employee of the corporation to surrender it to the corporation at its appraised asset value at any time determined by the board of directors. On demurrer to a bill to enjoin enforcement, the court held the provision invalid in the absence of a showing that it was so related to the corporation's successful operation as to be reasonable. The court reasoned that the provision, in effect, was an almost absolute restraint on alienation since any third party who purchased the stock would take it subject to the possibility that the corporation would repurchase it at a time when asset values were depressed.<sup>273</sup> The court concluded that such a contingency would prevent most, if not all, third parties from purchasing a shareholder's common stock. If the Kansas courts were to adopt a similar view, that is, that such provisions constitute indirect restraints on transfer, subsection (c)(1) might well be construed to validate certain options or rights of first refusal subject to contingencies other than an attempted transfer of the restricted securities.<sup>274</sup> Such a construction of subsection (c)(1) would be possible because subsection (c) speaks only in general terms of restrictions on transfer; it does not speak to the specific contingencies that cause the option or right of first refusal to become operative. It should be noted, however, that many provisions calling for retirement of a shareholder's interest upon withdrawal from active participation in the enterprise probably would not be subject to the *Greene* rationale unless they gave the corporation or other shareholders broad latitude with respect to timing of the purchase.<sup>275</sup> In addition, the Kansas court's strict construction of prior statutes in this area may indicate that section 17-6426 will be interpreted to authorize only direct restrictions on transfer.<sup>276</sup>

Another important provision of subsection (c)(1) is the requirement that the option or right of first refusal "be exercised within a reasonable time." There is no statutory definition of what constitutes a reasonable time, and

---

unately, the law in this area remains unsettled. See B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 8.07 (3d ed. 1971).

<sup>272</sup> 22 Del. Ch. 394, 2 A.2d 249 (Ch. 1938).

<sup>273</sup> The corporation was engaged in the business of investment banking.

<sup>274</sup> FOLK, *supra* note 45, at 199, states, in reference to an identical provision of the Delaware Law, that "[t]he new statute may well validate even such a restriction as [the one involved in *Greene*]."

<sup>275</sup> This point was stressed by the court in *Greene*: "Any possible purchaser would take [the stock] burdened with an obligation to transfer it any time to the corporation at a future asset value which might be far below what he paid for it." 22 Del. Ch. at 404, 2 A.2d at 253-54.

<sup>276</sup> See *Talbott v. Nibert*, 167 Kan. 138, 206 P.2d 131 (1949); *Wentworth v. Russell State Bank*, 167 Kan. 246, 205 P.2d 972 (1949).

presumably this will be a question of fact to be determined by reference to the circumstances of a particular case.<sup>277</sup> Periods ranging from 80 days to six months have been upheld in other jurisdictions.<sup>278</sup> Nevertheless, it would be prudent to specify as short a time period as is compatible with the need to determine whether the option or right of first refusal should be exercised and, if so, to obtain sufficient funds therefor.

A final problem under subsection (c)(1) is the price at which a first option is to be exercised. Since the legislature apparently intended to create a rule under which first options would be legal per se and since subsection (c)(1) contains no requirements as to price, it could be concluded that any price the parties set will be binding even though changed circumstances may render the price unreasonable in the sense that it is much less than the "fair" value of the stock.<sup>279</sup> Such a price disparity might cause a first option to approach an absolute restraint on alienation because a shareholder often would not attempt to transfer his stock in such a case.<sup>280</sup> Yet this approach seems to be in accord with the weight of authority under the common law, especially where the price or method of determining price was fair and reasonable when fixed and had become disproportionately small only over the course of time.<sup>281</sup> The rationale of these cases seems to be one of freedom of contract and probably stems, in part at least, from judicial reluctance to become embroiled in the problem of valuing an asset for which there is no ready market.<sup>282</sup> Because of such authority in other jurisdictions and the lack of any specific requirement in subsection (c)(1), it is likely that this is the approach Kansas will take.

Subsection (c)(2) provides that a restriction on transfer is permitted if it obligates the corporation, other security holders, any other person, or any combination thereof "to purchase the securities which are the subject of an agreement respecting the purchase and sale of the restricted securities." This

---

<sup>277</sup> *Brown v. McInvale*, 118 Ga. App. 375, 163 S.E.2d 854 (1968).

<sup>278</sup> See *Lawson v. Household Fin. Corp.*, 17 Del. Ch. 343, 152 A. 723 (1930) (80 days); *Cimo v. National Motor Club of La., Inc.*, 237 So. 2d 408 (La. App. 1970) (3 months); *Weiland v. Hogan*, 177 Mich. 626, 143 N.W. 599 (1913) (6 months).

<sup>279</sup> Compare ARK. STAT. ANN. § 64-211A (1966) (requiring "a fair price" with respect to options imposed by corporate act).

<sup>280</sup> 2 O'NEAL, *supra* note 13, § 7.06.

<sup>281</sup> See, e.g., *Palmer v. Chamberlin*, 191 F.2d 532 (5th Cir. 1951); *Cutter Laboratories, Inc. v. Twining*, 221 Cal. App. 2d 302, 34 Cal. Rptr. 317 (1963); *Allen v. Biltmore Tissue Corp.*, 2 N.Y.2d 534, 141 N.E.2d 812, 161 N.Y.S.2d 418 (1957); *In re Estate of Mather*, 410 Pa. 361, 189 A.2d 586 (1963); *Jones v. Harris*, 63 Wash. 2d 559, 388 P.2d 539 (1964).

<sup>282</sup> In *Allen v. Biltmore Tissue Corp.*, 2 N.Y.2d 534, 543, 141 N.E.2d 812, 817, 161 N.Y.S.2d 418, 424 (1957), the court stated:

Obviously, the case where there is an easily ascertainable market value for the shares of a closely held corporate enterprise is the exception, not the rule, and, consequently, various methods or formulae for fixing the option price are employed in practice—e.g., book or appraisal value, often exclusive of good will, or a fixed price, or the par value of the stock.

In sum, then, the validity of the restriction on transfer does not rest on any abstract notion of intrinsic fairness of price. To be invalid, more than mere disparity between option price and current value of the stock must be shown. Since the parties have in effect agreed on a price formula which suited them, and provision is made freeing the stock for outside sale should the corporation not make, or provide for, the purchase, the restriction is reasonable and valid.

(Citations omitted.)



subsection appears to authorize an arrangement whereby one of the stated parties is required to purchase a shareholder's stock—a so-called obligation to purchase.

It may not be an exaggeration to say that this is one of the most perplexing sections in the entire Code. The difficulty stems from the above-quoted phrase, and in particular from use of the term "agreement." Subsection (b) provides that a transfer restriction may be imposed by the articles of incorporation, the by-laws, or an agreement among any number of security holders or among such holders and the corporation. Subsection (c)(2) could be interpreted as a limitation on subsection (b), requiring that an obligation to purchase be imposed only pursuant to an agreement among the security holders or such holders and the corporation. If this had been the legislative intent, however, one would expect the general authority in subsection (b) to be limited by a proviso. Moreover, there appears to be no logic to a rule that would permit rights of first refusal, options, consent restrictions,<sup>283</sup> and prohibited class restrictions<sup>284</sup> to be imposed in any of the three ways specified in subsection (b) but would restrict the imposition of obligations to purchase to agreements.

Alternatively, use of "agreement" in subsection (c)(2) may be just a shorthand way of referring to any of the three methods of imposition authorized by subsection (b). Under such a view a number of further alternate interpretations of the quoted phrase are possible. It may mean simply that the party or parties who are obligated to purchase a shareholder's stock must agree to do so. Such an interpretation would render the phrase completely superfluous. One would assume that the parties to a right of first refusal, option, consent restriction, or prohibited class restriction also must agree to be bound thereby, yet no such additional phrase is contained in subsections (c)(1), (3), or (4). Or, use of the terminology "agreement respecting the purchase and sale of the restricted securities"<sup>285</sup> may indicate authorization of only an arrangement under which the shareholder is obligated to sell as opposed to an arrangement where the other parties are obligated to purchase but the shareholder is free to sell to other persons or not to sell at all. This interpretation is supported by the fact that section 17-6426 purports to apply to *restrictions* on the transfer of securities. An obligation on the part of others to purchase, standing alone, is not such a restriction, since it in no way restrains a shareholder from freely alienating his stock. However, of the two types of arrangements, this is the less onerous from the shareholder's point of view, and, in light of the strong policy favoring free alienability, there seems to be no reason why the legislature should *require* the parties to adopt the more stringent arrangement.

Finally, the phrase may mean that an obligation to purchase can be im-

<sup>283</sup> See text at note 288 *infra*.

<sup>284</sup> See text following note 293 *infra*.

