WILLIAM C. STALEY
Business Planning

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WHEN TO USE A CALIFORNIA CLOSE CORPORATION

A California close corporation is a specialized tool. If you have to ask if you need it, don't use it.

The California General Corporation Law applies to most business corporations. It contains many rules that have been in effect since 1977, in some cases much earlier. Most of these rules are fair and work well in the vast majority of situations, for corporations large and small.

But sometimes the general rules just don't fit a particular situation. In that case, using "**close corporation**" status allows the shareholders to vary one or more of the corporate laws that would otherwise apply to the corporation. Unless there is a specific provision of the General Corporation Law that chafes the shareholders, it is best not to use a close corporation.[1]

Example 1. Generally a California corporation with more than two shareholders must have at least three directors. A corporation with one shareholder can have only one director.[2] If Abe, who owns all of the outstanding shares of his corporation and is the sole director, gives 5% of the shares each to Bob and Carol, key employees, the corporation now must have at least three directors under the General Corporation Law. But Abe does not want the other directors (probably Bob and Carol, but possibly other friends or relatives of Abe) to be able to outvote Abe, who would have one vote on the Board of Directors to their two. So Abe makes the corporation a close corporation and adopts a shareholders agreement that says this corporation will have only one director and it will be Abe, until Abe dies, resigns, or his shareholdings are reduced to 50% or

[1] Think of it as a power tool. It's probably best not to pick it up and turn it on to see what happens.

[2] Cal. Corp. Code § 212(a).

less of the outstanding shares. When Bob and Carol acquire shares, this is already in place. If they receive their shares from the corporation, they need to sign off on the shareholders agreement. If they receive their shares from Abe, they do not technically need to do anything to become a party to the shareholders agreement, but it would be best to have them formally adopt it.[3]

In Example 1 the close corporation status allows Abe to continue to be the sole director, even when the corporation has more than one director.

Example 2. Mary, Nancy and Owen feel that having shareholders elect directors, and directors elect and supervise officers is too hierarchical for their free spirits. So they have their corporation elect close corporation status and provide in their shareholders agreement that they will have no officers or directors and no board of directors. Instead, the shareholders will all be called Creative Officers and will make all decisions collaboratively. They can do this, but they might have problems completing their Statement of Information and other documents that require regular officers. They might also have issues when they apply for directors and officers liability insurance. Finally, they will have the duties and liabilities of directors, without the benefit of the laws that delineate and limit those duties.[4]

Example 3. Ron, Sam and Tina anticipate needing multiple rounds of equity financing in their business as it grows. They are concerned that their control over the corporation will be diluted by new investors. So their new corporation elects close corporation status and their shareholders agreement provides that they each shall serve as directors and officer for life and that at least two of them shall serve as president, chief technical officer or chief financial officer as long as at least two of them are alive. This works. Tina sells some of her shares to Ursula, who does not like the provision but is bound by it. [5] Some prospective investors decline to invest with this arrangement. Victor wants

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[3] Cal. Corp. Code § 300(b).

[4] Cal. Corp. Code § 300(d) ("[A shareholders agreement] shall, to the extent and so long as the discretion or powers of the board [of directors] in its management of corporate affairs is controlled by such agreement, impose upon each shareholder who is a party thereto liability for managerial acts performed or omitted by such person pursuant thereto that is otherwise imposed by this division upon directors, and the directors shall be relieved to that extent from such liability.")

[5] Cal. Corp. Code § 300(b).

to invest, but won't agree to be bound by the shareholders agreement. If the corporation issues shares to Victor, the shareholders agreement terminates.[6]

Close corporation status is **elected** by including a statement to that effect in the articles of incorporation.[7] The "Articles of Incorporation of a Close Corporation" form on the California Secretary of State's website contains this statement in Article 6.[8]

Note that a corporation that elects close corporation status should have a **shareholders agreement** that states exactly how it varies the General Corporation Law.[9] It is good practice to state in the agreement exactly which section of the General Corporation Law is varied by the shareholders agreement, and to note that all other provisions of the General Corporation Law apply. It is also a good practice to include in the bylaws both a reference to the shareholders agreement and the rule that will apply if the rule in the shareholders agreement does not apply. Continuing Example 1: The bylaw provision for the number of shares would refer to the existence of the shareholders agreement. It also would state that the number of directors will be three. As long as Abe is alive, holds more than 50% of the outstanding shares, and wants to continue as a director, the number of directors will be one, because the bylaws make clear that the shareholders agreement trumps the bylaws. When Abe ceases to be a director or holds 50% or less of the outstanding shares, the number of directors must be three pursuant to the backup provision in the bylaws.

Sometimes the shareholders agreement is contained in another document, such as a buy-sell agreement. In that case it is good practice to have a provision captioned "Close Corpora-

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[6] Cal. Corp. Code § 300(b). Note that if the shareholders agreement was backed up with a voting agreement, the voting agreement would remain in effect. Cal. Corp. Code §§ 300(b), 706(a). Same with a voting trust. Another alternative is to not use a close corporation but to issue to each of Ron, Sam and Tina a separate class of shares, each of which was entitled to elect one director. This assures them of seats on the board of directors, but does not determine who the officers will be.

