U.S. Close Corporation Legislation: A Model Canada Should Not Follow

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Canadian corporate legislation has been influenced considerably by American models. The author considers whether Canada should follow a number of U.S. states by adopting legislation for close corporations in the form of a separate chapter in the general corporate legislation. In particular, the author focuses on the effectiveness of this approach in dealing with the special needs of close corporation participants and to reduce their transaction costs. The author concludes that the adoption of a separate close corporation chapter, even an improved version of U.S. models, is unnecessary in Canada because similar cost savings can be achieved under present, or amended, general corporate legislation.

La législation canadienne en droit des compagnies a été fortement influencée par les sources américaines. L'auteur s'interroge à savoir si, à l'instar de nombreux états américains, le Canada devrait adopter une loi spéciale sur la société fermée qui ferait l'objet d'un chapitre distinct au sein de la législation générale sur le droit des compagnies. Plus précisément, l'auteur évalue si un tel chapitre est vraiment apte à répondre aux besoins spécifiques des personnes impliquées dans une société fermée, et aussi à réduire leurs coûts de transactions. L'auteur conclut que l'adoption de ce chapitre distinct, même s'il représentait une amélioration par rapport aux modèles américains, n'est pas nécessaire puisque les coûts que l'on épargnerait par l'entremise du chapitre distinct le sont également sous la législation canadienne, dans sa présente forme ou avec modification.

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Synopsis

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Introduction

The American Bar Association's *Model Business Corporations Act* (*M.B.C.A.*) and other U.S. corporate legislation considerably influenced the thinking of Canadian corporate law reformers in the 1960s and 1970s.[1] The *Canada Business Corporations Act* (*C.B.C.A.*), which was enacted in 1975, was based to a significant extent on U.S. sources. In turn, legislation modelled after the *C.B.C.A.* was passed in six provinces.[2] Since this flurry of legislative activity

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[1]Ontario, Legislative Assembly, *Interim Report of the Select Committee on Company Law* (Toronto: Queen's Printer, 1967) (Chair: A.F. Lawrence) at vi-vii [hereinafter the *Lawrence Report*]; R. Dickerson, J.C. Howard & L. Getz, *Proposals for a New Business Corporations Act for Canada*, vols 1, 2 (Ottawa: Supply & Services Canada, 1971) at iii-iv [hereinafter the *Dickerson Report*]; and J. Howard, "The Proposals for a New Business Corporations Act for Canada" in *Special Lectures of the Law Society of Upper Canada, Corporate and Securities Law* (Toronto: Richard De Boo, 1972) 17 at 27-28.

[2]*Business Corporations Act*, R.S.O. 1970, c. 53; *Canada Business Corporations Act*, S.C. 1974-75-76, c. 33, now R.S.C. 1985, c. C-44 [hereinafter *C.B.C.A.*]; *The Corporations Act*, S.M. 1976, c. 40; *The Business Corporations Act*, R.S.S. 1978, c. B-10; *Business Corporations Act*, S.N.B. 1981, c. B-9.1; *Business Corporations Act*, S.A. 1981, c. B-15 [hereinafter *A.B.C.A.]; Business Corporations Act, 1982*, S.O. 1982, c. 4 [hereinafter *O.B.C.A., 1982*]; and *Corporations Act*, S.N. 1986, c. 12 [hereinafter *N.C.A.*]. The preceding statutes are hereinafter collectively referred to as the *C.B.C.A.* statutes. Quebec also borrowed substantially from the *C.B.C.A.* when its corporation law was reformed in 1981. See *Companies Act*, S.Q. 1980, c. 28. British Columbia reformed its company legislation in the 1970s, but borrowed more heavily from the United Kingdom. See *Companies Act*, S.B.C. 1973, c. 18, now R.S.B.C. 1979, c. 59 [hereinafter *B.C.C.A.*] and M.A. Waldron, "The Process of Law Reform: The New B.C. *Companies Act*" (1975) 10 U.B.C. L. Rev. 179 at 192-94. In Nova Scotia and Prince Edward Island few significant changes

ended in the early 1980s, reform of corporate legislation has become a much less debated topic in Canada. In the United States, however, reform of general incorporation legislation remains a live issue. One area that has received a great deal of attention has been special legislation for closely held corporations. A significant number of states have passed such legislation in recent years, and in the mid-1980s the American Bar Association adopted a Close Corporation Supplement to the *M.B.C.A.*[3] In light of the U.S. influence on present Canadian legislation, these developments suggest that serious consideration should be given to the introduction of similar close corporation legislation in Canada. The need for consideration of this issue is reinforced by the fact that Canadian commentators who have examined the topic have been supportive of close corporation legislation.[4] It will be argued in this article, however, that the adoption of special close corporation legislation in Canada would be unwise.

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have occurred. See generally F.H. Buckley & M.Q. Connelly, *Corporations: Principles and Policies*, 2d ed. (Toronto: Edmond Montgomery, 1988) at 151-52.

[3] A draft of the *M.B.C.A. Supplement* was prepared, with commentary, by the Committee on Corporate Laws, "Proposed Statutory Close Corporation Supplement to the *Model Business Corporations Act*" (1981) 37 Bus. Law. 269. The actual *M.B.C.A. Supplement* is set out as the *Model Statutory Close Corporation Supplement* in *Model Business Corporations Act Annotated*, vol. 3, 3d ed. (New York: Law and Business, 1985) [hereinafter *Model Stat. Close Corp. Supp.*]. In terms of corporate law reform generally, not only has the third edition of the *M.B.C.A. Supplement* been produced recently, but the American Law Institute is in the process of producing a series of drafts under the working title *Principles of Corporate Governance*.

[4] As a general rule, Canadian commentators have not considered close corporations in nearly as much detail as their American counterparts. See F. Iacobucci & D.L. Johnston, "The Private or Closely-held Corporation" in J.S. Ziegel, ed., *Studies in Canadian Company Law*, vol. 2 (Toronto: Butterworths, 1973) 68 at 71. Further, there has not been a comprehensive Canadian journal article on the topic since Iacobucci and Johnston's, and some leading texts, such as B. Welling, *Corporate Law in Canada: The Governing Principles* (Toronto: Butterworths, 1984) give almost no special attention to close corporations.

Two Canadian authorities who have favourably commented on U.S. close corporation legislation as such are F. Iacobucci, M.L. Pilkington & J.R.S. Prichard, *Canadian Business Corporations* (Agincourt, Ont.: Canada Law Book, 1977) at 75-83 and T. Hadden, R. Forbes & R.L. Simmonds, *Canadian Business Organizations Law* (Toronto: Butterworths, 1984) at 186-91. Canadian commentators who have commented favorably on close corporation legislation in a general sense include Iacobucci & Johnston, *ibid.* at 128-37; P.S. Elder, "Statutory Remedies of Minority Shareholders in Close Corporations" (1964-66) 2 U.B.C. L. Rev. 440 at 440-41, 466; and B. Slutsky, "Company Law — Minority Rights — Oppression Remedy —*Diligenti* v. *RWMD Operations Kelowna Ltd.*" (1977) 11 U.B.C. L. Rev. 326.

The author has argued in another paper, "The Closely Held Corporation in Canada", that the present legislative approach to close corporations is adequate. The paper, which is to be published in German by Verlag Otto Schmidt KG Koln, was prepared for the Symposium on Dualism in Corporation Law held in Austria in April 1989. The sources used for the paper were similar to those used for the present article but the contents differ significantly.

I. Background

A. *Nature of Close Corporations*

Establishing a satisfactory precise definition for closely held corporations is a difficult process because corporations vary greatly. Still, a number of prevalent characteristics of close corporations can be identified. Close corporations will generally have a small number of shareholders. There will often be a distinct overlap between ownership and management, as many, if not all, of the shareholders will be actively involved in the operation of the business. The business will likely be the primary source of income for those involved. Generally, there is not a public market for the shares of close corporations, in part because transfer restrictions will frequently be imposed on the shares. Even absent transfer restrictions, however, there will be few persons who will be interested in purchasing shares in a close corporation, especially if a minority interest is involved. The lack of a liquid market for the shares of close corporations means that the stock market does not act to monitor management. Consequently, the possibility of a take-over bid does not provide incentives to managers of a close corporation to operate the firm efficiently. Finally, close corporations will often be smaller business operations than their publicly traded counterparts, though there are notable exceptions. One result of this is that close corporations are much less likely to have independent directors, investment bankers and analysts monitoring the conduct of the managers.[5]

Despite these differences, the distinctive nature of close corporations should not be overstated.[6] The absence of a liquid market for shares and the less frequent use of other external monitoring devices does not mean that managers of close corporations operate free of constraints. The frequent overlap between directors and shareholders means that management in close corporations is not separated from risk bearing to nearly the same extent as in a public corporation. Consequently, direct monitoring of managers can occur much more easily. Further, the incentive to monitor directly will generally be greater than in a public corporation. This is because investors in close corporations tend to treat the

[5]See Hadden, Forbes & Simmonds, *ibid.* at 129-30, 190-91; R. Kingston *et al.*, eds, *Canada Corporation Manual* (Don Mills, Ont: Richard De Boo, 1986) at 13-11; Empirical Research Project, "Statutory Needs of Close Corporations — An Empirical Study: Special Close Corporation Legislation or Flexible General Corporation Law" (1985) 10 J. Corp. L. 849 at 852-54, 877-79; L.D. Soderquist, "Reconciling Shareholders' Rights and Corporate Responsibility: Close and Small Public Corporations" (1980) 33 Vand. L. Rev. 1387 at 1391-1407; H. Manne, "Our Two Corporation Systems: Law and Economics" (1967) 53 Va. L. Rev. 259 at 278-81; and F. Easterbrook & D. Fischel, "Close Corporations and Agency Costs" (1986) 38 Stan. L. Rev. 271 at 273-77.

[6]The following is based largely on Easterbrook & Fischel, *ibid.* at 274-75, 277-79, 283-86.

business as their primary source of income. The result is that investors do not have the diversified investment portfolio of investors in public companies, so they have a particularly strong incentive to see that the business is operated profitably.

Another implication of the absence of a liquid market should not be overemphasized. It has frequently been said that the lack of a market for shares in close corporations exposes minority shareholders to unique risks of exploitation as the minority has no exit option if the majority is engaging in opportunistic behaviour. This ignores the fact, however, that these corporations compete with other investment opportunities to raise capital. If minority shareholders in close corporations were systematically exploited, persons would not invest in close corporations. Thus, an incentive does exist for those controlling close corporations to accommodate, at least *ex ante*, the needs and concerns of minority shareholders. The extensive use of close corporations suggests that this business form does indeed constitute an attractive investment, so it may well be that minority shareholders are not in as disadvantageous a position as might appear to be the case.[7]

A factor which reduces the differences between close corporations and other corporations is that corporate law, both statutory and judicial, can be seen as performing the same basic function, regardless of the type of corporation. This is establishing a set of standard terms that lower the cost of contracting.[8] The contract process for investors will differ somewhat between close corporations and public corporations because the scope for bargaining in close corporations is greater, given the greater proximity between those involved in the cor-

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[7]It has been argued by F.H. O'Neal, "Oppression of Minority Shareholders: Protecting Minority Rights" (1987) 35 Clev. St. L. Rev. 121 at 121 and F.H. O'Neal & R.B. Thompson, *O'Neal's Oppression of Minority Shareholders*, 2d ed. (Wilmette, Ill: Callaghan, 1985) para. 1.04 that oppression of minority shareholders reduces investment in close corporations, but no empirical evidence is advanced to support this assertion.