<sup>285</sup> KAN. STAT. ANN. § 17-6426(c)(2) (1974) (emphasis added).

posed only in combination with one of the transfer restrictions authorized by subsections (c)(1), (3), or (4). This interpretation is also supported by the fact that an obligation to purchase is not a transfer restriction and section 17-6426 purports to apply to transfer restrictions. Again, however, there appears to be no reason why an obligation to purchase should be valid *only* if combined with one or more restrictions on transfer. In addition, the agreement must be an agreement respecting the purchase and sale of the securities. This terminology seems to preclude combining an obligation to purchase with consent or prohibited class restrictions because such restrictions do not give the other parties a right to purchase the shareholder's stock. If, on the other hand, "purchase and sale" refers to the proposed transfer by the shareholder that is sought to be restricted, it seems that a combination with a restriction designed to apply to gratuitous transfers would be precluded.<sup>286</sup>

From the foregoing it should be clear that nothing about this phrase in subsection (c)(2) is clear. It is submitted that the preferable interpretation is the one that would treat the phrase in question as a mere superfluity because it is most in keeping with the intended liberality of section 17-6426 and the view that participants in a close corporation usually should be free to arrange their affairs in a manner of their own choosing. The true meaning of subsection (c)(2) must await either judicial interpretation or legislative amendment.<sup>287</sup>

Another problem arising under subsection (c)(2) relates to enforcement. Subsection (a) provides that a transfer restriction that complies with section 17-6426 may be enforced *against* the holder of the restricted security or his successor or transferee. As previously stated, an obligation to purchase is not a restriction on transfer, and if enforcement is sought it will be sought *by* the holder against the party or parties who have agreed to purchase. There is no specific provision for enforcement in such a case, and once again subsection (c)(2) seems to be out of phase with the remainder of section 17-6426. It is highly unlikely that the legislature intended to create a right without a remedy, and it is submitted that the courts should not hesitate to fill the void.

It should finally be noted that the same problems in regard to price and funding the purchase discussed with reference to restrictions under subsection (c)(1) are present in arrangements utilizing an obligation to repurchase.

Subsection (c)(3) provides that a restriction on transfer is permitted if it requires the corporation or the holders of any class of securities to consent to a proposed transfer of the restricted securities or to approve the proposed transferee. This type of consent restriction had been upheld under prior

---

<sup>286</sup> Portions of the foregoing analysis were adapted from Current Legislation, *Section 202 of the Delaware Corporation Law—Per Se Rules for Stock Transfer Restrictions*, 9 B.C. IND. & COM. L. REV. 405, 415-16 (1968).

<sup>287</sup> Such an amendment might state that a restriction on transfer is permitted by § 17-6426 if it "[o]bligates the corporation or any holder of securities of the corporation or any other person or any combination of the foregoing, to purchase the securities which are the subject of the obligation."

Kansas law.<sup>288</sup> It may be more advantageous to those exercising it than a right of first refusal or a first option because it requires no cash outlay. It may also be much more onerous to the holder of restricted securities because transfers may be completely prohibited, whereas under subsection (c)(1) the stock eventually will be transferred, either to the proposed transferee or to the holders of the first option or right of first refusal. When these two factors are recognized, it becomes apparent that the potential for abuse of consent restrictions is great.

The problem of potential abuse is complicated by the lack of an express requirement in subsection (c)(3) that the withholding of consent to a transfer must be in good faith. Such a requirement was imposed on consent restrictions under the common law,<sup>289</sup> and one authority has commented, with respect to an identical provision of the Delaware Law, that good faith is a necessary element to enforcement of the restriction.<sup>290</sup> It is to be hoped that Kansas courts will share this view, but a contrary result seems possible because of the absence of a specific limitation in the statute and the fact that it appears to state a rule of per se legality.<sup>291</sup>

Even if a requirement of good faith is superimposed on subsection (c)(3), it does not necessarily follow that withholding of consent must be reasonable. Good faith seems to imply a subjective standard while reasonableness connotes an objective one. It appears completely possible for a person to act both in good faith and unreasonably, and the cases involving consent restrictions seem to be more concerned with the former than the latter.<sup>292</sup> In addition, subsection (c)(4) contains an express requirement that restrictions limiting the class of potential transferees be "not manifestly unreasonable." This suggests that the absence of a reasonableness requirement in subsection (c)(3) is not unintentional. This is not to say that a court should not or would not give effect to specific limitations of good faith and reasonableness contained in a cor-

---

<sup>288</sup> See *Wallace v. Southwestern Sanitarium Co.*, 160 Kan. 331, 161 P.2d 129 (1945).

<sup>289</sup> *Carlson v. Ringgold County Mut. Tel. Co.*, 252 Iowa 748, 108 N.W.2d 478 (1961); cf. *In re West Waterway Lumber Co.*, 59 Wash. 2d 310, 367 P.2d 807 (1962).

<sup>290</sup> FOLK, *supra* note 45, at 199. But see *Bradley, A Comparative Evaluation of the Delaware and Maryland Close Corporation Statutes*, 1968 DUKE L.J. 525, 541 [hereinafter cited as *Bradley*]: "No convincing reason exists why the parties should not be allowed to agree to give each other an absolute, arbitrary control over associates. In the absence of legislative clarity, the Delaware statute should be read by the courts as permitting close corporation stockholders to reject a proposed transferee without any possibility of judicial review of the purity of their motives."

<sup>291</sup> Professor Folk also states that where the power of consent is lodged in the corporation, the rules regarding transactions in which directors are interested presumably would apply. FOLK, *supra* note 45, at 199. The Kansas counterpart of these rules appears in KAN. STAT. ANN. § 17-6304 (Supp. 1973). Although good faith and fairness are required in § 17-6304, its applicability would be limited to cases in which a director was the proposed transferor who desired corporate consent to the transfer. Section 17-6304 covers only contracts or transactions between a corporation and its directors or officers and is intended merely to validate transactions that otherwise might be voidable by the corporation because of the director's or officer's interest. It can have no application to a case where the corporation withholds its consent to a proposed transfer by one of its shareholders. In such a case no one is seeking to take advantage of the corporation in a way that might permit it to avoid the transaction. Rather, the converse is true.

<sup>292</sup> See cases cited note 289 *supra*. These cases are cited in 2 O'NEAL, *supra* note 13, § 7.08 n.5 to support the proposition that both good faith and reasonableness are required. It is submitted that a careful reading of these cases will show them to be directed primarily at the former.

poration's articles or by-laws or in an agreement imposing a consent restriction. Because of the potential for abuse of this type of transfer restriction, such provisions should be given serious consideration by counsel and, if employed, should be upheld by the courts.<sup>293</sup>

Subsection (c)(4) provides that a restriction on transfer is permitted if it prohibits the transfer of securities to designated persons or classes of persons if the designation is not manifestly unreasonable. This subsection represents a major addition to Kansas law. It allows the parties to segregate forever from the rest of the world certain persons or classes of persons to whom transfer will not be permitted, if such segregation is not manifestly unreasonable.

The exact meaning of the limitation that the designation not be manifestly unreasonable is not clear, but it may be directed, in part at least, toward the breadth of a prohibition. Section 17-7202(b), which applies only to statutory close corporations, permits the articles of such a corporation to specify the qualifications of shareholders either by stating the classes of persons who shall be entitled to be shareholders or by stating the classes who shall not be so entitled, or both. Section 17-7202(b) arguably permits a much broader, and therefore much greater restraint than subsection (c)(4) because it allows the parties to segregate from the rest of the world those persons who will be permitted to become shareholders as well as those who will not. Section 17-7202(b) applies only to corporations that meet certain fairly strict qualifications, while subsection (c)(4) is generally available to any corporation choosing to utilize it. For these reasons it could be concluded that to the extent a prohibited class restriction under subsection (c)(4) is drafted in such broad terms that it in effect becomes a negatively-stated approved class restriction it is manifestly unreasonable. Otherwise, the distinction between the two sections would be purely semantic.

A contrary interpretation could be based upon the factors courts have considered in passing upon the reasonableness of a transfer restriction absent a statute. Among these are the size of the corporation, the degree of restraint, the likelihood of its contributing to the attainment of corporate objectives, the possibility of injury to the corporation from a hostile shareholder, and the likelihood that the restriction would promote the best interests of the corporation as a whole.<sup>294</sup> Under this approach the breadth of the prohibited class would be only one factor to be balanced against numerous other factors relating to the necessity of the restriction for the corporate welfare. Such an analysis could lead to the conclusion that even an extremely broad prohibition was not manifestly unreasonable.<sup>295</sup> Moreover, the negative phrasing of the stand-

---

<sup>293</sup> A requirement that consent not be withheld for an unreasonable period of time should not be employed. If the party whose consent to a transfer is required withholds such consent in good faith and upon reasonable grounds, he should be permitted to withhold it indefinitely. Anything less would subvert the effectiveness of the restriction.

<sup>294</sup> 2 O'NEAL, *supra* note 13, § 7.06.

<sup>295</sup> Professor Folk, the official Reporter for the Delaware Law, has commented that a bar to sales outside a family or a defined business group probably could be sustained under the "not manifestly

ard and inclusion of the modifying adverb "manifestly" appears to indicate a legislative intent that transfer restrictions under subsection (c)(4) be given a fair degree of latitude. It is submitted that the validity of a prohibited class restriction should not be determined solely by a mechanical test that measures its breadth. Rather, it should be upheld unless it is so broad that it is clearly unrelated to the legitimate needs of the business.

Because the courts have not interpreted this subsection it may be exceedingly difficult to draft a provision broad enough to be fully effective yet narrow enough to be upheld if challenged. It therefore would be prudent to combine any prohibited class restriction with a first option or right of first refusal. Depending upon the circumstances of a given case, the latter restrictions could be made either generally applicable or contingent upon the invalidity of the prohibited class restriction.<sup>296</sup>

Subsection (d) of section 17-6426 provides that any transfer restriction imposed for the purpose of maintaining the corporation's status under Subchapter S of the *Internal Revenue Code* shall be conclusively presumed to be for a reasonable purpose. The effect of this subsection is not clear. Subsection (a) states that a restriction "permitted" by section 17-6426 is enforceable, and presumably legal. Subsection (c) lists four types of restrictions that are "permitted," and subsection (e) states that any other lawful restriction is "permitted." Subsection (d) is not phrased in terms of "permitted" but merely creates a presumption of reasonableness of purpose. Thus, it cannot be concluded that subsection (d) validates virtually any transfer restriction designed to maintain Subchapter S status.