[7] Cal. Corp. Code § 158.

[8] Form ARTS-CL (rev. 3/2014). Note that the form does not have typical provisions to limit director liability or to provide the maximum possible indemnification. *See* Cal. Corp. Code § 309(c), 317(g).

[9] Cal. Corp. Code §§ 186, 300. Note the list in Section 300(c) of rules that a shareholders agreement cannot vary.

tion Status" and to state in it the provision of the buy-sell agreement that changes the General Corporation Law, that the buy-sell agreement serves as the shareholders agreement, and that all of the other rules in the General Corporation Law apply to the corporation. The best practice is to use a stand-alone shareholders agreement unless the "tweaked" corporate law rule is integral to the buy-sell agreement or other document. People who should see the shareholders agreement do not always need to see the entire buy-sell agreement. Example 2: The three principal shareholders have a buy-sell agreement. The corporation is a close corp that allows the founder to designate the officers. The officers want to give stock to key employees, who will have a buy-back plan for their shares and will not become parties to the buy-sell agreement. In that case, it makes more sense to have a shareholders agreement that can be shown to the key employees. They have no need to see the buy-sell agreement.

When a corporation elects close corporation status, it must have a **legend** to that effect on its stock certificates.[10]

The General Corporation Law provides that:

> The failure of a close corporation to observe corporate formalities relating to meetings of directors or shareholders in connection with the management of its affairs [that is, to have minutes of at least annual meetings or written consents to action taken without meeting], pursuant to [a shareholders agreement for a close corporation], shall not be considered a factor tending to establish that the shareholders have personal liability for corporate obligations.[11]

When close corporation status was first introduced in 1975 and effective in 1977, many attorneys thought that all new "closely-held" corporations (that is, those which just a few shareholders) should be close corporations because the directors and officers of closely-held corporations typically find it difficult to keep up with corporate minutes. However, there are no California reported cases in which appellate courts have applied this provision. The decision to "pierce the corporate veil" and hold the shareholders liable

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[10] Cal. Corp. Code § 418(c). Note the effects of the legend. Cal. Corp. Code §§ 418(d), 421. It would be a good idea to require the legend and to recite these effects in the shareholders agreement.

(footnote continued from preceding column)

[11] Cal. Corp. Code § 300(d).

for a corporate debt is made by a judge based on a variety of factors. Keeping minutes is easy and not very expensive, if tedious. "Piercing the corporate veil" makes it useless to go to the expense and hassle of having a corporation, and might have terrible financial consequences for the shareholders. So it makes more sense to keep minutes, even for close corporations, at least until courts have said more about the "no minutes" rule. Given that risk-adverse approach, it does not make sense for every corporation with less than 35 shareholders to be a close corporation.

For those who want the protection of the "no minutes" rule, it is important to invoke it in the shareholders agreement and to pay close attention to maintaining the close corporation status and the effectiveness of the shareholders agreement.[12]

At one time many tax advisors were concerned that a close corporation might be classified for tax purposes as a partnership rather than a corporation. That might have been a tax disaster then. However, after the "check-the-box" entity classification regulations were issued in the late 1990s, this has ceased to be a concern.[13]

What if a corporation elects close corporation status but does not change any provision of the General Corporation Law, does not have a shareholders agreement and does not put the required legend on the stock certificates? Expect everyone who sees the articles of incorporation to ask for the shareholders agreement. They will expect to see the legend on the stock certificates. If these do not exist, they will look more carefully at the other corporate transactions. If a buyer's attorneys sees this during corporate due diligence of the target corporation, they probably will look more carefully for other corporate missteps.

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[12] There is a similar "no minutes necessary if you say so" rule for LLCs. Cal. Corp. Code § 17703.04(b). It almost always makes sense to invoke this rule in the operating agreement for a California LLC. Partnerships do not need minutes, and LLCs are as much like partnerships as corporations, if not more so. So judges won't expect an LLC to have minutes. So failing to have minutes in an LLC is less likely to influence a judge's gut reaction about whether the "corporate" veil should be pierced for an LLC. Because the lack of

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minutes will not look bad in this context, the members might as well invoke the "no minutes" rule in the operating agreement and, if they do, do not need to fret about annual minutes.

[13] Treas. Reg. § 301.7701-2.

Changing to and from close corporation status is subject to several special rules and requires specific statements in the **certificate of amendment to the articles of incorporation**.[14]

When changing from close corporation status, consider if any parts of the shareholders agreement should remain in effect.[15]

We consult regularly on corporate law issues for which the California close corporation might be a solution.

-- William C. Staley
(818) 936-3490
www.staleylaw.com

[14] Cal. Corp. Code § 158.

[15] Cal. Corp. Code § 300(b).