[8]J.A.C. Hetherington, "Redefining the Task of Corporation Law" (1985) 19 U.S.F.L. Rev. 229 at 256-59; H.N. Butler, "The Contractual Theory of the Corporation" (1989) 11 Geo. Mas. U.L. Rev. 99 at 119-23; and L.A. Moody, "Statutory Solutions to Conflicts of Interest in Close Corporations" (1987) 35 Clev. St. L. Rev. 95 at 98. The bargaining approach to corporate law has generated a significant amount of literature in the U.S., especially in relation to corporations with widely traded shares. For an overview and mildly sceptical appraisal of the bargaining approach, see P. Cox, "Reflections on Ex Ante Compensation and Diversification of Risk as Fairness Justifications for Limiting Fiduciary Obligations of Corporate Officers, Directors, and Controlling Shareholders" (1987) 60 Temp. L.Q. 47.

Analyzing corporations from the perspective of contractual relations is not as prevalent in Commonwealth countries as it is in the U.S., but this appears to be changing. See, for example, Buckley & Connelly, *supra*, note 2; D.F. Partlett & G. Burton, "The Share Repurchase Albatross and Corporation Law Theory" (1988) 62 Aust. L.J. 139; D.D. Prentice, "The Theory of the Firm: Minority Shareholder Oppression: Sections 459-61 of the *Companies Act 1985*" (1988) 8 Oxf. J. of L. St. 55; and New Zealand Law Commission, *Preliminary Paper No. 5 — Company Law* (Wellington: Law Commission, 1988) at 9-10.

poration.[9] Nevertheless, as will be seen, this difference, and other differences between close corporations and other corporations, are not sufficient to justify establishing a distinct set of elective, presumptive or mandatory terms for close corporations, assuming that participants are given the freedom to arrange their affairs in the manner which best suits them.

B. Historical Developments

Given the recent development of close corporation legislation in the United States, it is ironic that historically Canadian corporate legislation has been more responsive to the existence of smaller corporations without publicly traded shares. In the 19th century, no distinctions were drawn in Canadian company legislation between such corporations and other corporations. Beginning in 1910, however, Canadian jurisdictions began to introduce the private company concept which had been adopted in England in 1907. By the 1940s all but three provinces had adopted the private company concept. The definition of private company was basically uniform. Companies which stipulated in the documents of incorporation that the number of shareholders was limited to fifty, that there were transfer restrictions on the company's shares and that the shares were not to be distributed to the public were deemed to be private companies. It was possible, however, for the documents of incorporation to be varied to convert a private company into a public company and vice versa. The benefits granted to private companies varied from jurisdiction to jurisdiction, but most related to relief from some filing and financial disclosure requirements. There were no special provisions relating to management or remedies.[10]

In contrast, no U.S. jurisdiction had any provisions specifically dealing with closely held corporations until 1955.[11] This was the case even though commentators had begun arguing for legislative reform as early as 1929. It was pointed out that the existing general incorporation laws and judicial doctrines had been developed with larger, publicly held corporations in mind and without

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[9]See, for example, V. Brudney & R.C. Clark, "A New Look at Corporate Opportunities" (1981) 94 Harv. L. Rev. 998 at 1006-10.

[10]The first jurisdiction to introduce the private company concept was British Columbia — see *Companies Act, 1910* S.B.C. 1910, c. 7, s. 130. On the emergence of private companies in Canada, see generally Iacobucci & Johnston, *supra*, note 4 at 77-78; W.K. Fraser, *Handbook on Canadian Company Law*, 4th ed. (Toronto: Carswell, 1945) at 25-41, 51-56; and F.W. Wegenast, *The Law of Canadian Companies* (Toronto: Burroughs, 1931) at 189-90, 707-08.

[11]On the history of closely held corporation legislation in the United States, see Empirical Research Project, *supra*, note 5 at 867-74 and F.H. O'Neal, "Close Corporations: Existing Legislation and Recommended Reform" (1978) 33 Bus. Law. 873 at 873-75.

Prior to 1955, there were some provisions in certain jurisdictions which were intended to assist closely held corporations, but which were applicable to all corporations. See, for example, C.O. Israels, "The Close Corporation and the Law" (1948) 33 Cornell L.Q. 488 and Manne, *supra*, note 5 at 282-84.

regard for the fact that corporations differ significantly. Accordingly, existing general incorporation legislation was not entirely appropriate for closely held corporations, with their small number of shareholders, informal operations, and overlap between shareholders and management. For example, costs were likely imposed on close corporation participants by virtue of their having to comply with statutory formalities intended to protect passive shareholders. In addition, close corporation participants who wished to vary the corporate governance model established by corporate law found it difficult to do so since U.S. corporate legislation did not sanction departures from the principles of majority rule and did not authorize variations on the grant of exclusive managerial control to the board of directors. As well, the judiciary was hostile to shareholders' agreements. The upshot of all this was that strong support emerged for the introduction of legislative provisions which would reduce statutory formalities for close corporations and which would give such corporations more freedom with respect to internal operations and other planning concerns.[12]

One response to the calls for legislative reform was the enactment of provisions applicable only to close corporations. North Carolina enacted the first such provision. The objective of the North Carolina provision was to overcome judicial resistance to shareholders' agreements by sanctioning the use of unanimous shareholders' agreements which infringed on the powers of directors of corporations without publicly traded shares. In 1961, New York enacted a similar provision. Two years later, Florida took a different approach. It established a special chapter in its corporation legislation which close corporations could elect to have apply to the corporation. In the 1960s, three other states, including Delaware, followed suit. The objective of these special chapters was to allow electing corporations to operate informally and to increase the scope of planning devices available to participants.[13]

Another trend which arose in part as a response to the problems of closely held corporations and which initially had much greater acceptance than special legislation was the movement towards flexible general incorporation laws. Traditionally, U.S. general incorporation legislation was rigid and restrictive in comparison with, for example, the permissive, enabling approach of the English *Companies Act*. In the 1960s and early 1970s, however, the prevalence of

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[12]See, for example, J.L. Weiner, "Legislative Recognition of the Close Corporation" (1929) 27 Mich. L. Rev. 273; W.B. Rutledge, "Significant Trends in Modern Incorporation Statutes" (1937) 22 Wash. U.L.Q. 305; N. Winer, "Proposing a New York "Close Corporation Law"" (1943) 28 Cornell L.Q. 313; Israels, *ibid.*; "Proceedings at the Annual Meeting of the Section of Corporation, Banking and Business Law" (1954) 10 Bus. Law. 9; E.R. Latty, "The Close Corporation and the New North Carolina Business Corporation Act", (1956) 34 N.C.L. Rev. 432; and F.H. O'Neal, "Forward" in "A Plea for Separate Statutory Treatment of the Close Corporation" (1958) 33 N.Y.U. L. Rev. 700.

[13]See *supra*, note 11; Latty, *ibid.*; and R.S. Stevens, "Close Corporations and the New York Business Corporation Law of 1961" (1962) 11 Buffalo L. Rev. 481 at 486-91.

restrictive corporate law statutes was displaced by a dual process. First, the provisions of the *M.B.C.A.*, which has been promulgated by the American Bar Association's Committee on Corporate Laws since 1950, became increasingly flexible. Second, the *M.B.C.A.* became the dominant state corporation law as the number of states adopting the legislation rose from sixteen in 1966 to thirty-four in 1977. Further, the *M.B.C.A.* had a substantial influence on almost all of the remaining states.

By virtue of these trends, provisions permitting incorporation by one person instead of the traditional three became commonplace, as did provisions specifically authorizing the use of transfer restrictions on shares. In addition, provisions authorizing the use of voting trusts and the creation of supermajority and high quorum requirements became much more prevalent. Many general corporations statutes also sanctioned the taking of certain shareholder and director actions without a meeting and established broader grounds for involuntary dissolution. It was widely recognized that these provisions, though available to all corporations, would be primarily useful for closely held corporations. Indeed, in 1969 the authors of the *M.B.C.A.* rejected the idea of adopting special provisions aimed specifically at closely held corporations on the basis that general incorporation legislation, including the above reforms, was sufficiently flexible to meet the needs of closely held corporations.[14]

C. Present Canadian Legislation

At the same time that U.S. corporate law was becoming more responsive to closely held corporations, Canadian corporation legislation, was, on first glance, becoming less responsive. In the 1960s and 1970s those appointed to examine the reform of corporate legislation recommended that the existing distinction between public and private companies be abandoned. Following these recommendations, the public/private company concept was dropped from federal corporation legislation with the enactment of the *C.B.C.A.* and was similarly dropped in provinces which modelled their legislation after the *C.B.C.A.*[15]

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[14]See Empirical Research Project, *supra*, note 5 at 860-64; R.A. Kessler, "Hooray (?) for the Model Act — the 1969 Revision and the Close Corporation" (1970) 38 Fordham L. Rev. 743; and D. Branson, "Countertrends in Corporation Law: Model Business Corporation Act Revision, British Company Law Reform and Principles of Corporate Governance and Structure" (1983) 68 Minn. L. Rev. 53.

[15]British Columbia also dropped the public/private distinction, but in effect replaced this with a similar arrangement, this being a reporting/non-reporting company dichotomy. A reporting company is defined in the *B.C.C.A.*, *supra*, note 2, s. 1. On the dropping of the public/private distinction, see *Lawrence Report*, *supra*, note 1 at 14-17; *Dickerson Report*, *supra*, note 1 at 13; Howard, *supra*, note 1 at 32-33; New Brunswick, Company Law Project Law Reform Division, *Report on Company Law* by R. Bird (Fredericton: Department of Justice, 1974) at 36-37; Institute of Law Research and Reform, *Proposals for a New Business Corporations Law for Alberta* (Edmonton: Institute of Law Research and Reform, University of Alberta, 1980) at 15-16 [hereinafter *Alberta*

Despite the abandonment of the private company concept, the *C.B.C.A.* statutes were drafted with the intention of accommodating closely held corporations. This was done through a combination of two approaches. The first was consistent with the then dominant trend in the United States, this being the development of flexible rules applicable to all corporations. This approach was used in relation to internal regulations and formalities, planning and remedies. For example, directors and shareholders were specifically authorized to pass resolutions without meetings if all concerned consented in writing. In addition, statutory affirmation was given to unanimous shareholders' agreements, and appraisal rights and the oppression remedy were introduced.[16] It was recognized that these and similar provisions, which were frequently borrowed from American corporate law, might well be of more use to closely held corporations than other corporations.[17] Nevertheless, such provisions were made applicable to all corporations.

The second approach used by the drafters of the *C.B.C.A.* statutes was making certain provisions applicable only to selected corporations. It does not appear, however, that U.S. special close corporations provisions had much influence on this process. Canadian corporate reformers gave little consideration to the idea of a special statute for close corporations and those who considered the idea rejected it.[18] Further, the areas where distinctions were drawn under the *C.B.C.A.* statutes differed from the areas where distinctions were drawn in the U.S. Generally, U.S. close corporation legislation was, and continues to be, aimed at internal formalities, planning devices and remedies. As mentioned, under the *C.B.C.A.* statutes provisions dealing with these areas were almost invariably made available to all corporations.[19] A primary example is sharehol-

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Report]; and J.S. Ziegel, "The New Look in Canadian Corporation Laws" in Ziegel, ed., *supra*, note 4, 1 at 11-13.