In order to qualify for Subchapter S tax status a corporation must: (1) be a domestic corporation which is not a member of an affiliated group of corporations; (2) not have more than ten shareholders; (3) not have as shareholders persons other than individuals or estates; (4) not have as shareholders any nonresident aliens; and (5) not have more than one class of stock.<sup>297</sup> The important requirements for purposes of a discussion of transfer restrictions are those that relate to the number and identity of shareholders. It seems that continued compliance with these requirements could be assured solely through use of some or all of the restrictions specifically authorized by subsection (c) of section 17-6426. For example, a consent restriction could control the number of shareholders, and their identity could be controlled by means of a carefully drafted restriction prohibiting transfers to business entities, trusts, and nonresident aliens. Employment of such restrictions would make reliance

---

unreasonable" standard. *FOLK*, *supra* note 45, at 199. Such a bar clearly is the equivalent of an approved class restriction. *See In re West Waterway Co.*, 59 Wash. 2d 310, 367 P.2d 807 (1962), in which the court, unaided by a statute, expressed approval of a restriction limiting stock ownership to persons engaged in lumber manufacturing on the Pacific coast.

<sup>296</sup>The Code provides such a safety device in the case of statutory close corporations but not in the case of other corporations. KAN. STAT. ANN. § 17-7209 (1974) (granting a 30 day first option to the corporation in case a transfer restriction is held invalid).

<sup>297</sup>INT. REV. CODE OF 1954, § 1371(a).

on subsection (d) unnecessary, except possibly if the prohibited class restriction were challenged as manifestly unreasonable. Thus resort to subsection (d) would be limited to types of transfer restrictions not specifically authorized by subsection (c). The approved class restriction is an example of a restriction that might not be specifically authorized by subsection (c) but that would be particularly well adapted to solution of the shareholder identity problem. As previously stated, subsection (e) permits "[a]ny other lawful restriction on transfer" of a security. This subsection was apparently designed to authorize "lawful" transfer restrictions other than those permitted by subsection (c). Lawfulness must be determined from some source other than section 17-6426, and the term appears broad enough to include the common law not only of Kansas but also of other states.<sup>298</sup> Under the common law, reasonableness of purpose is an element necessary to the legality of a transfer restriction.<sup>299</sup> In the case of restrictions designed to preserve Subchapter S status, that element is supplied by subsection (d).

In conclusion, it may be said that in spite of some ambiguities the Code has liberalized and clarified the area of restrictions on the transfer of securities. As a result, counsel for small corporations should be able to cope more effectively with the problem of controlling stock ownership.<sup>300</sup>

## V. STATUTORY CLOSE CORPORATIONS

A recent trend in corporate legislation has been increased recognition of the unique characteristics and requirements of close corporations.<sup>301</sup> In line with this trend, Kansas in article 72 of the Code, has adopted a number of statutory provisions applicable only to close corporations that elect to be governed thereby and meet certain qualifications. To the extent there is no conflict, these provisions are designed to be supplementary to, and not exclusive of, the general provisions of the Code.<sup>302</sup>

### A. Acquisition and Maintenance of Close Corporation Status

A statutory close corporation is one whose articles of incorporation identify

<sup>298</sup> See text at notes 142-45 *supra* for a discussion of the phrase "not contrary to the laws of this state" as used in KAN. STAT. ANN. § 17-6002(b)(1) (1974). See FOLK, *supra* note 45, at 199-201. Since § 17-6426(e) uses the general term "lawful" rather than "not contrary to the laws of this state," it seems that an inquiry into the legality of a particular transfer restriction beyond the borders of the state was intended. If the inquiry is limited to prior Kansas case law, subsection (e) would be meaningless because the only types of transfer restrictions the Kansas courts recognized already are encompassed by subsection (c).

<sup>299</sup> See *Lawson v. Household Fin. Corp.*, 17 Del. Ch. 343, 152 A. 723 (Sup. Ct. 1930); *Royal China, Inc. v. Regal China Corp.*, 279 App. Div. 515, 110 N.Y.S.2d 718 (1952).

<sup>300</sup> After institution of a transfer restriction, shareholders must take care to adhere strictly to its terms with respect to any and all proposed transfers to avoid a possible claim of waiver of, or estoppel to assert, the restriction at some subsequent time. *Thompson v. Anderson*, 209 Kan. 547, 498 P.2d 1 (1972) (because of prior conduct inconsistent with a transfer restriction, a shareholder waived his right to assert it against another shareholder); *Browning v. Lefevre*, 191 Kan. 397, 381 P.2d 524 (1963) (to the same effect).

<sup>301</sup> *E.g.*, DEL. CODE ANN. tit. 8, §§ 341-56 (Cum. Supp. 1968); FLA. STAT. ANN. §§ 608.70-77 (Supp. 1973); MD. ANN. CODE art. 23 §§ 100-11 (1973); N.Y. BUS. CORP. LAW §§ 620, 1002 (McKinney 1963), as supplemented (McKinney Supp. 1973); N.C. GEN. STAT. §§ 55-73(b), -125(a)(3) (1965); S.C. CODE ANN. §§ 12-16.22, -22.14 (Supp. 1973).

<sup>302</sup> KAN. STAT. ANN. § 17-7201(b) (1974).

it as such<sup>303</sup> and contain provisions to the effect that: (1) all of the corporation's issued stock shall be held of record by a specified number of persons, not exceeding 30; (2) all of the issued stock shall be subject to one or more of the transfer restrictions permitted by section 17-6426; and (3) the corporation shall make no "public offering" of its stock within the meaning of the Federal Securities Act of 1933, as amended.<sup>304</sup> These definitional elements not only must be stated in the articles of incorporation but they also must be complied with in fact.<sup>305</sup>

The first element, as noted, requires the corporation's articles to provide that its stock shall not be held of record by more than a specified number of persons, not greater than 30. Specifying a number less than 30 could result in loss of close corporation status if the total number of shareholders should grow to exceed the specification, even though it remains less than 30. In order to avoid the necessity of amending the articles at some future time, it will be best in many cases to originally set the number at 30.<sup>306</sup>

It is clear that the numerical element refers only to shareholders of record. Thus, stock registered in the name of a trustee of a trust with numerous beneficiaries will be deemed held by a single shareholder.<sup>307</sup> Also, section 17-7202(c) provides that stock held in tenancy in common, joint tenancy, or tenancy by the entireties will be treated as held by one shareholder. It is therefore possible that many more than 30 persons actually be beneficially interested in the corporation.

The requirement that the corporation not make a "public offering" of its stock within the meaning of the Securities Act of 1933 seems to be based on the theory that a close corporation is the antithesis of a public corporation, and a public corporation is one that makes public offerings of its stock. The appropriateness of such a test is questionable. The purpose of the Securities Act of 1933<sup>308</sup> is protection of the investing public by requiring full disclosure of all material facts when a public offering of securities is made. The words "public offering" are construed, in light of this purpose, to mean any offering of securities to persons, no matter how few, who need the protection afforded by such disclosure.<sup>309</sup> It is not clear what relevance a body of law based on this concept of investor protection has to the state law question of what

---

<sup>303</sup> *Id.* § 17-7203(a).

<sup>304</sup> *Id.* § 17-7202(a). Devising a satisfactory definition is one of the most important, yet one of the most difficult, tasks involved in drafting legislation specially applicable to close corporations. Some states have defined a close corporation as one whose shares are not regularly traded. *E.g.*, FLA. STAT. ANN. § 608.70(2) (Supp. 1974); N.Y. BUS. CORP. LAW § 620(c) (McKinney Supp. 1973); N.C. GEN. STAT. § 55-73(b) (1965); S.C. CODE ANN. § 12-16.22(c) (Supp. 1973). One state has defined a close corporation simply as one that identifies itself as such in a provision of its articles of incorporation to which every shareholder has assented. MD. ANN. CODE art. 23, § 100(a) (1973).

<sup>305</sup> KAN. STAT. ANN. § 17-7205(b) (1974).

<sup>306</sup> FOLK, *supra* note 45, at 506.

<sup>307</sup> *Id.*

<sup>308</sup> 15 U.S.C. §§ 77a-77bbbb (1970).

<sup>309</sup> SEC v. Ralston Purina Co., 346 U.S. 119 (1953).

corporations should be entitled to take advantage of provisions permitting the alteration of general corporate norms.<sup>310</sup>

In practice, this definitional element may be severely restrictive. The Securities and Exchange Commission recently promulgated rule 146, which provides a nonexclusive "safe harbor" test for transactions by an issuer that are exempt from the registration requirement because they do not involve a public offering.<sup>311</sup> This rule contemplates that an offering will be non-public only when, among other things, the offerees have such knowledge and experience in business and financial matters that they are capable of evaluating the merits and risks of the investment or when they utilize a representative who has such knowledge and experience *and* the offeree is able to bear the economic risk of the investment.<sup>312</sup> As a result, a corporation's status as a close corporation may be jeopardized if it offers its stock to even a single uninformed person.<sup>313</sup> It might be said that this burden is not imposed by the Code but by the Securities Act of 1933, which also must be complied with in most cases. However, the actual result is that the Code will force a close corporation to rely always only on the nonpublic offering exemption from registration rather than on other exemptions that, but for the Code, might be equally available.<sup>314</sup> This result seems needlessly and unduly restrictive.

The final definitional element requires utilization of one of the transfer restrictions enumerated in section 17-6426. Since the transfer restriction is required to be stated in the articles of incorporation and since this is a jurisdictional element for close corporation status, it should take precedence over section 17-6426(b), which permits transfer restrictions to appear in the articles, the by-laws, or a private agreement.<sup>315</sup> The transfer restriction requirement must be read in light of the requirement that the corporation make no

<sup>310</sup> Bradley, *supra* note 290, at 532.

<sup>311</sup> SEC Securities Act Release No. 5487 (April 23, 1974), *reprinted in* 1 CCH FED. SEC. L. REP. ¶¶ 2709-10 (1974) [hereinafter referred to as Release No. 5487].

<sup>312</sup> *Id.* Although rule 146 is designed to be nonexclusive, the alternative judicial and administrative interpretations are not substantially more lenient. *See* SEC v. Ralston Purina Co., 346 U.S. 119 (1953); SEC Securities Act Release No. 4552 (Nov. 6, 1962), *reprinted in* 1 CCH FED. SEC. L. REP. ¶¶ 2770-83 (1973) [hereinafter referred to as Release No. 4552].

<sup>313</sup> One writer has suggested that in light of the possibility for oppression of minorities inherent in the flexible rules applicable to close corporations the requirement that there be no public offering may be designed to insure that only those with sufficient bargaining power to protect their interests will become participants. Comment, *Delaware's Close-Corporation Statute*, 63 Nw. U.L. REV. 230, 239-40 (1968). It is submitted that if the legislature was concerned with oppression of the minority it could have prevented it by less Draconian means, such as requiring unanimous consent to the application of certain of the special provisions of the Code.

<sup>314</sup> For example, § 3(a)(11) of the Securities Act of 1933 exempts from registration issues which are offered and sold only to persons resident within a single state in which the issuer is incorporated and doing business. 15 U.S.C. § 77c(a)(11) (1970); *see* SEC Rule 147, 17 C.F.R. § 230.147, 1 CCH FED. SEC. L. REP. ¶¶ 2253, 2340 (1974). SEC Regulation A provides another exemption from registration with respect to public offerings of an issuer that do not exceed \$500,000 and meet certain other requirements. However, the issuer must file a notification and offering circular with the SEC, and the circular must also be furnished to all offerees. 17 C.F.R. § 230.251-263 (1974). Finally, SEC proposed rule 240 would exempt offerings by close corporations where certain conditions are met, the most important of which are: (1) that the corporation have 50 or fewer beneficial owners both before and after the sales; (2) that sales of unregistered securities in any year not exceed \$100,000; and (3) that sales of unregistered securities in any year not be made to more than 25 purchasers. SEC Securities Act Release No. 5499 (June 3, 1974), *reprinted in* 1 CCH FED. SEC. L. REP. ¶ 2358D (1974).

<sup>315</sup> FOLK, *supra* note 45, at 506.



public offering of its stock. For example, a restriction prohibiting transfers of stock to competitors would be sufficient to satisfy the definitional element relating to transfer restrictions, but would not be sufficient to insure that there would be no public offering of the stock. Although the requirement that there be no public offering by its terms applies only to the corporation and not to its shareholders, under some circumstances sales by a shareholder will be attributed to the corporation.<sup>316</sup> If such sales would not themselves meet the requirements for a nonpublic offering, the corporation's status as a close corporation would be threatened. Consequently, a consent restriction or a restriction permitting transfer only to a class of persons who possess the requisite business and financial knowledge and experience, or some combination thereof, will be necessary.<sup>317</sup>

Finally, it should be noted that the three elements in the definition of a close corporation apply only to stock. Nothing in the statute prevents genuine debt securities from being held by more than 30 persons or even from being offered to the public.<sup>318</sup>

An existing corporation may elect to become a close corporation by amending its articles of incorporation to state that it so elects and to conform with the previously-discussed requirements for close corporation status. Such an amendment must be adopted by the affirmative vote of the holders of record of at least two-thirds of the shares of each class of stock outstanding, whether or not such stock otherwise would be entitled to vote.<sup>319</sup> The corporation will remain a close corporation until one of the requirements for that status is breached and no corrective action is taken or until the shareholders adopt an amendment to the articles voluntarily terminating such status.<sup>320</sup> An amendment to terminate must be adopted by the affirmative vote of the holders of record of at least two-thirds of the shares of each class of stock outstanding, whether or not such stock otherwise would be entitled to vote, except that

---

<sup>316</sup> See, e.g., Release No. 4552, *supra* note 312, at ¶ 2777, where the problem of resales by the initial purchaser is discussed in connection with the issuer's exemption for transactions not involving a public offering:

An important factor to be considered is whether the securities offered have come to rest in the hands of the initial informed group or whether the purchasers are merely conduits for a wider distribution. Persons who act in this capacity, whether or not engaged in the securities business, are deemed to be "underwriters" within the meaning of section 2(11) of the Act. If the purchasers do in fact acquire the securities with a view to public distribution, the seller assumes the risk of possible violation of the registration requirements of the Act and consequent civil liabilities.

(Footnote omitted.)

Regarding the problems of a shareholder who acquires securities from an issuer in a nonpublic offering, see SEC Rule 144, 17 C.F.R. § 230.144 (1974), 1 CCH FED. SEC. L. REP. ¶ 2705A (1974).

<sup>317</sup> In addition to the transfer restrictions authorized by § 17-6426, KAN. STAT. ANN. § 17-7202(b) (1974) permits the articles of a close corporation to set forth the qualifications of shareholders by specifying either classes of persons who will be entitled to be shareholders or classes who will not be entitled to be shareholders, or both.

<sup>318</sup> *FOLK*, *supra* note 45, at 507. The problem whether a debt security actually represents a disguised equity interest may well be present in cases involving the status of close corporations, as it is in other areas of the law. See, e.g., *Tomlinson v. 1661 Corp.*, 377 F.2d 291 (5th Cir. 1967); *Costello v. Fazio*, 256 F.2d 903 (9th Cir. 1958).

<sup>319</sup> KAN. STAT. ANN. § 17-7204 (1974).

<sup>320</sup> *Id.* § 17-7205.

the articles may provide that greater than a two-thirds vote, or even a unanimous vote, will be required.<sup>321</sup>

Requiring a two-thirds class vote for election of close corporation status is thought to be desirable because shareholders of such a corporation may be subject to burdens and liabilities not imposed on shareholders of ordinary corporations.<sup>322</sup> Similarly, a two-thirds class vote for voluntary termination of close corporation status is felt necessary to preserve mutually bargained-for rights and privileges which might be lost or jeopardized if termination were too readily achievable.<sup>323</sup> At least one writer has criticized these requirements as not stringent enough because they permit close corporation status to be elected or terminated over the objection of a substantial minority.<sup>324</sup> More to the point, one may question why specific statutory permission for a greater than two-thirds vote requirement was granted with respect to voluntary termination but not with respect to election of close corporation status. Actually, because of an apparent statutory disjunction, unanimity may be required in *every* case in which close corporation status is elected by a corporation all of the stock of which was not subject to a pre-existing restriction on transfer. While section 17-7204 requires only a two-thirds class vote for the adoption of an amendment to the articles of incorporation, section 17-7202(a)(2) requires *all* the issued stock of all classes to be subject to one or more of the transfer restrictions authorized by section 17-6426. Section 17-6426(b) provides that no transfer restriction will be binding with respect to securities issued prior to the adoption of the restriction unless the holders of the securities assented thereto. The result seems to be that unless all shareholders vote to elect close corporation status, one of the elements of which is imposition of a transfer restriction, the definitional requirements of section 17-7202 will not be met.<sup>325</sup> In any event, the broad permission granted by section 17-6002(b)(4) for adoption of a vote requirement higher than is required by the Code should be sufficient to allow the parties to employ a greater than two-thirds vote requirement for the election of close corporation status if they so desire.

The Code also contains a number of provisions designed to aid in pre-

<sup>321</sup> *Id.* § 17-7206. Section 17-7206(b) also states that if the articles contain a provision requiring greater than a two-thirds vote for termination of close corporation status, such "provision shall not be amended, repealed or modified by any vote less than that required to terminate the corporation's status as a close corporation." The intent of this statement appears to be that the provision requiring a greater than two-thirds vote for termination cannot itself be altered or deleted except by such greater vote. FOLK, *supra* note 45, at 511. However, because of unfortunate phrasing, subsection (b) is subject to the interpretation that a high vote requirement could be altered or deleted by a two-thirds class vote, since that is all that ordinarily is necessary to terminate close corporation status. Compare KAN. STAT. ANN. § 17-6602(c)(4) (1974). Such an interpretation is not dictated by the phraseology of subsection (b) and would be a misconstruction of legislative intent.

<sup>322</sup> FOLK, *supra* note 45, at 509.

<sup>323</sup> *Id.* at 510-11.

<sup>324</sup> Comment, *The Close Corporation—Comparing the Separate Statutory Treatments of Florida, Delaware and Maryland with Virginia's Version of the Model Act*, 7 U. RICH. L. REV. 511, 515 (1973).