[16]*C.B.C.A.*, *supra*, note 2, ss. 117, 142, 146, 190, 241. There are equivalent provisions in jurisdictions modelled after the *C.B.C.A.*. See, for example, *O.B.C.A. 1982*, *supra*, note 2, ss. 104, 108, 129, 184, 247, and see generally H. Sutherland, D.B. Horsley & J.M. Edmiston, eds, *Fraser's Handbook on Canadian Company Law*, 7th ed. (Toronto: Carswell, 1985) at 139-64, 224-28, 234-45, 289-303 [hereinafter *Fraser's Handbook*].

[17]See *Lawrence Report*, *supra*, note 1 at 83-84; *Dickerson Report*, *supra*, note 1 at 10-11, 78, 115-16, 123-24, 162-63; *Alberta Report*, *supra*, note 15 at 24-25, 126-27, 136-42; Howard, *supra*, note 1 at 33-34, 47-50; and R. Dickerson, *The Canada Business Corporations Act: Implications for Management and the Accountant* (Hamilton, Ont: Society of Management Accountants of Canada, 1978) at 16, 51, 56-58. The oppression remedy was borrowed from English law, with modifications suggested by the Jenkins Committee in *Report of the Company Law Committee* (London: H.M.S.O., 1962).

[18]See Howard, *ibid.* at 33-34; *Alberta Report*, *ibid.* at 15-16; and Dickerson, *ibid.* at 55.

[19]Two exceptions might be that only non-distributing corporations can have one board member (distributing corporations must have at least three) and can impose transfer restrictions. See *C.B.C.A.*, *supra*, note 2, ss. 49(9), 112. The position is the same in the jurisdictions with statutes modelled after the *C.B.C.A.*. See, for example, *O.B.C.A.*, *1982*, *supra*, note 2, ss.42, 115.

ders' agreements. In contrast, it is extremely rare for U.S. statutory provisions authorizing shareholders' agreements to be available to all corporations.[20]

The primary areas where distinctions were drawn and continue to exist under the *C.B.C.A.* statutes relate to the preparation and filing of financial information and to the providing of information to shareholders before shareholders' meetings. The purpose of these provisions, in large part, is to facilitate the monitoring of management. However, because these statutory formalities likely would not be observed in many close corporations and because, as has been described, more direct methods of monitoring management exist, the exceptions established under the *C.B.C.A.* statutes appear to be justified.[21] In terms of financial information, under these statutes, corporations which do not distribute shares to the public are relieved from the requirement of having to file annual financial statements with the administrative official supervising the Act, are not subject to the mandatory direction to appoint an audit committee and are permitted to waive, by unanimous shareholder approval, the statutory obligation to appoint an auditor.[22] Obligations relating to financial information have traditionally been, and continue to be, mandatory for all corporations under U.S. general corporation legislation. These requirements have not, however, imposed significant costs for U.S. close corporations because U.S. corporate law has been

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[20]An example is Minnesota. See generally Empirical Research Project, *supra*, note 5 at 868-70, 907-09; D.S. Karjala, "A Second Look at Special Close Corporation Legislation" (1980) 58 Tex. L. Rev. 1207 at 1253-57; and L.J. Miller, "Illinois Close Corporations: Analysis of the New Act" (1978) 27 De Paul L. Rev. 587 at 601-03. Almost inevitably, American statutes limit the availability of shareholders' agreement provisions to corporations without publicly traded shares, with less than a certain number of shareholders, or with transfer restrictions.

Professor Karjala has also written papers on U.S. and Japanese close corporation law for the Symposium on Dualism in Corporation Law referred to in note 4. The author has relied on these papers in preparing this article. Page references to these papers are not given in the notes for this article because the papers were in draft form when this article was written. As with the author's paper for the Symposium, Professor Karjala's papers will be published as part of the proceedings, though only in abbreviated form. In addition, Professor Karjala's paper on U.S. law will be published in (1989) 21:3 Ariz. St. L.J. and his paper on Japanese law will be published in (1989) 7:2 B.U. Int'l L.J.

[21]On the likelihood of close corporations not complying with the formalities, see *Alberta Report*, *supra*, note 15 at 112-13 and F.H. O'Neal & R.B. Thompson, *O'Neal's Close Corporations*, 3d ed., (Wilmette, Ill.: Callaghan, 1986) para. 8.02. On the monitoring function of the statutory requirements, see Iacobucci, Pilkington & Prichard, *supra*, note 4 at 368-70, 390-91 and R.L. Watts & J.L. Zimmerman, "Agency Problems, Auditing, and the Theory of the Firm: Some Evidence" (1983) 26 J.L. & Econ. 613.

[22]See, for example, *C.B.C.A.*, *supra*, note 2, ss. 160, 163, 171(1) and see generally Hadden, Forbes & Simmonds, *supra*, note 4 at 166-68 and *Fraser's Handbook*, *supra*, note 16 at 360-92. In the *C.B.C.A.* and most of the statutes modelled after it, the exemptions do not apply to corporations with over $10 million in assets or annual revenues of over $5 million. This is not the case in Alberta and Newfoundland. See *A.B.C.A.*, *supra*, note 2, ss. 154, 157; *Alberta Report*, *supra*, note 15 at 103-04; and *N.C.A.*, *supra*, note 2, ss. 259, 262.

comparatively lax in this area.[23]

In terms of providing information to the shareholders before meetings, the *C.B.C.A.* statutes require a corporation to solicit proxies when a shareholders' meeting is called by the directors. The effect is that management is obliged to provide prescribed information to shareholders about the matters to be considered at the meeting.[24] This obligation, however, is not imposed on corporations with fifteen or fewer shareholders. In the United States, there has never been any need to develop distinctive treatment in respect of proxy solicitation for close corporations under general corporate legislation. This is because, unlike in Canada where the matter is governed both by corporate and securities laws, the regulation of proxy solicitation has been left to securities legislation.[25] Consequently, close corporations have never been subject to regulations concerning proxies since securities legislation is inapplicable to such corporations.

II. Close Corporation Legislation in the United States

In the years since the enactment of the *C.B.C.A.*, academic opinion in the United States has moved steadily in favor of special close corporation legislation as opposed to flexible general legislation as the proper approach to the problems of closely held corporations. For example, corporate formalities, such as retaining distinctions between shareholders and directors and requiring the use of articles and by-laws to govern the affairs of the corporations, are seen as being inappropriate because participants most often act informally. Consequently, it is argued that general incorporation legislation, despite the concessions which have been made, does not go far enough in terms of allowing informality in close corporations.[26] In terms of planning, it is suggested that even though managerial power can be reallocated to a significant extent and

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[23]See generally Branson, *supra*, note 14 at 79-80; R.L. Knauss, "Corporate Governance — A Moving Target" (1981) 79 Mich. L. Rev. 478 at 486-87; *Fletcher Cyclopedia of the Law of Private Corporations*, vol. 5A (Wilmette, Ill.: Callaghan, 1987) paras. 2186, 2267-72 [hereinafter *Fletcher Cyclopedia*]; and H. Golter, ed., *Fletcher Cyclopedia of the Law of Private Corporations: Corporate Practise Deskbook*, vol. 19 (Wilmette, Ill.: Callaghan, 1988) paras. 4.02-4.05.

[24]See, for example, *C.B.C.A.*, *supra*, note 2, s. 149 and *O.B.C.A. 1982*, *supra*, note 2, s. 111. For corporations with fifteen or fewer shareholders, the *C.B.C.A.* requires management to provide the stipulated information if proxies are actually solicited, but this pattern has not necessarily been followed in other *C.B.C.A.*-type jurisdictions. Indeed, proxies are one of the few areas where the statutes modelled after the *C.B.C.A.* have not completely followed it. See generally *Fraser's Handbook*, *supra*, note 16 at 276-89.

[25]See *Fletcher Cyclopedia*, *supra*, note 23, paras. 2008-2009.1.

[26]Empirical Research Project, *supra*, note 5 at 910-17; R.A. Kessler, "The ABA Close Corporation Statute" (1985) 36 Mercer L. Rev. 661 at 663-64, 675-76, 681; K.S. Chittur, "Resolving Close Corporation Conflicts: A Fresh Approach" (1987) 10 Harv. J. L. & Pub. Pol'y 129 at 137-39, 172; and S.C. Bahls & M.C. Quist, "The ABA Model Statutory Close Corporation Act: A New Opportunity for "Made in Montana" Corporations" (1988) 49 Mont. L. Rev. 66 at 79-81, 96-97.

substantial protection can be provided for minority shareholders, general incorporation legislation remains inadequate for close corporations because making such alterations is unduly complex and costly.[27] Finally, it is said that general corporation legislation does not provide adequate remedies for minority shareholders in close corporations in situations where the minority has not negotiated for protection.[28] The appropriate response to all of these problems, it is now argued by many commentators, is special close corporation legislation.[29]

Legislatures in U.S. states have become increasingly responsive to these arguments. There is now some form of close corporation legislation in over twenty states, including most of the leading commercial and industrial states.[30] This legislation varies widely.[31] In two states, for example, special close corporation legislation is restricted to remedies. In Minnesota and North Dakota, a provision in the general incorporation statute which authorizes a court to grant a wide range of remedies for oppressive, fraudulent or unfairly prejudicial conduct is only applicable in most respects to corporations with fewer than thirty-five shareholders.[32]

The legislation in other states consists of two basic types. Nine states have followed the approach developed by North Carolina and have limited their special treatment of close corporations to providing special protection in the general incorporation statute for shareholders' agreements entered into by close corporation participants. Most often, the agreement must be unanimous and in writing. The majority of these states allow the agreement to be in the articles,

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[27]Kessler, *ibid.* at 669-70, 681-87; Bahls & Quist, *ibid.* at 71-72, 81-83, 96-102; K.B. Smith, "Oklahoma Close Corporations: A Need to Recognize Shareholder Expectations" (1986) 11 Okla. City U.L. Rev. 357 at 369-71, 375-77, 382-84; and F.B. Weinberg, "The Close Corporation under Ohio Law" (1987) 35 Clev. St. L. Rev. 165 at 184-88.

[28]O'Neal, *supra*, note 11 at 881-88; E.J. Bradley, " Comparative Assessment of the California Close Corporation Provisions and a Proposal for Protecting Individual Participants" (1976) 9 Loy. L.A.L. Rev. 865 at 898-902; J.E. Olson, "A Statutory Elixir for the Oppression Malady" (1985) 36 Mercer L. Rev. 627 at 627-34; J.A.C. Hetherington & M.P. Dooley, "Illiquidity and Exploitation: A Proposed Statutory Solution to the Remaining Close Corporation Problem" (1977) 63 Va. L. Rev. 1 at 1-6, 34-62; and G.C. Ivey, "Standards of Management Conduct in Close Corporations: A Transactional Approach" (1981) 33 Stan. L. Rev. 1141 at 1153-60.

[29]See, for example, Miller, *supra*, note 20 at 588-603, 622-24; Bahls & Quist, *supra*, note 26 at 70-73, 80-85; Kessler, *supra*, note 26 at 666, 698-99; Chittur, *supra*, note 26 at 144-51; Smith, *supra*, note 27 at 360, 390-92; R. Blunk, "Analyzing Texas Articles of Incorporation: Is the Statutory Close Corporation Format Viable" (1980) 34 Sw. L.J. 941 at 956-60; and H.J. Haynsworth, "The Need for a Unified Small Business Legal Structure" (1978) 33 Bus. Law. 849 at 857-61.