<sup>325</sup> Bradley, *supra* note 290, at 534. It may be possible to argue that "subject to" as used in § 17-7202 (a)(2) is not the equivalent of "binding" as used in § 17-6426(b). That is, although a transfer restriction may not be binding upon a particular shareholder because he dissented from its adoption, his stock nevertheless is subject thereto in the sense that the restriction will be binding upon any subsequent transferee.

venting involuntary termination of close corporation status by reason of breach of one of the definitional requirements. Section 17-7207 is directed to the problem of issuance or transfer of stock in breach of mandatory conditions or restrictions on such issuance or transfer. It provides that if the issuance or transfer of stock would violate a limitation with respect to the qualifications of shareholders, a limitation on the number of shareholders, or a transfer restriction, and if such qualifications, limitations, or restrictions are conspicuously noted on the stock certificate, the issuee or transferee is conclusively presumed to have notice that, in essence, his acquisition of the stock is wrongful.<sup>326</sup> In such a case the corporation may refuse to register transfer of the stock unless all shareholders consent to the registration of transfer or unless the corporation has amended its articles to terminate its close corporation status.<sup>327</sup>

This section embodies the partnership norm of *delectus personae* and, in connection with section 17-7208(a)(2), is designed to prevent loss of close corporation status because of a nonqualifying transfer of stock. It clearly will serve this purpose with respect to the limitation on the number of shareholders, since that limitation refers to holders of record, and a refusal to register transfer will prevent the transferee from becoming a holder of record. It should also be sufficient to preserve the integrity of the transfer restriction limitation. It is not as clear that a refusal to register transfer will prevent at least a technical violation of the public offering limitation even though the corporation has done all it could to prevent the transfer. Because the terminology of that limitation seems to contemplate mere offers as well as completed transfers, a breach could be held to occur notwithstanding the corporation's refusal to register transfer.<sup>328</sup> However, it is submitted that such a technical violation, if it is a violation at all, should not precipitate involuntary loss of close corporation status, especially in light of the somewhat more lenient attitude of the Securities and Exchange Commission recently enunciated in rule 146.<sup>329</sup>

The phrase "conspicuously noted" should be given the same meaning it

<sup>326</sup> KAN. STAT. ANN. §§ 17-7207(a), (b), (c) (1974).

<sup>327</sup> *Id.* §§ 17-7207(d), (e). Of course if the corporation refuses to register transfer of the stock the transferee may have a cause of action against his transferor for breach of warranty that the transfer was effective and rightful. *Id.* § 17-7207(g); *id.* § 84-8-306(2)(a) (1965).

<sup>328</sup> See Release No. 4552, *supra* note 312.

<sup>329</sup> Rule 146(d) requires that prior to making an offer the issuer have reasonable grounds to believe that the offeree is qualified and that prior to making a sale the issuer make a reasonable inquiry that confirms the offeree's qualifications. If the inquiry does not confirm the offeree's qualifications the nonpublic offering exemption will still be available as to the offer if the issuer had reasonable grounds to believe, and did believe, prior to making the offer that the offeree was qualified. Subsection (h) of rule 146 is directed to the issuer's obligations with respect to the resale problem. It merely requires the issuer to exercise reasonable care to assure that purchasers are not statutory underwriters. Such care includes making a reasonable inquiry to determine whether the purchaser is acquiring the securities for his own account; placing transfer restrictions on the securities; issuing stop transfer instructions to its transfer agent or, if none, making an appropriate notation on its own records; and securing an agreement from the purchaser which restricts resale. Release No. 5487, *supra* note 311. Presumably, if such reasonable care is exercised a subsequent resale by the purchaser should not preclude reliance by the issuer on the nonpublic offering exemption if it refuses to register the transfer. A similar result should obtain with respect to close corporation status under the Code.

has under section 17-6426.<sup>330</sup> Additionally, under section 17-7207(d) it seems that even if the qualification, limitation, or restriction is not conspicuously noted on the stock certificate, the corporation may refuse to register transfer if the transferee had actual notice that his acquisition of the stock was wrongful.<sup>331</sup>

Section 17-7208 creates a kind of hiatus that permits a close corporation to take corrective action to prevent involuntary termination of its status where a condition for continuation of that status has been breached. Within 30 days after the later of the breach or its discovery the corporation must file with the secretary of state and furnish to each shareholder a certificate relating the fact of such breach.<sup>332</sup> This requirement is designed to put all parties on notice that close corporation status is threatened so they may institute corrective action.<sup>333</sup> The corporation concurrently must take action to correct the breach, including, but not limited to, refusal to register a transfer of stock pursuant to section 17-7207 or institution of a judicial proceeding.<sup>334</sup> If the corporation institutes a judicial proceeding, the Code gives the district court broad jurisdiction to issue all orders necessary to prevent loss of close corporation status or to restore such status.<sup>335</sup> Any shareholder also has standing to initiate a like judicial proceeding.<sup>336</sup> Shareholders apparently were given standing to provide protection in cases in which the corporation can not or will not act. This might occur where a majority desires to terminate close corporation status but cannot procure the necessary two-thirds or greater class vote under section 17-7206. In such a case their obvious course of action would be to attempt to circumvent the voting requirement for voluntary termination by committing acts or causing the corporation to commit acts that would result in involuntary termination. It is necessary under these circumstances that a shareholder have standing to file suit for corrective action because the corporation cannot be expected to do so.<sup>337</sup>

Section 17-7209 grants the corporation a 30 day first option on a restricted security in case any transfer restriction is adjudged not to be authorized by section 17-6426. The option price is to be agreed upon by the parties, and, failing agreement, the district court is to determine a price equal to the fair value of the security. The court may make this determination by means of

---

<sup>330</sup> See text at notes 243-49 *supra*.

<sup>331</sup> KAN. STAT. ANN. § 17-7207(d) (1974) states that a corporation may refuse to register transfer "[w]henever any person to whom stock of a close corporation has been issued or transferred has, or is conclusively presumed under this section to have, notice" that his acquisition of the stock was wrongful.

<sup>332</sup> *Id.* § 17-7208(a)(1).

<sup>333</sup> FOLK, *supra* note 45, at 516.

<sup>334</sup> KAN. STAT. ANN. § 17-7208(a)(2) (1974).

<sup>335</sup> *Id.* § 17-7208(b). The court may enjoin or set aside any act or threatened act on the part of the corporation or a shareholder that would be inconsistent with the provisions in the corporation's articles relating to its status as a close corporation, it may enjoin or set aside transfers or threatened transfers of stock, and it may enjoin any public offering or threatened public offering of stock.

<sup>336</sup> *Id.*

<sup>337</sup> The district court's jurisdiction clearly should be broad enough to include an order requiring the corporation to comply with the mandatory notice requirements of § 17-7208(a)(1).

an appraisal procedure similar to that employed in determining the price to be paid to shareholders who dissent from a merger.<sup>338</sup> This is an innovative provision intended to supplement section 17-6426. Although its terms apply to any restricted security of a close corporation, its basic purpose is to give the corporation a second chance to comply with the definitional element relating to restrictions on the transfer of stock. The underlying premise is that a first option running to the corporation is more in accord with the parties' presumed intent than the complete absence of restriction, a fact that would cause loss of close corporation status.<sup>339</sup> Since section 17-7209 will come into play only if a pre-existing transfer restriction imposed by the parties is declared invalid, and since a first option is one of the restrictions permitted by section 17-6426, the definitional element relating to transfer restrictions should be satisfied even though the option is imposed by statute rather than by the articles of incorporation. This statutory option will apply only with respect to the transfer or attempted transfer that resulted in the judicial declaration that a particular transfer restriction was invalid. Beyond this, the parties must agree upon and impose a new transfer restriction permitted by section 17-6426.

### B. *Management of the Business*

The Code contains three sections intended to free an electing close corporation from general corporate norms relating to management of its business and affairs. Section 17-7210 provides that a written agreement among the holders of a majority of the voting stock of a close corporation, or among such holders and nonshareholders, will not be invalid, as between the parties thereto, on the ground that it so relates to conduct of the business and affairs of the corporation as to restrict or interfere with the powers or discretion of the board of directors. Such an agreement relieves the directors and imposes upon the shareholders who are parties to the agreement liability for managerial acts and omissions.<sup>340</sup> The purpose of this section seems to be to declare, as a matter of public policy, that agreements restricting or interfering with the discretion or powers of the board of directors are not invalid.<sup>341</sup> An agreement among shareholders may cover such things as allocation of corporate offices, fixing of compensation by means of salaries and bonuses, and shaping of dividend policy.<sup>342</sup> Because section 17-7210 states that agreements with nonshareholders are not invalid, arrangements delegating managerial powers to outsiders now appear to be authorized for close corporations.<sup>343</sup>

<sup>338</sup> KAN. STAT. ANN. § 17-7209 (1974); *see id.* § 17-6712.

<sup>339</sup> FOLK, *supra* note 45, at 517.

<sup>340</sup> KAN. STAT. ANN. § 17-7210 (1974).

<sup>341</sup> FOLK, *supra* note 45, at 518. It seems that the legislature properly could have gone farther and affirmatively declared such agreements valid and specifically enforceable. *See* MD. ANN. CODE art. 23, § 104(d) (1973); Hall, *The New Maryland Close Corporation Law*, 27 MD. L. REV. 341, 357 (1967).

<sup>342</sup> FOLK, *supra* note 45, at 518; Bradley, *supra* note 290, at 537-38.