[30]O'Neal & Thompson, *supra*, note 21, para. 1.15; Weinberg, *supra*, note 27 at 170; and Bahls & Quist, *ibid.* at 73. Further, a survey of state legislators found that about 70 per cent of legislators supported some form of special treatment for close corporations — see Empirical Research Project, *supra*, note 5 at 1020.

[31]A concise overview is provided by O'Neal & Thompson, *ibid.*, para. 1.16.

[32]See Olson, *supra*, note 28.

by-laws or a side agreement, though some require that the agreement be set out in the articles. Some provisions affirmatively state that qualifying shareholders' agreements are valid. Most, however, are worded negatively because they were drafted to overcome case law hostile to shareholders' agreements.[33]

The second basic approach which has been used is that initially adopted by Florida and Delaware. Under this approach, participants in a business can elect to have a close corporation chapter apply to the corporation. These provisions are most often organized in a separate chapter of the general corporation statute.[34] The remainder of the paper will focus primarily on this approach to close corporation legislation. The North Carolina approach, as such, will not be considered in any detail in this paper because the *C.B.C.A.* statutes contain similar provisions. In fact, the Canadian provisions are broader since they apply to all corporations rather than just close corporations. The *C.B.C.A.* statutes, however, contain nothing along the lines of a close corporation chapter, and the introduction of such a chapter could bring some significant changes in the governance of close corporations.

Ten states utilize the close corporation chapter approach, and the *M.B.C.A. Supplement* has been drafted along these lines.[35] The provisions vary quite significantly; however, in order to provide an overview, the Delaware and *M.B.C.A.* provisions will be considered. The Delaware chapter has thus far been the more influential, as four states have adopted a similar approach.[36] In contrast, only two states have adopted the *M.B.C.A. Supplement*, but given the past influence of *M.B.C.A.* proposals, it is reasonable to suggest that most future close corporations chapters will be modelled after the *M.B.C.A. Supplement.*[37]

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[33]The states following the North Carolina approach are South Carolina, Florida, Georgia, Maine, Ohio, Michigan, New Jersey, New York and Rhode Island. See Empirical Research Project, *supra*, note 5 at 868-70, 898-900, 908-09, 918; Karjala, *supra*, note 20 at 1251-53; and Miller, *supra*, note 20 at 602-03.

[34]*C.B.C.A.*, *supra*, note 2, s. 146 was modelled after the shareholders' agreement provisions in North Carolina and New York, although the drafters intentionally dropped the qualification requirements in these provisions, save that of unanimity. See Howard, *supra*, note 1 at 34.

[35]The states are California, Delaware, Maryland, Texas, Arizona, Illinois, Alabama, Kansas, Pennsylvania and Wisconsin. See generally Empirical Research Project, *supra*, note 5 at 870-74.

In California, provisions available to close corporations appear in various locations in the general statute rather than in a single chapter. Most relate to shareholders' agreements, so California arguably should be grouped with the North Carolina states. On the California provisions, see Bradley, *supra*, note 28 and D. Berger, "Statutory Close or Closely Held Corporation?" (1980) 11 Pac. L.J. 699 at 699-708.

Florida dropped its special close corporation chapter in 1975. On the problems with this particular legislation, see D.L. Dickson, "The Florida Close Corporation Act: An Experiment that Failed" (1967) 21 U. Miami L. Rev. 842.

[36]The states are Pennsylvania, Kansas, Illinois and Alabama. The approaches used in Maryland, Texas and Arizona differ appreciably. See Empirical Research Project, *ibid.* at 871-73.

[37]The two states are Wisconsin and Montana. See Bahls & Quist, *supra*, note 26 at 72-73. On the promising long term future of the *M.B.C.A. Supplement*, see Kessler, *supra*, note 26 at 661-62.

The Delaware and *M.B.C.A.* provisions, like all U.S. close corporations chapters, are not mandatory.[38] Instead, close corporations, and only close corporations, can elect to have the provisions apply. When such an election takes place, inconsistent provisions in the general incorporation legislation are displaced, but otherwise the general legislation continues to apply. Legislative definitions of close corporations have traditionally been based on some combination of three criteria, these being the number of shareholders, the absence of public trading of the corporations' shares and the presence of transfer restrictions.[39] Delaware incoporates all three criteria, as only a corporation which has thirty or fewer shareholders, which has some form of transfer restrictions on its shares and which has disavowed any public offering of its shares may elect.[40] The *M.B.C.A. Supplement* is much less restrictive, permitting any corporation with fewer than fifty shareholders to adopt the close corporation provisions.[41]

Qualifying Delaware corporations elect to have the close corporation chapter apply by stating in the articles that the corporation is a close corporation. This can be done on incorporation or subsequently by a resolution approved by two-thirds of holders of each class of shares. Electing corporations will have their close corporation status terminated involuntarily if an event occurs which breaches the qualifying conditions for such status, though close corporation status can be preserved if the breach is corrected within thirty days. Close corporation status can also be voluntarily terminated by a vote of a two-thirds majority within each class of shares.[42]

Under the *M.B.C.A. Supplement*, any newly formed corporation can elect to be a close corporation. An existing corporation with fewer than fifty shareholders can also so elect if a two-thirds majority in each class of shares approves. Both the articles and the share certificates of the corporation must identify the corporation as being a close corporation. The voluntary termination provisions are the same as those under the Delaware provisions. There are, how-

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[38]Empirical Research Project, *supra*, note 5 at 1022 and Committee on Corporate Laws, *supra*, note 3 at 272, 275-77.

[39]Empirical Research Project, *ibid.* at 878-79.

[40]*Del. Code Ann.* tit. 8, s. 342(2) (1986) [hereinafter *Del. Code Ann.*]; Empirical Research Project, *ibid.* at 880, 882, 884; and G.J. Siedel, "Close Corporation Law: Michigan, Delaware and the Model Act" (1986) 11 Del. J. Corp. L. 383 at 403, 408.

[41]*Model Stat. Close Corp. Supp.*, *supra*, note 3, s. 3; Empirical Research Project, *ibid.* at 875, 880-81; Kessler, *supra*, note 26 at 667; Committee on Corporate Laws, *supra*, note 3 at 277-78; and Siedel, *ibid.* at 407-08. In Montana, the limit was dropped to twenty-five-in order to prevent corporations which are not closely held from using the provisions; see Bahls & Quist, *supra*, note 26 at 73.

[42]*Del. Code Ann.*, *supra*, note 40, ss. 342-46, 348; Empirical Research Project, *ibid.* at 871, 888-92; and Siedel, *ibid.* at 403-05.

ever, no involuntary termination provisions, as an electing corporation does not automatically lose its status if the number of shareholders exceeds fifty.[43]

Both the Delaware chapter and the *M.B.C.A. Supplement* contain provisions permitting electing corporations to operate less formally. The Delaware statute provides that if the participants have agreed that the shareholders are to manage the corporation, a shareholders' meeting does not need to be called to elect directors.[44] The *M.B.C.A. Supplement* allows electing corporations to waive the obligation of holding an annual general meeting unless a shareholder applies for one.[45] It also relieves an electing corporation from any obligation to promulgate by-laws.[46]Further, both chapters specifically affirm that shareholders' agreements will not be rendered invalid by the corporation carrying on its affairs in a manner resembling a partnership. These provisions exist, in part, to help protect electing corporations from having the veil of incorporation lifted. The concerns in this regard flow from the fact that operating without regard for corporate formalities is a factor U.S. courts take into consideration in lifting the corporate veil. The *M.B.C.A. Supplement* reinforces this protection by containing a provision specifically stating that failure to observe corporate formalities should not be grounds for imposing personal liability on participants in the corporation.[47]

In terms of planning, the Delaware chapter authorizes an electing corporation to abolish the board of directors and shift managerial authority to the shareholders if the shareholders unanimously approve placing a statement to this effect in the articles.[48] In addition, the chapter authorizes electing corporations to include a provision in the articles giving shareholders the right to compel dissolution at will or upon the occurrence of special circumstances.[49] Otherwise, it is assumed that participants in an electing corporation will rely on provisions in a shareholders' agreement or in the articles and by-laws to meet their planning objectives. To assist in the use of these devices, the Delaware close corporation chapter facilitates enforcement of transfer restrictions on shares and protects

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[43]*Model Stat. Close Corp. Supp., supra*, note 3, ss. 3, 10, 31; Empirical Research Project, *ibid.* at 888-92; Kessler, *supra*, note 26 at 667-69, 682; Committee on Corporate Laws, *supra*, note 3 at 277-78, 283-88; and Siedel, *ibid.* at 407-09, 411-12.

[44]*Del. Code Ann., supra*, note 40, s. 351(1) and Empirical Research Project, *ibid.* at 914.

[45]*Model Stat. Close Corp. Supp., supra*, note 3, s. 23; Committee on Corporate Laws, *supra*, note 3 at 293; and Siedel, *supra*, note 40 at 421-23.

[46]*Model Stat. Close Corp. Supp., ibid.*, s. 22. Such a provision is unnecessary under the Delaware provisions since there is no requirement under the general Delaware corporation law to enact by-laws. See Siedel, *ibid.* at 420-21.

[47]See generally *Del. Code Ann., supra*, note 40, s. 354; *Model Stat. Close Corp. Supp., ibid.*, ss. 20, 25; Empirical Research Project, *supra*, note 5 at 916-23; Committee on Corporate Laws, *supra*, note 3 at 290-91, 306-07; and Siedel, *ibid.* at 428-29.

[48]*Del. Code Ann., ibid.*, s. 351; Smith, *supra*, note 27 at 370- 71; and O'Neal, *supra*, note 11 at 876.

[49]*Del. Code Ann., ibid.*, s. 355; Smith, *ibid.* at 389; and Siedel, *supra*, note 40 at 426.

written shareholders' agreements, entered into by shareholders holding a majority of shares, from attack on the basis that the powers of the directors are being infringed.[50]

The *M.B.C.A. Supplement* contains provisions relating to abolition of the board, enforcement of transfer restrictions and validation of shareholders' agreements which are similar to those in the Delaware chapter, though only unanimous shareholders' agreements are given special statutory protection.[51] Overall, however, the *M.B.C.A. Supplement* is more ambitious than the Delaware chapter in terms of planning, and thus constitutes a greater attempt to reduce the transaction costs associated with structuring the internal rules of close corporations. The *M.B.C.A. Supplement* attempts to codify some basic provisions that experienced practitioners often draft for close corporation shareholder clients,[52] though none of these provisions are mandatory. For example, under the *M.B.C.A. Supplement*, as with the Delaware close corporation chapter, electing corporations may give any shareholder the right to dissolve the corporation at will or on the occurrence of specified events by including a statement to this effect in the articles.[53] Unlike the Delaware chapter, however, the *M.B.C.A. Supplement* authorizes an electing corporation to adopt a comprehensive procedure dealing with the purchase of shares from the estate of a deceased shareholder by the corporation.[54] Further, the *M.B.C.A. Supplement* establishes presumptive transfer restrictions, the primary effect of which is to give the participants in the corporation the right to match the offer made by a potential transferee in most circumstances. This right of first refusal, and other transfer restriction provisions in the *M.B.C.A. Supplement*, can be varied or excluded by the articles.[55]

The *M.B.C.A. Supplement* is also more ambitious than the Delaware chapter in terms of remedies. The remedies provisions in the *M.B.C.A. Supplement* find their origins in statutory provisions and case law authorizing shareholders

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[50]On the validation of shareholders' agreements, see *Del. Code Ann., ibid.*, s. 350; Smith, *ibid.* at 371; and O'Neal, *supra*, note 11 at 876. It is specifically provided that liabilities imposed on directors shall be shifted to the extent that managerial power is reallocated. On the transfer restriction provisions, see *Del. Code Ann., ibid.*, ss. 347, 348(b); O'Neal & Thompson, *supra*, note 21, para. 1.16; and Smith, *ibid.* at 382-84. It should be remembered that a close corporation must have transfer restrictions in order to be eligible to elect close corporation status. See Siedel, *ibid.* at 410-11.