<sup>343</sup> FOLK, *supra* note 45, at 518. In the past some courts viewed such agreements as an illegal delegation of duties by the board of directors. *See, e.g.,* *Sherman & Ellis, Inc. v. Indiana Mut. Cas. Co.*, 41 F.2d 588 (7th Cir. 1930).

Section 17-7214 provides that no written agreement among shareholders of a close corporation, nor any provision of its articles of incorporation or by-laws, that relates to any phase of corporate affairs shall be invalid on the ground that it constitutes an attempt to treat the corporation as a partnership or to arrange relations in a way that would be appropriate only among partners.<sup>344</sup> The purpose of section 17-7214 appears to be similar to that of section 17-7210, but it constitutes a broader generalization regarding the internal structure of a close corporation.<sup>345</sup> The section seems intended to declare the public policy of the state to be contrary to the notion that persons engaged in business cannot be partners among themselves but a corporation to the rest of the world.<sup>346</sup> Section 17-7214 would probably be most useful where the parties wish to allocate control or profits in a different manner than their stock holdings would indicate—for example, on a per capita basis.<sup>347</sup>

Section 17-7211 states that the articles of incorporation of a close corporation may provide that the business shall be managed directly by the shareholders rather than by a board of directors. Such a provision may be inserted in the articles only by unanimous vote of all shareholders, whether or not they hold stock ordinarily entitled to vote, but may be deleted by a simple majority vote of such shareholders. The existence of a provision for management by the shareholders must be noted conspicuously on every stock certificate. While the provision is in effect, no shareholder meeting for the election of directors need be called, the shareholders are deemed the directors for purposes of applying other sections of the Code unless the context clearly requires otherwise, and the shareholders are subject to all liabilities of directors. Section 17-7211 appears to be a legislative recognition and acceptance of a practice already common among the shareholders of many close corporations and an attempt to more closely define and regulate such practice.

While these three sections, taken together, represent a commendable attempt to introduce flexibility into the management structure of close corporations, their exact effect and interplay are often obscure and problematic. One area of possible difficulty is the degree of shareholder participation required for institution or termination of the various arrangements authorized by these sections. Direct management by the shareholders does not seem much more radical a departure from the traditional corporate management structure than an agreement that completely restricts the discretion of the board of directors so that their every decision is subject to the will of the shareholders.<sup>348</sup> If this premise is correct one might question why the former

<sup>344</sup> The section cites the following as nonexclusive examples of matters that may be treated by such an agreement or provision: management of the business, declaration and payment of dividends or other division of profits, election of directors or officers, employment of shareholders, and arbitration of disputes.

<sup>345</sup> FOLK, *supra* note 45, at 526.

<sup>346</sup> See *Jackson v. Hooper*, 76 N.J. Eq. 592, 75 A. 568 (Ct. Err. & App. 1910).

<sup>347</sup> Partnership law provides that, absent an agreement to the contrary, profits and losses shall be borne equally by the partners and each shall have an equal voice in management, regardless of the amounts of their capital contributions. KAN. STAT. ANN. §§ 56-318(a), (e) (Supp. 1974).

<sup>348</sup> This seems especially true when it is recognized that in many instances the directors will be the same individuals as the shareholders.

arrangement must be adopted by a vote of all shareholders, whether or not their stock ordinarily carries voting privileges, and must be memorialized in the articles of incorporation while the latter may be the subject of a private agreement among less than all shareholders. One commentator has criticized a Delaware provision identical to section 17-7210 on the basis that it opens the door to oppression of minority shareholders who are not given an opportunity to participate in the management agreement.<sup>349</sup> This criticism seems unfounded, however, because section 17-7210 provides only that the agreement shall not be invalid as between the parties thereto. It leaves open the possibility that the agreement may be successfully challenged by a non-participating minority shareholder.<sup>350</sup> In fact, section 17-7210 merely seems to codify the waiver and estoppel principles of *Peck v. Horst*,<sup>351</sup> and thus might more properly be criticized as being superfluous.<sup>352</sup> Section 17-7211, on the other hand, has no antecedents in Kansas case law, and there seem to be two reasons for the requirement of unanimity. The first is that this requirement protects minority shareholders at least to the extent that a management structure without a board of directors can not be forced upon them without their consent. The second is that section 17-7211 imposes directorial liability on all shareholders, and the necessary concomitant would seem to be consent to such an imposition.<sup>353</sup>

The provision for termination of direct shareholder management by majority vote has been termed a trap for the unwary minority in that an investor may be lured into participation in a close corporation by the vision of direct shareholder management only to discover that the structure may revert to the traditional form at the whim of the majority. In such a case the minority may be subject to being squeezed out at less than an adequate price for his stock.<sup>354</sup> If this danger is perceived as real, it would behoove the prospective investor in such an enterprise to bargain for a high vote provision that would give him power to veto any proposed change in the direct shareholder management structure.<sup>355</sup>

Section 17-7214 is the most enigmatic of the three sections. As noted above, it purports to remove similarity to partnership operation as a ground for invalidity of a shareholder agreement or a provision of a close corporation's articles or by-laws. Section 17-7214 seems broad enough to encompass all the

<sup>349</sup> Comment, *The Close Corporation—Comparing the Separate Statutory Treatments of Florida, Delaware and Maryland with Virginia's Version of the Model Act*, 7 U. RICH. L. REV. 511, 517-18 (1973).

<sup>350</sup> FOLK, *supra* note 45, at 518; Bradley, *supra* note 290, at 538.

<sup>351</sup> 175 Kan. 479, 264 P.2d 888 (1953), *aff'd on rehearing*, 176 Kan. 581, 272 P.2d 1061 (1954) (two judges dissenting).

<sup>352</sup> *Peck v. Horst* involved an agreement in which all shareholders participated, and to the extent that § 17-7210 authorizes an agreement among less than all shareholders it could be said to broaden the law in this area. However, it is submitted that a proper interpretation of *Peck* would extend it to an agreement involving less than unanimous participation, with an effect identical to that of § 17-7210. See text at notes 130-35 *supra*.

<sup>353</sup> See FOLK, *supra* note 45, at 520.

<sup>354</sup> Bradley, *supra* note 290, at 538.

<sup>355</sup> Presumably the majority vote provision in § 17-7211 is subject to change by an appropriate clause in the articles of incorporation pursuant to the authority of KAN. STAT. ANN. § 17-6002(b)(4) (1974).

arrangements authorized by sections 17-7210 and 17-7211, yet it lacks those sections' specificity with respect to the adoption and binding effect of such arrangements. Section 17-7214 speaks only in terms of an "agreement among stockholders of a close corporation" or "any provision of the articles of incorporation or of the bylaws of the corporation." The Code does not indicate whether the agreement must be among all shareholders or whether less than unanimous participation is permitted. If less than unanimous participation is authorized, there is no statement as to whether the agreement will be valid only as between the parties or whether nonparticipating shareholders also are precluded from challenging it.<sup>356</sup> Similar problems exist with respect to provisions in the corporation's articles or by-laws. It would subvert the carefully expressed requirements of section 17-7211 to permit less than all shareholders to abolish the board of directors under section 17-7214 merely because operation without a board of directors resembles the operation of a partnership. It may be that sections 17-7210 and 17-7211 are specific exceptions carved out of the general rule of section 17-7214; that control devices falling within the scope of those sections will be governed thereunder; that any number of shareholders may participate in other agreements under section 17-7214; and that by-laws or provisions in the articles of incorporation, other than those falling within the purview of sections 17-7210 and 17-7211, merely are subject to the general voting requirements of the Code. However, since most control devices *will* fall within the scope of either section 17-7210 or section 17-7211, section 17-7214 may be no more than a broad legislative policy statement rather than an operative provision. It is submitted that in any event the underlying purpose of all of these sections is to prevent a party to a control device from avoiding the obligations of his bargain by raising arguments based upon traditional corporate norms. These provisions were not designed to facilitate oppression of nonconsenting minority shareholders and section 17-7214 should not be so construed.

Further problems exist regarding all three provisions. Section 17-7211 provides that if a close corporation is managed directly by its shareholders, the shareholders shall be deemed directors for purposes of applying the other provisions of the Code. Since the board of directors may act only at a meeting or by unanimous written consent,<sup>357</sup> it could be urged that shareholders proceeding under section 17-7211 may act only with similar formality. However,

<sup>356</sup> Professor Folk is of the opinion that the Delaware counterpart to § 17-7214 "should be liberally construed to authorize all sorts of internal agreements and arrangements which are not affirmatively improper or, more particularly, injurious to third parties." FOLK, *supra* note 45, at 526. He also believes that it "accords with [§ 17-7210], relating to agreements restricting director discretion, but as a generalization regarding internal arrangements it is broader" than § 17-7210. It thus may be inferred that Professor Folk feels this provision authorizes less than unanimous arrangements, but that such arrangements should be open to challenge by third parties, presumably nonparticipating or nonconsenting shareholders. Professor Bradley seems to hold protection of minority shareholders paramount and therefore has suggested that the term "stockholders" be interpreted to mean "all stockholders." Bradley, *supra* note 290, at 537-38. Such an interpretation, however, does not seem warranted by the statute and would not answer the question of what vote is needed for the insertion of this type of provision in the articles or by-laws.