[51]*Model Stat. Close Corp. Supp., supra*, note 3, ss. 13, 20, 21. The Delaware and *M.B.C.*A. Supplement provisions are contrasted by Siedel, *ibid.* at 411-12, 415, 417-18.

[52]Committee on Corporate Laws, *supra*, note 3 at 275.

[53]*Model Stat. Close Corp. Supp., supra*, note 3, s. 33; Kessler, *supra*, note 26 at 690-91; and Committee on Corporate Laws, *ibid.* at 299-300.

[54]*Model Stat. Close Corp. Supp., ibid.*, ss. 14-17; Kessler, *ibid.* at 685-88; and Committee on Corporate Laws, *ibid.* at 293-99.

[55]*Model Stat. Close Corp. Supp., ibid.*, ss. 11-12; Kessler, *ibid.* at 682-85; and Committee on Corporate Laws, *ibid.* at 279-83.

to apply for dissolution of the corporation on the basis of a deadlock or misconduct by those in control of the corporation. In U.S. corporate law, however, involuntary dissolution has traditionally been treated as an exceptional remedy only available in special circumstances.[56]

The Delaware close corporation chapter is a rather stark example of the cautious approach to dissolution. Unlike most general corporation legislation in the United States, the general Delaware statute does not provide statutory authorization for involuntary dissolution upon an application by a minority shareholder.[57] However, if a corporation is deadlocked, a court is authorized to appoint a custodian. The close corporation chapter moderately expands the situations where a custodian can be appointed, and further allows a court to appoint a provisional director if this would be the more appropriate solution.[58]

In sharp contrast to the cautious approach of the Delaware legislation, the remedies provisions in the *M.B.C.A. Supplement* are the result of a concerted attempt to expand the jurisdiction of the courts in intra-corporate disputes. By the time the *M.B.C.A. Supplement* was first proposed, a small number of U.S. states had departed from the traditionally restrictive approach to involuntary dissolution and had borrowed from the English *Companies Act,1948* in enacting a provision allowing a court to grant dissolution or certain alternative remedies on the grounds that the applicant had suffered from oppressive conduct.[59] In preparing the *M.B.C.A. Supplement*, the drafters relied on these provisions, but also sought to expand the conduct which could give rise to relief and further sought to break down the connections between involuntary dissolution and other remedies. Thus, the *M.B.C.A. Supplement* authorizes a court, upon an application by a shareholder in an electing close corporation, to grant a remedy on the basis of deadlock or fraudulent, illegal, oppressive or unfairly prejudicial conduct by the directors or those in control of the corporation. The court is authorized to grant a number of remedies, including appointing a custodian or provisional director, removing directors or officers and ordering a buy-out of the applicant's

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[56]C.B. Capel, "Corporation Law — *Meiselman v. Meiselman*: "Reasonable Expectations" Determine Minority Shareholders' Rights" (1984) 62 N.C.L. Rev. 999 at 1005-08 and R.W. Hillman, "The Dissatisfied Participant in the Solvent Business Venture: A Consideration of the Relative Permanence of Partnerships and Close Corporations" (1982) 67 Minn. L. Rev. 1 at 38-41, 45-49.

[57]O'Neal & Thompson, *supra*, note 21, para. 9.28 n. 14.

[58]*Del. Code Ann.*, *supra*, note 40, ss. 226, 352 and Empirical Research Project, *supra*, note 5 at 976-77.

[59]See, the *Companies Act, 1948* (U.K.), 1948, c.38, s. 210. The states specifically identified by the Committee on Corporate Laws were Michigan, Minnesota, New Jersey and South Carolina, see *supra*, note 3 at 302. A significantly larger number of states followed the approach of the *M.B.C.A.* and established oppression as grounds for dissolution but did not specifically authorize the granting of alternative remedies. See Hillman, *supra*, note 56 at 39-41.

shares. Dissolution can also be ordered, but this is to be treated as a last resort.[60] The result is one of the most broadly drafted dissolution/oppression provisions in the United States. At present, only Minnesota and North Dakota have provisions which are more broadly cast.[61]

III. Evaluation of Close Corporation Legislation

A. *The Delaware Chapter and the M.B.C.A. Supplement*

The foregoing illustrates that the introduction of a close corporation chapter along the lines of the Delaware chapter or the *M.B.C.A. Supplement* would bring some significant changes to the *C.B.C.A.* statutes. In evaluating whether such changes would be desirable it is important to remember that close corporation chapters should not be analyzed in terms of whether they allow close corporations to be governed and operated in accordance with partnership law principles. This point needs to be addressed because many commentators have advocated special close corporation legislation on the basis that such legislation allows close corporations to operate as partnerships.[62] The reasons why the partnership analogy has been drawn are not difficult to trace. In some respects, close corporations do resemble partnerships, as there is often a similar degree of overlap between management and risk-bearing. Also, ownership interests in both types of business enterprise are often not liquid and the investment made by the participants tends to be more firm specific than in publicly traded corporations.

This does not mean, however, that partnership law should be applied to close corporations. This should only occur if partnership law accurately reflects the bargain which close corporation participants would have reached if negotiations had been costless. It is unlikely that this would be the case except in a small percentage of firms. Depending upon one's definition of a close corporation, many close corporations do not resemble the *Partnerships Act*'s presumptive partnership, which involves equal sharing of profits and liabilities, and participation in management by each partner.[63] Such a partnership presumably would involve a small number of participants who each wanted to be involved in management. The further a close corporation departs from this structure, the

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[60]*Model Stat. Close Corp. Supp., supra*, note 3, ss. 40-43; Kessler, *supra*, note 26 at 691-95; Committee on Corporate Laws, *ibid.* at 300-306; and Hillman, *ibid.* at 41-43.

[61]See Olson, *supra*, note 8.

[62]See, for example, Hadden, Forbes & Simmonds, *supra*, note 4 at 186-91; Kessler, *supra*, note 26 at 663-67; Bahls & Quist, *supra*, note 26 at 68-69, 82-83; Smith, *supra*, note 27 at 360, 390-92; Bradley, *supra*, note 28 at 866-67, 899; and Haynsworth, *supra*, note 29 at 857-61. Other commentators have expressed enthusiasm for the partnership analogy without specifically endorsing the adoption of a close corporation chapter. See, for example, Manne, *supra*, note 5 at 278-83 and Hetherington & Dooley, *supra*, note 28 at 41-50.

[63]*E.g. Partnerships Act*, R.S.O. 1980, c. 370, s.2.

less reason there is to suspect that participants in that corporation would prefer to be governed by the standard terms provided by partnership law. For example, while a corporation with twenty shareholders would fall within many definitions of close corporation, there is good reason to suspect that these parties would not bargain for equal rights in terms of participation in management and profits.[64]

Further, even in relation to corporations which structurally resemble the *Partnerships Act*'s presumptive partnership, there is reason to be sceptical whether participants in such corporations would choose to be governed by partnership law if such a choice was available at no cost. This is because the decision to incorporate rather than operate as a partnership cannot be lightly dismissed. In order to argue that close corporation participants would rather be governed by partnership law, one must assume that participants in such corporations were either unaware of, or indifferent to, the distinctions between corporate law and partnership law.[65] Such an assumption is questionable since it is widely assumed that sophisticated commercial considerations, such as tax law and estate planning, will influence the decision to incorporate. To suggest that participants in close corporations are aware of these issues and are not cognizant of the distinctions between corporate law and partnership law is rather dubious.[66]

A more appropriate standard for evaluating close corporation chapters is whether they will reduce transaction costs of participants.[67] It has been stated earlier that corporate law can be seen as establishing a set of standard terms

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[64]See Hillman, *supra*, note 56 at 64-65 and M.R. Chesterman, "The "Just and Equitable" Winding Up of Small Private Companies" (1973) 36 Mod. L. Rev. 129 at 131-36, who points out that one of the problems with the partnership analogy is determining with which partnership a close corporation is being compared.

[65]This is done, for example, by O'Neal & Thompson, *supra*, note 7, para. 2.10 and Capel, *supra*, note 56 at 1003-04.

[66]Easterbrook & Fischel, *supra*, note 5 at 298-99. Admittedly, concern about limited liability, greater flexibility in terms of borrowing and tax issues might outweigh internal governance considerations and could cause participants to incorporate even though they would otherwise prefer to be governed by partnership rules. If this was the case, however, one would expect that there would be a good deal of enthusiasm among businesspersons for the introduction of partnership law rules into corporate law. Such enthusiasm, however, is absent. This is indicated by the lack of use of elective close corporation chapters in the U.S., which will be discussed *infra* and by a 1980 survey of English businesspersons which indicated that they had little interest in any new form of incorporation based on partnership lines. On the latter, see F. Wooldridge, "A New Form of Incorporation — Responding to the Gower Proposals" (1982) 3 Co. L. 58 at 58, 60-61.

On the factors involved in the decision to incorporate, see generally R.W. Bird, "Incorporation and the Reasons Therefor" (1974) 23 U.N.B.L.J. 89; D. Cameron, "The Form and Organization of the Business Entity" in Buckley & Connelly, *supra*, note 2 at 41-44; and H. Haynsworth, *Selecting the Form of a Small Business Entity* (Philadelphia: American Law Institute — American Bar Association, 1985).

[67]Easterbrook & Fischel, *ibid.* at 283-84, 299 and Buckley & Connelly, *ibid.* at 765.

which will reduce the cost of contracting and that this analysis is applicable to close corporations as well as other corporations. Under this framework, the introduction of special close corporation chapters will only be justified if they reduce the costs associated with planning and operating close corporations.

The empirical evidence indicates that close corporation chapters do not achieve this result. If they did, one would expect that election would frequently take place because the cost savings would be passed on to the participants. Close corporation chapters, however, are rarely utilized in the United States. In the U.S., as in Canada, a large majority of corporations have most or all of the traditional indicia of close corporations.[68] Nevertheless, the pattern in states with special close corporation chapters is that only a small percentage of corporations elect close corporation status.[69]

When confronted with this, supporters of U.S. close corporation legislation have relied on factors external to the content of the legislation to explain the phenomenon. For example, it is said that those incorporating without legal advice will not use close corporation chapters because of a lack of awareness of the provisions. Also, it is asserted that even when lawyers are used, there is no guarantee that the election of close corporation status will be considered, as many lawyers are ignorant of the provisions or are unjustifiably reluctant to use the elective chapters.[70]

There is reason to be sceptical of these justifications for the lack of use of close corporation chapters.[71] Given that the decision to incorporate will be based on commercial and legal considerations, it would be rather odd for investors in close corporations and their lawyers to be ignorant of provisions in corporation statutes which are organized into a separate chapter dealing with close corporations. Further, if cost savings indeed arose by virtue of election, there is every

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[68]In the United States, see Haynsworth, *supra*, note 29 at 851-52 and in Canada, see Hadden, Forbes & Simmonds, *supra*, note 4 at 47-51.