<sup>357</sup> KAN. STAT. ANN. §§ 17-6301(b), (f) (1974).



an agreement to dispense with such formalities apparently would be authorized by section 17-7214.<sup>358</sup> If managerial decisions are made by means of a formal vote, an additional problem arises with respect to the voting power of each shareholder. Directors vote on a per capita basis, but shareholders vote on a per share basis. The Code leaves open the vital question of which method will control under section 17-7211. Moreover, if the shareholders merely agree to treat their corporation "like a partnership" under section 17-7214, the result may be that each shareholder possesses far-reaching apparent authority to bind the corporation in all transactions of ordinary business with third parties.<sup>359</sup> These problems remain unanswered but ought at least to be foreseen by counsel and made the subject of advance planning.

Finally, it is necessary to examine the effect of these control devices on transferees of stock of the close corporation. Section 17-7211 provides that if a close corporation's articles contain a provision for direct shareholder management its existence must be noted conspicuously on every stock certificate. Although the section is silent as to the effect of such a notation, it clearly is intended to prevent a transferee of stock from objecting to the arrangement.<sup>360</sup> The section is also silent regarding the rights of a transferee who has actual knowledge of the provision even though the stock certificate fails to conspicuously note its existence. In view of the express provisions in other sections binding a transferee under similar circumstances,<sup>361</sup> the absence of such a statement in section 17-7211 could be taken to mean that the transferee is not bound and may insist upon management by a board of directors. However, because the purpose of a notation on the stock certificate is simply to provide notice, the better view would be that a transferee with actual knowledge is barred from objecting, notwithstanding a failure to note existence of the management provision on the stock certificate.

Sections 17-7210 and 17-7214 do not even provide for notation of a control arrangement thereunder on the stock certificates. It is submitted that lack of an express provision for notation should not be construed to mean that a conspicuous notation will not be sufficient to import constructive notice to a transferee. Rather, the matter should be resolved by analogy to other sections that do provide expressly for conspicuous notation.<sup>362</sup>

### C. *Dissension and Deadlock*

The Code includes a number of remedies for problems of dissension and deadlock that are uniquely suitable to the needs of a close corporation. Section 17-7212 governs appointment of a custodian for a close corporation in certain

<sup>358</sup> Bradley, *supra* note 290, at 539.

<sup>359</sup> See KAN. STAT. ANN. § 56-309(a) (Supp. 1974). It is submitted that such a conclusion is not warranted by § 17-7214. That section is directed only to the internal structure of the corporation and does not purport to vary general corporate law with respect to external transactions.

<sup>360</sup> See FOLK, *supra* note 45, at 520.

<sup>361</sup> KAN. STAT. ANN. §§ 17-6426(a), -7207(d) (1974).

<sup>362</sup> Cf. FOLK, *supra* note 45, at 513.

cases in which section 17-6516, the general Code section covering custodians, would be inapplicable. Section 17-6516 will govern cases that do not fall within section 17-7212.<sup>363</sup> Under section 17-6516(a)(2), a district court may appoint a custodian for a corporation if its board of directors is in a deadlock that the shareholders are unable to break and the business is suffering or is threatened with irreparable injury. The first ground for appointment of a custodian under section 17-7212(a)(1) applies to a situation different only in that the board of directors has been abolished and the shareholders are managing the business directly. However, it requires in addition to deadlock and actual or threatened irreparable injury the failure of any deadlock-breaking remedy specified in the close corporation's articles or by-laws or in a shareholder agreement. This requirement is noteworthy in that it allows exhaustion of internal remedies before a shareholder may resort to a judicial proceeding to appoint a stranger to take over the corporate affairs. Such remedies might consist of arbitration or mediation or the compulsory buy-out of one or more shareholders.<sup>364</sup> Of course if the parties have not provided for such remedies in advance, the exhaustion requirement will be met. The implicit authorization of internal deadlock-breaking remedies adds desirable flexibility to the operation of close corporations. It is unfortunate that a similar requirement does not govern appointment of a custodian under section 17-6516 for a close corporation with a board of directors. This defect may be counteracted by the broad discretion that section gives to district courts. It is hoped that they will use their discretion wisely to refuse appointment of a custodian until all internal remedies are exhausted.<sup>365</sup>

Section 17-7212(a)(2) provides that a district court may appoint a custodian if the articles of incorporation, adopted pursuant to section 17-7215, give the petitioning shareholder the right to have the corporation dissolved.<sup>366</sup> The interplay between sections 17-7212(a)(2) and 17-7215 make it appear that the option of whether the corporation is dissolved or a custodian appointed rests solely with the shareholder possessing the right of dissolution. Appointment of a custodian involves invocation of the jurisdiction of a district court while dissolution under section 17-7215 does not. Since standing to petition under section 17-7212(a)(2) is limited to a shareholder with a right of dissolution, it seems clear that custodianship will be available as an alternate remedy only if such a shareholder so desires.<sup>367</sup> Section 17-6516(b) states that a custodian will

<sup>363</sup> KAN. STAT. ANN. §§ 17-7201(b), -7212(a) (1974).

<sup>364</sup> FOLK, *supra* note 45, at 521; *see* KAN. STAT. ANN. §§ 17-6426(c)(2), (e) (1974).

<sup>365</sup> *See* FOLK, *supra* note 45, at 522. Unless district courts follow this procedure, the majority shareholders may find it advantageous under some circumstances to terminate shareholder management under § 17-7211, thus thwarting application of § 17-7212(a)(1). *See* Bradley, *supra* note 290, at 550. This would be possible only where a veto provision not broad enough to cover a vote under § 17-7211 was the cause of the shareholder deadlock.

<sup>366</sup> Section 17-7215(a) permits the articles of incorporation of a close corporation to contain a clause giving a shareholder the right to have the corporation dissolved at will or upon the occurrence of a stated contingency.

<sup>367</sup> However, if the articles of incorporation confer the right to dissolve on more than one shareholder, as may often be the case, presumably any would have standing to petition for appointment of a custodian under § 17-7212(a)(2).

have a receiver's powers to liquidate the affairs and distribute the assets of a corporation in cases arising under section 17-7212(a)(2). As this language appears mandatory, it may be that a shareholder will petition for appointment of a custodian under section 17-7212(a)(2) only if he wants the process of liquidation placed in the hands of an impartial third party. Since appointment of a custodian to continue the business is a less drastic remedy than liquidation, it would be preferable to permit a shareholder with a right to dissolve the corporation to petition for the former rather than solely for the latter.

Section 17-7213 grants another remedy for deadlock. It authorizes a district court to appoint a provisional director for a close corporation, notwithstanding any provision to the contrary in its articles, by-laws, or a shareholder agreement, if the directors are deadlocked with the result that the business and affairs of the corporation no longer can be conducted to the advantage of its shareholders generally.<sup>368</sup> Unless the articles of incorporation specify a lesser number, an application for appointment of a provisional director must be filed by one-half of the directors in office or by the holders of at least one-third of the voting stock, or, if there is more than one class of voting stock, by the holders of at least two-thirds of the stock of any such class.<sup>369</sup> A provisional director is an impartial person who is neither a creditor nor a shareholder of the close corporation or of any subsidiary or affiliate. He is not a receiver or custodian but merely an additional director appointed to break the deadlock.<sup>370</sup>

Since a provisional director, unlike a custodian, does not assume complete control over management of the business, his appointment is a less extreme remedy. Use of the more lenient standard for appointment—that the business and affairs of the corporation can no longer be conducted to the advantage of the shareholders generally—rather than irreparable injury may be seen as evidencing legislative intent to encourage use of the provisional director remedy.<sup>371</sup> However, requiring the petition to be filed by one-half of the directors in office or by the holders of one-third of the voting stock, or by the holders of two-thirds of any class of voting stock if there is more than one, appears to be incompatible with this purpose, since *any* shareholder, acting alone, may petition for appointment of a custodian.<sup>372</sup> Section 17-7213(d) was apparently intended to rectify this problem. It provides that even though the requirements with respect to the number of directors or shareholders who may petition are not satisfied, the district court still may appoint a provisional director if this would be permitted by section 17-7212(b). Section 17-7212(b) states that in lieu of appointing a custodian the court may appoint a provisional

---

<sup>368</sup> KAN. STAT. ANN. § 17-7213(a) (1974). Note that unlike § 17-6516(a)(2), there is no requirement that the shareholders be unable to terminate the deadlock.

<sup>369</sup> *Id.* § 17-7213(b). It seems clear that although the articles of incorporation may decrease the numerical requirements relating to petitioners, they may not increase them, since this would be an affirmative infringement upon the court's jurisdiction. FOLK, *supra* note 45, at 524; see KAN. STAT. ANN. § 17-7213(a) (1974).

<sup>370</sup> KAN. STAT. ANN. § 17-7213(c) (1974).

<sup>371</sup> FOLK, *supra* note 45, at 523.

<sup>372</sup> KAN. STAT. ANN. §§ 17-6516(a), -7212(a) (1974).

director if it would be in the best interest of the corporation. These two sections, taken together, seem to mean that less than the requisite number of shareholders may not petition directly for appointment of a provisional director, but instead may petition only for appointment of a custodian, with the alternate remedy of a provisional director left solely to the discretion of the court.<sup>373</sup> This gives rise to the anomaly that the less disruptive remedy, use of which is sought to be encouraged, is more difficult to implement than is the more extreme remedy. The only way to avoid the more stringent requirements regarding petitioning for appointment of a provisional director, absent a permissive clause in the articles of incorporation, is to petition for the more extreme remedy and hope that the court will grant the lesser. Presumably this would occur when the petitioning shareholder is unable to demonstrate irreparable injury but the court nevertheless feels that some remedial action is called for.<sup>374</sup> It seems that although the legislature intended to encourage use of the provisional director, it feared too much encouragement. As a planning matter, it appears desirable to adopt a provision in the articles of incorporation permitting any shareholder to bring an action for appointment of a provisional director. This would be preferable to forcing a shareholder to pursue the more drastic remedy, a pursuit that may be successful.