[69]The percentage of incorporating corporations which elect close corporation status in states with special chapters varies from 5 to 20 percent. See O'Neal & Thompson, *supra*, note 21, para. 1.19; Blunk, *supra*, note 29 at 955-56; and M. Harris, "Assessing the Utility of Wisconsin's Close Corporation Statute: An Empirical Study" [1986] Wis. L. Rev. 811 at 827-28.

[70]Bahls & Quist, *supra*, note 26 at 82-83; Harris, *ibid.* at 829-30; and H. Haynsworth, *Organizing a Small Business Entity* (Philadelphia: American Law Institute — American Bar Association, 1986) at 229-30. Supporters of close corporation chapters are prepared to admit that there may be minor defects with the terms of the close corporation chapter, but it is rarely suggested that the lack of use arises because the basic premise is flawed. See, for example, Blunk, *ibid.* at 956-60. Some commentators, however, have tied the lack of use of the chapters to basic problems with their operation. See Weinberg, *supra*, note 27 at 166 and Hetherington & Dooley, *supra*, note 28 at 60-61.

[71]For example, in terms of non-lawyers being unaware of close corporation chapters, the evidence from California indicates that non-lawyers use elective chapters more often than lawyers. See O'Neal & Thompson, *supra*, note 21, para. 1.18.

reason to suspect that any ignorance of, and resistance to, using close corporation chapters would be quickly displaced.

A more plausible explanation for the lack of special close corporation chapters is that as compared with general corporation legislation, they do not reduce transaction costs. To the extent that this is accurate, one would expect that the same result would ensue in Canada, given that the *C.B.C.A.* statutes were derived largely from U.S. precedents. Indeed, it is even less likely that transaction cost savings would arise from election in Canada. This is because, unlike most U.S. general corporate statutes, the *C.B.C.A.* statutes already contain a significant portion of the provisions in close corporation chapters which potentially could reduce transaction costs. Further, other provisions in the close corporation chapters which could reduce transaction costs could be satisfactorily incorporated into the *C.B.C.A.* statutes.

For example, with respect to corporate formalities, annual meetings are one instance where Canadian corporate legislation offers essentially the same potential transaction cost savings as special close corporation chapters. As mentioned, the *M.B.C.A. Supplement* allows an electing corporation not to hold annual general meetings, which are invariably compulsory under U.S. general corporation legislation. In those corporations where monitoring can occur satisfactorily without an annual general meeting, election under the *M.B.C.A. Supplement* would allow avoidance of the unnecessary costs of holding the meeting. However, such cost savings are already available to businesses incorporated under the *C.B.C.A.* statutes since business carried out at annual general meetings, as with all other general meetings, can be carried out by a resolution in writing signed by all of the shareholders.[72]

Similarly, the provision in the *M.B.C.A. Supplement* relieving an electing corporation from any obligation to promulgate by-laws might reduce transaction costs for electing corporations in jurisdictions where such an obligation is imposed. This will be the case in corporations where the monitoring function provided by the by-laws can be achieved with less cost through the use of other devices. However, election would not be necessary to obtain such cost savings in Canada because a corporation is not obliged to enact by-laws under the *C.B.C.A.* statutes.[73]

Corporate formality provisions in the Delaware and *M.B.C.A.* legislation which do not have direct equivalents in the *C.B.C.A.* statutes and which, on first glance, might be attractive to participants in Canadian close corporations would be those which seek to protect electing corporations from having the corporate

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[72]See, for example, *C.B.C.A.*, *supra*, note 2, s. 142. On the waiver of annual general meetings in the U.S., see *supra*, note 45 and Empirical Research Project, *supra*, note 5 at 914-15, 997-99.

[73]Note the permissive wording of *C.B.C.A.*, *supra*, note 2, ss. 103(1), 104(1) and see D. Goldenberg, *Alberta Corporation Manual* (Don Mills,Ont.: Richard DeBoo, 1985) at 5-11 – 5-12.

veil lifted on the basis that corporate business has been conducted informally or along the lines of a partnership. There have been Canadian cases where the court has relied on the failure to observe corporate formalities as at least a partial justification for lifting the corporate veil.[74] However, the effectiveness, and hence the attraction, of a legislative provision limiting the lifting of the corporate veil on the basis of corporate formalities may be minimal. A decision by a court to lift the veil is almost inevitably based on a variety of factors and is most often ultimately determined by the equities of the case.[75] Consequently, a failure to follow formalities is unlikely to be the sole factor in a decision to lift the veil, and thus it is unlikely that a judge would refrain from lifting the veil solely on the basis of an elective statutory provision.[76] As a result, reasons other than concern about limited liability would likely be needed for participants in a corporation to elect close corporation status.

The costs involved with the resolution of planning issues would also not cause Canadian corporations to elect under a close corporation chapter modelled after the Delaware chapter or the *M.B.C.A. Supplement*, especially if some amendments were made to the *C.B.C.A.* statutes. In relation to the Delaware chapter, this is primarily because the *C.B.C.A.* statutes utilize a similar approach to planning questions by providing specific statutory approval to the reallocation of managerial control in corporations through shareholders' agreements.

Some differences exist, however, between the shareholders' agreement provisions in the Delaware close corporation chapter and those in the *C.B.C.A.* statutes. The Delaware provisions leave no doubt that shareholders, acting unanimously, can shift managerial power from the board to the shareholders. The ability to do this under the *C.B.C.A.* and most of the statutes modelled after it is somewhat uncertain, though it is likely that an affirmative shift of managerial power can be made.[77] Other differences include the possibility of abolition of the board of directors under the Delaware chapter[78] and unanimity not being

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[74]See, for example, *Wolfe* v. *Moir* (1969), 69 W.W.R. 70 (Alta. S.C.).

[75]See *Constitution Insurance Co. of Canada* v. *Kosmopoulos*, [1987] 1 S.C.R. 2 at 18, 34 D.L.R. (4th) 208 at 213, Wilson J.

[76]See Karjala, *supra*, note 20 at 1216, 1263 and O'Neal & Thompson, *supra*, note 21, para. 1.17. For a contrary view on the utility of such a provision, see Empirical Research Project, *supra*, note 5 at 921-23.

[77]Contrast R.J. Hay & L.A. Smith, "The Unanimous Shareholder Agreement: A New Device for Shareholder Control" (1985) 10 Can. Bus. L.J. 440 at 450-51, who argue that managerial power can be affirmatively shifted, with D.H. Sohmer, "Controlling the Power to Manage in Closely-Held Corporations under the *Canada Business Corporations Act*" (1976) 22 McGill L.J. 673 at 675 who argues that this cannot occur. On the unanimous shareholders' agreement provisions in the *C.B.C.A.* statutes, see generally *Fraser's Handbook*, *supra*, note 16 at 224-28.

[78]That this cannot be done under the *C.B.C.A.* statutes is indicated by the fact that a corporation will have to continue to comply with the provisions respecting number and residency requirements for the board. See, for example, *C.B.C.A.*, *supra*, note 2, ss. 102(2), 105(3).

necessary to insulate a shareholders' agreement from judicial scrutiny on the basis that managerial discretion is infringed.[79]

These differences might cause participants in some Canadian close corporations to prefer the rules established by the Delaware chapter. For example, shareholder management could be established with more confidence. In addition, the reduced emphasis on unanimity could lessen the possibility of opportunistic behavior on the part of the minority. Further, the ability of shareholders to abolish the board would reduce costs for close corporations which wished to operate without directors.[80]

However, these differences do not strengthen the case in favor of introducing the Delaware chapter to Canadian corporate legislation. First, one can be sceptical whether the Delaware rules would be preferred by many close corporation participants. For instance, minority shareholders might be strongly supportive of a unanimity requirement and U.S. close corporations have shown little inclination to abolish the board when they have had this option.[81] Further,

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[79]To reiterate, only a majority of shareholders need to be parties. See *supra*, notes 48 and 50. Under the *C.B.C.A.* statutes, however, unanimity is required. In addition, while unanimous approval is required to shift managerial power to the shareholders under the Delaware chapter, a majority vote is all that is needed to return managerial power to the board. In contrast, under the *C.B.C.A.* statutes, unanimous agreement would be required before the agreement could be altered to shift managerial power back to the board. Nevertheless, it is of course open for the participants in a unanimous shareholders' agreement to stipulate whether majority rule or unanimity will determine business decisions made by the participants.

[80]On the benefits of operating without a board of directors, see Kessler, *supra*, note 26 at 675-76.

[81]In relation to unanimity, there is going to be a trade-off between the dangers of opportunistic conduct by the minority and the benefits to the minority arising from reduced agency costs. See Buckley & Connelly, *supra*, note 2 at 741, 754 and O'Neal & Thompson, *supra*, note 21, paras. 4.02-03, 4.21-22. Academic commentators generally favor a unanimity requirement in the context of displacing the board's managerial power. See Iacobucci, Pilkington & Prichard, *supra*, note 4 at 79-80; Welling, *supra*, note 4 at 318; Kessler, *ibid.* at 668-69, 678-79; Siedel, *supra*, note 40 at 419-20; Weinberg, *supra*, note 27 at 193; and J.A.C. Hetherington, "Defining the Scope of Controlling Shareholders' Fiduciary Responsibilities" (1987) 22 Wake Forest L. Rev. 9 at 29-30. Some, however, are less enthusiastic. See Karjala, *supra*, note 20, at 1229-32 and R.M. Shapiro, "The Statutory Close Corporation: A Critique and a Corporate Planning Alternative" (1976) 36 Md. L. Rev. 289 at 292-96. The survey by the Empirical Research Project indicates that more attorneys favor a unanimity requirement than a two-thirds or simple majority requirement. See *supra*, note 5 at 988-90.

On the empirical evidence from the U.S., see Blunk, *supra*, note 29 at 955 and Harris, *supra*, note 69 at 822 n. 72. One reason that Canadian close corporations might not be interested in operating without a board is that the costs to corporations which have already established shareholder management should be minor. Under the *C.B.C.A.* statutes, directors' duties and liabilities are shifted to the shareholders to the extent that the powers of the board are assumed. See, for example, *C.B.C.A.*, *supra*, note 2, s. 146(5) and *A.B.C.A.*, *supra*, note 2, s. 140(7), which is drafted more clearly on the point. Further, close corporation participants might find that third parties would be more comfortable if the corporation had directors. On abolition of the board in close corporations,

even if the aforementioned features of the Delaware shareholders' agreement provisions would be preferred by many close corporation participants, these features could be introduced into the *C.B.C.A.* statutes without the need for a special chapter. Indecd, this has been done to a certain extent under the *A.B.C.A.*, which has shareholders' agreement provisions which go as far as the Delaware close corporation chapter in authorizing affirmative shifts of managerial power to the shareholders.[82] De-emphasizing the significance of unanimity could also be done quite easily by statutory amendment of the shareholders' agreement provisions. Permitting elimination of the board would involve some more intricate statutory changes, as provisions such as those requiring the board to meet certain residency requirements would have to be either dropped or redrafted.[83] It should be remembered, though, that adoption of a close corporation chapter along the lines of the Delaware chapter would require similar alterations. This is because, as mentioned, the provisions of the general corporation statute continue to apply to electing corporations. Consequently, statutory provisions dealing with the board in the *C.B.C.A.* statutes would have to be altered to take into account electing corporations which decided to abolish the board.