The utility of the provisional director is his power to cast the tie-breaking vote, but his vote will be no help when deadlock is caused not by an evenly divided board but by a director veto provision. In such a case all a provisional director could do would be to attempt to persuade the other directors to adopt a different course of action; that is, to act as a conciliator. However, since most deadlocks in close corporations are based upon deep-seated personality or business differences, appointment of a provisional director may only postpone the inevitable invocation of more drastic remedies.<sup>375</sup>

A provisional director remains in office until he is removed by the court, the holders of a majority of the voting stock, or the holders of two-thirds of the class of voting stock that secured his appointment.<sup>376</sup> In theory, the parties will remove the provisional director when they have reached some sort of accord, if only an agreement to fight things out among themselves without the interference of an outsider.<sup>377</sup> This removal provision may seem overly solicitous of the rights of the majority because the appointment of a provisional director, like a custodian, is essentially a minority remedy. It might seem futile to allow a minority to secure appointment of a provisional director and then to permit a majority to dismiss him immediately. However, if the deadlock that precipitated his appointment was the result of dissension between two equal factions, the necessary majority vote could not be mustered until some sort of accord had been reached. If the deadlock was the result of a

<sup>373</sup> Bradley, *supra* note 290, at 550.

<sup>374</sup> FOLK, *supra* note 45, at 523.

<sup>375</sup> FOLK, *Corporation Statutes: 1959-1966*, 1966 DUKE L.J. 875, 953.

<sup>376</sup> KAN. STAT. ANN. § 17-7213(c) (1974).

<sup>377</sup> FOLK, *supra* note 45, at 524.

veto provision, the minority shareholder or director who caused the deadlock would not be among those who petitioned for the provisional director's appointment, and he certainly would not object to the provisional director's removal. If the holders of two-thirds of one of a number of classes of voting stock secured the provisional director's appointment, surely the holders of the same number of shares of the same class ought to be able to remove him. Viewed this way, the removal provisions of section 17-7213(c) seem a reasonable implementation of the concept of self determination.

Section 17-7215 contains the third remedy for deadlock and dissension. It permits the articles of incorporation of a close corporation to include a provision granting any shareholder, or the holders of any specified number or percentage of shares, the option to have the corporation dissolved at will or upon the occurrence of any specified event or contingency.<sup>378</sup> Because of its potentially harsh effects with respect to other shareholders, dissolution at will is properly limited to close corporations, where there is no market mechanism to provide a ready avenue of escape for a dissident shareholder.<sup>379</sup> This provision furthers the analogy of a close corporation to a partnership, where each partner has the power to dissolve the partnership at any time.<sup>380</sup> However, unlike partnership law, here the remedy is not self-executing. That is, the statute does not grant an option to dissolve; a shareholder will have this right only if it is included in the articles of incorporation.

If the original articles do not include a dissolution provision, one may be added only by an amendment approved by all shareholders, whether or not otherwise entitled to vote. The articles may specifically authorize a lesser vote, but in no event can it be less than two-thirds.<sup>381</sup> This statutory high vote requirement was obviously intended to protect minority shareholders. In view of the high potential for oppression inherent in an option to dissolve at will, it is submitted that the Code should not authorize a procedure that would allow a less than unanimous vote for adoption of such an option.<sup>382</sup> This seems especially true since, absent a veto provision, a simple majority could adopt an amendment to the articles to reduce the statutory unanimous vote requirement to two-thirds.<sup>383</sup> For this reason, careful advance planning is a must.

Because of the harsh effect that dissolution of a going enterprise could have on other shareholders, a draftsman should consider use of an alternative

---

<sup>378</sup> The shareholder is to exercise the option by giving written notice of exercise to all other shareholders. Thirty days after notice is sent, dissolution is to proceed as though the required number of shareholders had voted for voluntary dissolution. KAN. STAT. ANN. § 17-7215(a) (1974).

<sup>379</sup> Comment, *Delaware's Close-Corporation Statute*, 63 Nw. U.L. REV. 230, 236-37 (1968).

<sup>380</sup> KAN. STAT. ANN. §§ 56-331(a)(2), (b) (Supp. 1974).

<sup>381</sup> *Id.* § 17-7215(b) (1974).

<sup>382</sup> Compare *id.* § 17-7211, which permits a less drastic provision but contains no exception to its unanimous vote requirement.

<sup>383</sup> *Id.* § 17-6602(c)(1). An option to dissolve at will under § 17-7215 should be distinguished from an agreement among less than all shareholders to vote in favor of voluntary dissolution. In the latter case a nonparticipating shareholder should be free to challenge the validity of the agreement. See text at notes 190-91 *supra*. This would not be true under § 17-7215.

remedy. Under partnership law, although each partner has the power to dissolve the partnership at any time, if such dissolution would be in contravention of the partnership agreement, the other partners may choose to continue the business by paying the dissident partner the value of his interest.<sup>384</sup> A similar approach could be taken in the close corporation context. One possibility would be to make the option to dissolve subject to the contingency that the corporation or other shareholders fail to purchase the stock of the dissident shareholder. This type of contingency seems to be authorized by the broad language of section 17-7215 and also by section 17-7214, which removes similarity to a partnership as a ground for invalidity of any provision in a shareholder agreement or in the articles or by-laws of a close corporation.<sup>385</sup>

Section 17-7215(c) provides that the existence of a dissolution option must be noted conspicuously on the face of every stock certificate and that if it is not so noted it will be ineffective. The laudable purpose of this section is to put transferees on notice of an unusual remedy for corporate dissension.<sup>386</sup> But the draftsmen appear to be guilty of either carelessness or excessive zeal, for the section speaks in absolute terms of ineffectiveness. Use of such terminology suggests that even if all shareholders voted in favor of the option to dissolve and no stock was transferred to a third party, the option could not be exercised if its existence was not noted conspicuously on the face of every stock certificate. The language would support a similar result in a case where stock had been transferred, but the transferee had actual knowledge of the option even though its existence was not noted on the face of the stock certificate.<sup>387</sup> Clearly, in light of its purpose, section 17-7215(c) should not be so construed. A literal construction would impose a penalty totally out of proportion to the infraction; it would render rights created by arm's-length bargaining nugatory in a case in which innocent third parties suffered no harm. In such a case the purpose of the statute, which simply is to provide notice, should take precedence over its literal wording.<sup>388</sup> A proper construction of the section would hold an option to dissolve ineffective only if its

<sup>384</sup> KAN. STAT. ANN. §§ 56-331(b), -338(b)(2) (Supp. 1974).

<sup>385</sup> For a codification of this approach, see MD. ANN. CODE art. 23, §§ 109(a), (c) (1973), which provide that the other shareholders may purchase the shares of a dissident, thereby barring his right to continue dissolution proceedings.

<sup>386</sup> FOLK, *supra* note 45, at 528.

<sup>387</sup> Even more absurd cases could be imagined. For example, the option to dissolve could be ineffective even if its existence was noted conspicuously on the face of every stock certificate except one, it was noted on the back of that one, all shareholders approved adoption of the option, there were no subsequent transfers of stock, and the holder of the single certificate with the notation on the back was the party seeking to exercise the option to dissolve. Section 17-7215(c) seems to say that the option cannot be exercised in such a case if one of the other shareholders objects to dissolution.

<sup>388</sup> With reference to statutory interpretation Judge Learned Hand has stated:

Of course it is true that the words used, even in their literal sense, are the primary, and ordinarily the most reliable, source of interpreting the meaning of any writing: be it a statute, a contract, or anything else. But it is one of the surest indexes of a mature and developed jurisprudence not to make a fortress out of the dictionary; but to remember that statutes always have some purpose or object to accomplish, whose sympathetic and imaginative discovery is the surest guide to their meaning.

*Cabell v. Markham*, 148 F.2d 737, 739 (2d Cir.), *aff'd*, 326 U.S. 404, 409 (1945) ("[r]esort to the policy of a law may be had to ameliorate its seeming harshness or to qualify its apparent absolutes"). *See, e.g.*, *Church of the Holy Trinity v. United States*, 143 U.S. 457 (1892).

existence was not noted conspicuously on the face of a stock certificate held by a transferee without actual knowledge of the provision who objected to dissolution.

#### VI. CONCLUSION

The Code appears to go as far as the legislation of any other state in recognizing and attempting to deal with the unique problems of close corporations. Article 72 provides for special treatment of close corporations meeting certain qualifications and electing to be governed thereunder. It provides a framework that, if sometimes confusing, nevertheless affords sufficient latitude for a thoughtful and imaginative practitioner to meet the needs of his close corporate clients. The provisions of the Code applicable to all corporations, supplemented by a generally benign body of case law, also create a climate that permits a great degree of freedom for the close corporation that either cannot or will not meet the qualifications of article 72. This is especially true in the areas of most concern to close corporations, such as shareholder voting agreements, high vote requirements, provisions restricting director discretion, restrictions on the transfer of securities, and remedies for dissension and deadlock.