As mentioned, the *M.B.C.A. Supplement*, like the Delaware chapter, authorizes the use of shareholders' agreements which infringe on the managerial authority of the board, authorizes the shift of managerial power from the board and allows abolition of the board. Where the *M.B.C.A. Supplement* differs significantly from the Delaware chapter in terms of planning is by the inclusion of detailed terms dealing with transfer restrictions and the purchasing of shares from the estate of deceased shareholders. On first consideration, these provisions might be attractive to close corporation participants, as share transfers and buy-outs upon death are frequently areas of concern in close corporations. Indeed, if these terms accurately set out how participants in a close corporation would deal with these issues, then election under the *M.B.C.A. Supplement* would lead to cost savings for the participants because time and effort would not have to be expended in negotiating and drafting the relevant provisions.[84] These cost savings in turn probably would operate as an incentive to elect close corporation status.

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see generally *Alberta Report*, *supra*, note 15 at 25; Bahls & Quist, *supra*, note 26 at 97; and Hay & Smith, *supra*, note 77 at 447.

[82]*A.B.C.A.*, *ibid.*, s. 140. The provisions are described by Goldenberg, *supra*, note 73 at 10-76 – 10-82. They were introduced in accordance with the recommendations of the *Alberta Report*, *supra*, note 15 at 23-29.

[83]See *supra*, note 79. Abolishing some of these requirements might be justified in any event. See Buckley & Connelly, *supra*, note 2 at 372.

[84]This was in fact put forward as an argument for the *M.B.C.A. Supplement*. See Committee on Corporate Laws, *supra*, note 3 at 273.

It is unlikely, however, that the planning terms in the *M.B.C.A. Supplement* would reduce transaction costs for Canadian close corporations.[85] Both the transfer restriction and purchase on death provisions in the *M.B.C.A. Supplement* are detailed, which is not surprising since well-drafted provisions dealing with these issues will most often be intricate.[86] A cost which arises from the detailed nature of the provisions, however, is that the provisions require careful consideration to determine their precise nature and effect. Further, displacing the terms or making the terms applicable has to be done with some care because the transfer restriction provisions are presumptive while the buy-out on death terms are elective.[87] Most significantly, the level of detail increases the likelihood that the provisions will not be suitable for most close corporations. Close corporations differ significantly and even subtle distinctions between close corporations can render a well-drafted transfer restriction or purchase on death provision inappropriate for a particular close corporation. This is illustrated by F. Hodge O'Neal and Robert Thompson's general comment on the preparation of transfer restrictions:

> "[T]he drafter must thoroughly explore the ramifications of the particular business situation, for the instrument he is drafting should be adapted to both the particular business and the particular shareholders. The drafter should use forms and instruments prepared for other businesses only as 'idea guides' or as checklists, and not permit them to channel his thinking. Restrictive provisions may well vary with the size of the enterprise, the nature and scope of its activities, the number of persons holding shares, the extent to which the shareholders participate in the business, the health of the shareholders, the financial conditions and family situations of the shareholders, and the individual preferences of the interested persons."[88]

The result is that the transfer restriction and purchase on death provisions in the *M.B.C.A. Supplement* will most often not meet the needs of close corporations.[89] For example, under the *M.B.C.A. Supplement*, the right of first refusal does not apply to transfers between shareholders or between family members. The absence of controls over these transfers could lead to unantieipated shifts in control of the corporation or to the unwanted participation of a spouse or child in the business. If this did not accord with the intentions of the partici-

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[85]Even strong proponents of the *M.B.C.A. Supplement* acknowledge that election of close corporation status does not eliminate the need for careful planning. Bahls & Quist, *supra*, note 26 at 113.

[86]O'Neal & Thompson, *supra*, note 21, paras. 7.04, 7.21, 7.26.

[87]See *supra*, notes 54 and 55. The combination of elective and presumptive provisions, together with the requirement of dealing with the relevant matters in the articles, is criticized by Kessler, *supra*, note 26 at 669-75, 697-99.

[88]*Supra*, note 21, para. 7.04.

[89]See E.J. Bradley, "An Analysis of the *Model Close Corporation Act* and a Proposed Legislative Strategy" (1985) 10 J. Corp. L. 817 at 822, 834. Even supporters of the *M.B.C.A.* format acknowledge that it is likely that the transfer restriction and purchase on death provisions will have to be changed in most electing close corporations. Bahls & Quist, *supra*, note 26 at 85-96.

pants, election of close corporation status under the *M.B.C.A. Supplement* would not reduce transaction costs in relation to transfer restrictions because the participants and their advisers would have to negotiate and draft new transfer restriction provisions. A similar process would take place in any electing close corporation whenever the transfer restriction or purchase on death provisions did not match the needs of the participants. In the result, the detailed planning provisions in the *M.B.C.A. Supplement* would probably not provide significant cost savings for participants in close corporations incorporated under the *C.B.C.A.* statutes.[90]

A final area in which election of close corporation status under a chapter modelled after the Delaware legislation or the *M.B.C.A. Supplement* could potentially reduce transaction costs would be remedies. As mentioned, close corporations, like other business organizations, have to compete for investing capital. As part of this process, close corporations must provide an attractive investment opportunity, and giving minority shareholders more substantial remedies could provide such an incentive.[91] The Delaware chapter and the *M.B.C.A. Supplement* could facilitate this because, as mentioned, election provides greater scope for judicial intervention to protect minority shareholders than does the corresponding general corporation law.[92]

In Canada, however, the remedies provisions would do little to encourage election. This is because the oppression remedy in the *C.B.C.A.* statutes is much broader than any similar provision in the Delaware chapter and is as broad as the relevant provision in the *M.B.C.A. Supplement*.[93] Thus, election of close corporation status under a chapter modelled after the *M.B.C.A. Supplement* would add little to the protection of minority shareholders.

In sum, corporations incorporated under the *C.B.C.A.* statutes would likely not utilize a close corporation chapter drafted along the lines of the Delaware chapter or the *M.B.C.A. Supplement*. This, in large part, is because election under either of these chapters would do little, if anything, to reduce the transaction costs associated with formulating the relationship between the partici-

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[90]Further, it is also possible that election might cause counsel and their clients to not consider the issues involved when the terms of the *M.B.C.A. Supplement* do not meet the participants' bargain. On the possibility of election deflecting careful planning, see Shapiro, *supra*, note 81 at 291, 309 and Bradley, *ibid.* at 834.

[91]See Easterbrook & Fischel, *supra*, note 5 at 285. There has been very little empirical work done on the issue of whether shareholders' remedies affect the decision of shareholders to invest. This is beginning to change — see, for example, D.R. Fischel & M. Bradley, "The Role of Liability Rules and the Derivative Suit in Corporate Law: A Theoretical and Empirical Analysis" (1986) 71 Cornell L. Rev. 261.

[92]See *supra*, notes 56 to 61. See also O'Neal & Thompson, *supra*, note 21, para. 1.16.

[93]See, for example, *C.B.C.A.*, *supra*, note 2, s. 247. The author has written about the oppression remedy in Canada and dissolution/oppression provisions in the United States in "The Oppression Remedy in Corporate Law: The Canadian Experience" (1988) 10 U. Pa. J. Int'l Bus. L. 305.

pants. This strongly suggests that there is little reason to introduce a close corporation chapter based on either of these models, especially if shareholders' agreement provisions were introduced along the lines of those in the *A.B.C.A.* This, however, does not end matters. Two further scenarios need to be considered before the case for close corporation chapters can be dismissed.

B. Improved Elective Close Corporation Legislation

One possibility would be to improve the provisions of close corporation chapters to make them more attractive to potentially electing corporations. The most obvious way would be to increase the number of detailed planning provisions available to electing corporations. For example, even in corporations which have adopted the *M.B.C.A. Supplement* and where the terms of the *M.B.C.A. Supplement* closely match the bargain which the participants would have reached on the issues covered therein, detailed drafting of a shareholders' agreement and/or the corporate constitution will still be needed to fully reflect the participants' bargain.[94] This is because many issues which are important in close corporations are not dealt with by election under the *M.B.C.A. Supplement*, such as employment, allocation of income, preservation of proportional shareholdings, buy-outs and dispute resolution.[95] This suggests that if these issues were dealt with in a close corporation chapter, the transaction costs of electing corporations would be reduced and election would be more attractive.

In fact, however, changes along these lines would do little to improve the case in favor of close corporation legislation. As with transfer restriction and purchase on death provisions, it is unlikely that statutory provisions dealing with issues such as protection of income flow, buy-outs, employment and dispute resolution can be drafted to accord with what participants in most close corporations would have bargained for absent transaction costs. This, again, is because such issues cannot easily be reduced to satisfactory universal standard terms. Provisions dealing with these issues which accurately reflect the participants' bargain will carefully balance flexibility with protection of the minority's interest and will have to be able to stand the test of time. Consequently, well drafted terms dealing with these issues will most often be detailed and com-

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[94]On the complexities involved with drafting in relation to close corporations despite the presence of close corporation legislation see *supra*, note 85; Karjala, *supra*, note 20 at 1241-42, 1249-52; and Berger, *supra*, note 35 at 726-27. See also O'Neal & Thompson, *supra*, note 21, paras. 3.03, 4.22, 5.38, 7.04, 7.21, 9.03 and Haynsworth, *supra*, note 70 at 354-55, 374-78.

[95]On areas of importance in close corporations, see Empirical Research Project, *supra*, note 5 at 862, 905; Easterbrook & Fischel, *supra*, note 5 at 277-79; and Haynsworth, *ibid.* at 227-29.

plex.[96] This would have to be the case as much with a statutory provision as with one drafted by a lawyer. The detail, however, which would be necessary to achieve the appropriate balance in a statutory provision would cause the provision to be inconsistent with the intentions of participants in most close corporations. The result, again, would be that participants and legal advisers in most close corporations would have to draft new provisions suited to the individual close corporation, and the potential cost savings arising from election would largely be lost.

Other, more minor potential improvements to close corporation chapters can be envisioned. For example, as has been seen under both the Delaware chapter and the *M.B.C.A. Supplement*, adoption or displacement of many of the provisions will not be effective unless the matter is dealt with in the articles of incorporation.[97] This will be the case even if the shareholders have otherwise agreed by unanimous written agreement. In such situations, the requirement of inclusion in the articles will be a trap for the unwary. Consequently, making the shareholders' agreement the sole document whereby election or displacement of provisions of the chapter can occur would help to reduce costs arising from errors.[98]

This does not, however, strengthen the case in favor of close corporation legislation since, as illustrated by the *A.B.C.A.*, general corporate legislation can be developed to allow such cost savings. Under the *C.B.C.A.*, a significant number of matters are required in the articles, thus raising the possibility of an agreed upon term being rendered unenforceable by an inadvertent failure to include it in the articles. This problem is much less likely to arise under the *A.B.C.A.* because it provides that most of the matters which are required to be dealt with in the articles can also be dealt with in a unanimous shareholders' agreement.[99]

Another possible change which could be made to close corporation chapters would be to improve their signalling effect. This could be done by highlighting areas where planning can take place, thus reducing, though perhaps marginally, the costs associated with planning in close corporations.[100] This is an explicit objective of Ohio's close corporation legislation, which is based on the North Carolina model and thus is restricted to validating the use of share-

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[96]See *supra*, note 94. The utility of detailed contractual formulations is noted on a more general level by C.J. Goetz & R.E. Scott, "The Limits of Expanded Choice: An Analysis of the Interactions Between Express and Implied Contract Terms" (1985) 73 Calif. L. Rev. 261 at 265.

[97]See *supra*, notes 42, 43, 48, 49, 51, 53 , 55.

[98]See Kessler, *supra*, note 26 at 669-75 and O'Neal and Thompson, *supra*, note 21, para. 1.19.

[99]For a comprehensive list, see Goldenberg, *supra*, note 73 at 10-78 – 10-79.

[100]The utility of legislative signalling in the context of close corporation planning is noted by Kessler, *supra*, note 26 at 698 and Bradley, *supra*, note 89 at 846. Both suggest that this might be a better approach than the use of detailed terms.

holders' agreements by close corporations.[101] Again, however, the *A.B.C.A.* illustrates that general corporation legislation can achieve the same objective. For instance, the *A.B.C.A.*, in addition to expressly authorizing a shift of managerial powers to the shareholders, lists a number of topics which can be dealt with by shareholders' agreements.[102] This has the dual advantage of reducing uncertainty and performing a signalling function by highlighting matters which should be considered for potential inclusion in a unanimous shareholders' agreement.

In sum, while it is not difficult to conceive of changes which could be made to the Delaware or *M.B.C.A.* chapters, such changes would do little to improve the case in favor of introducing such chapters into Canadian corporate legislation. Ambitious alterations, such as adding more detailed terms, would do little to reduce planning costs in close corporations. On the other hand, more cautious changes, which might actually reduce the costs to close corporation participants, could be satisfactorily accommodated by general incorporation legislation, as is illustrated by the *A.B.C.A.*

C. Presumptive or Mandatory Close Corporation Legislation

Given that tinkering with the provisions of the Delaware and *M.B.C.A.* chapters does not displace the arguments against introduction of a special close corporation chapter in Canadian corporate legislation, it is necessary to consider more radical variations on the Delaware and *M.B.C.A.* models. The essential thrust of these variations is to displace the passive, elective format. The stronger version would be to have a chapter of mandatory rules for close corporations. The weaker version would be to make the rules presumptive.[103]

Regardless of how a mandatory chapter was drafted, such a proposal suffers from serious problems. Mandatory legislation would force close corporations into a legal strait jacket by imposing provisions on them which might well be unsuitable. For example, a close corporation would lose the option of electing to be governed entirely under the general incorporation law even if this better suited the needs of the participants. Further, even if the provisions of the chapter were basically suitable to a close corporation upon incorporation, this

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[101]Weinberg, *supra*, note 27 at 178-79, 185.

[102]See *supra*, note 2, s. 140(1) and statutory provisions listed in Goldenberg, *supra*, note 73 at 10-78 – 10-79.

[103]See generally Empirical Research Project, *supra*, note 5 at 886-88. Supporters of more radical variations of close corporation legislation tend to advocate a mix of presumptive and mandatory rules. See Secretary of State for Trade, *A New Form of Incorporation for Small Firms* (Annex A: A Code for Incorporated Firms) by L.C.B. Gower (London: H.M.S.O., 1981); Miller, *supra*, note 20 at 621-22; Chittur, *supra*, note 26 at 145-51, 167-72; and Bradley, *supra*, note 28 at 898-904. Bradley now recommends a less ambitious approach, restricting his recommendation of a mandatory provision to a broad dissolution/remedy. See *supra*, note 89 at 847.

might change as the nature of the business evolved. Because of the mandatory nature of the provisions, the corporation would be restricted in its ability to respond to these changes.[104]

Making the chapter presumptive rather than mandatory is the logical way of displacing the rigidity criticism while maintaining advantages over the passive, elective approach. For example, a presumptive chapter would operate more simply than its elective counterpart because the rules would apply without any election and without affirmative statements in the corporate constitution or a shareholders' agreement. This could provide a cost saving for corporations which would have elected anyway.

A further possible advantage of a presumptive chapter would be its application to close corporations where little or no planning took place. In a regime with an elective chapter, such corporations will probably be governed entirely by the general corporate statute as it is unlikely that serious consideration will be given to electing. Nevertheless, it is possible that participants in such corporations would have departed significantly from traditional corporate law rules if bargaining had occurred. For example, it is frequently asserted that absent the costs involved with detailed legal planning, minority shareholders would bargain for improved protection from the potential impact of the principle of majority rule and the lack of a liquid market for minority interests.[105]

If, as compared with general corporate law principles, the set of presumptive rules in the close corportion chapter more closely matched the bargain which would be reached absent transaction costs in close corporations where planning did not take place, then a strong case can be made for the introduction of these rules. The reason for this is that in resolving intracorporate disputes, a great deal of weight should be placed on what the parties would have bargained for absent transaction costs.[106] Because no consideration will be given to contracting out in close corporations where planning has not occurred, whatever regulations are imposed by the relevant corporate legislation will govern disputes between the participants. Hence, if the presumptive rules in a close corporation chapter more closely match the bargain which would have been made absent transaction costs in close corporations where no planning has taken

[104]See Commentary by Committee on Corporate Laws, *supra*, note 3 at 272 and Empirical Research Project, *supra*, note 5 at 887-88. Ironically, the basic thrust of these criticisms is much the same as those made by the U.S. commentators who attacked the manner in which general corporation law applied to close corporations. These commentators accurately pointed out that "the corporation" does not exist. Consequently, they recommended that allowances be made so that certain corporations could depart from general corporation law principles. With mandatory close corporation legislation, however, the problem would come full circle.

[105]See, for example, O'Neal & Thompson, *supra*, note 7, paras. 2.17, 7.20; Weinberg, *supra*, note 27 at 196-97; Chittur, *supra*, note 26 at 130-31; and Olson, *supra*, note 28 at 633, 658.

[106]Easterbrook & Fischel, *supra*, note 5 at 291-96.

place, it would be appropriate to have intracorporate disputes governed by these rules rather than by traditional corporate law principles.

The case for a presumptive chapter, however, is not a strong one. Most of the proposals of this nature focus upon establishing rules along the lines of partnership law.[107] The underlying assumption here is that partnership rules more closely match the bargain which the participants would have reached than would general corporate law provisions. As has been suggested, however, the proposition that partnership law more closely parallels the bargain which would have been reached by close corporation participants absent transaction costs is highly dubious.

An alternative method which could be used to develop detailed presumptive rules would be to rely on the provisions which are adopted by close corporations which have the financial resources to engage in detailed planning.[108] Utilizing such a procedure would recognize that the business organizations involved were corporations rather than partnerships and, intuitively, would be more closely related to the objective of providing participants with terms they would have bargained for if bargaining had been costless. There is reason to doubt, however, whether such a procedure could develop suitable provisions on a wide scale. The drafting of some presumptive rules, such as whether a close corporation would have a board of directors, would be fairly straightforward once it was determined what close corporation participants would bargain for absent transaction costs. However, as has been suggested before, for most matters of importance in close corporations, such as buy-sell rights, transfer restrictions, preservation of employment and income flow, well-drafted provisions will tend to be complex. Because of this, the use and drafting of such provisions will generally differ in well-planned close corporations even if there are basic similarities in format. Consequently, developing one precise, well-balanced presumptive rule from all of these sources will be difficult. Further, it is unlikely that whatever rule is developed will precisely match the terms which the participants would have bargained for since close corporations are all different.

The implications of this would differ for particular close corporations, depending on the extent of planning. In terms of close corporations where participants engaged in careful planning, it might be thought that the presence of inappropriate presumptive rules would cause no difficulty. This is because the participants could bargain out of the presumptive rule at little if any cost. Indeed, this is a common assumption which is made about elective or presumptive terms created by the legislature in the context of commercial law generally.

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[107]See *supra*, note 103.

[108]See Easterbrook & Fischel, *supra*, note 5 at 299-300 and Buckley & Connelly, *supra*, note 2 at 766. This is basically the approach that the drafters of the *M.B.C.A. Supplement* took in preparing the transfer restriction and buy-out on death provisions. See supra, note 52.

Under what is referred to as the Expanded Choice postulate, state-supplied implied contractual terms are justified on the basis that they provide widely suitable preformulations for participants, thus eliminating the cost of negotiating every detail of the proposed arrangement. Part of this thesis is that atypical parties lose nothing as they are unrestrained from designing customized provisions.[109]

Such an assumption may well be erroneous. As Goetz and Scott have observed, there likely are costs involved with departing from state-supplied terms, thus discouraging the use of terms which would maximize the wealth of the participants. For example, the risks of misinterpretation by the courts will be greater with terms generated by the parties because the intent of such terms likely will not be as clear as state-supplied terms. Further, the possibility of misinterpretation by the courts will be increased in situations where it is necessary to integrate the terms generated by the parties with state-supplied terms.[110] On a broader level, the existence of state-supplied terms might well discourage innovation in the development of contractual terms, thus reducing the range of choice available to participants.[111] All of this suggests that in most close corporations where extensive planning takes place, the existence of detailed presumptive rules could impose significant costs without providing much in the way of benefits.

In relation to close corporations where planning does not take place to any significant extent, the case against presumptive rules cannot be dismissed so readily. As with close corporations where planning takes place, the precise terms of any detailed set of presumptive rules will probably only match the precise bargain which would have been reached in a small number of such corporations. However, as mentioned, if the presumptive rules, as compared with general corporate law doctrines, more closely match the bargain which would have been reached in such corporations if detailed planning had taken place, a strong argument can be made that the presumptive rules should apply, as they would establish more appropriate guidelines for resolving intracorporate disputes.

If Canadian corporate legislation was based upon strict principles of majority rule and non-intervention by the courts, a complex set of presumptive rules might better match the bargain that would have been reached in close corporations where little or no planning takes place.[112] Corporate law rules, applied consistently with these guidelines, could often expose minority shareholders to risks of exploitation by virtue of the lack of the market for shares. Given that

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[109]See Goetz & Scott, *supra*, note 96 at 262, 265-66.

[110]*Ibid.* at 283-86, 290-91, 301-03, 321.

[111]*Ibid.* at 291-98, 303-05, 321.

[112]On the status of majority rule in Canadian corporate law, see, for example, P. Anisman, "Majority-Minority Relations in Canadian Corporation Law: An Overview" (1986-87) 12 Can. Bus. L.J. 473.

rational persons would not consent to an exploitation of their investment, presumptive rules incorporating some form of protection for the minority might indeed match more closely the bargain which would have been reached absent transaction costs.[113]

However, Canadian corporate law is not based on strict majoritarian and non-interventionist principles, and a strong case can be made that the law, as set out in the *C.B.C.A.* statutes, provides a more appropriate set of guidelines for resolving disputes in close corporations than would detailed presumptive rules. To start, most people in business probably understand that a majority shareholder has some general power to control the business and thus exercise of this power will rarely cause great surprise, even if the minority would have preferred a different course.[114] Consequently, the principle of majority rule which permeates Canadian corporate law is likely an appropriate one. This does not mean, however, that the *C.B.C.A.* statutes permit exploitation of the minority's investment since they contain a number of statutory remedies for minority shareholders.

The most important of these is the oppression remedy. The existence of this remedy can be justified in terms of imposing a term the participants would have agreed on absent transaction costs since participants in corporations would not agree upon investing to be subjected to unfair prejudice or oppression.[115] Further, because of the open-ended and flexible nature of the oppression remedy, a court can be cognizant of the contractual nature of the corporation and can consider the case within a framework of what the parties would have agreed to if they had bargained in relation to the matter in dispute.[116] Detailed presumptive rules, on the other hand, would not lend themselves as easily to adaptation by the courts. Instead, a court would be strongly inclined to apply the presumptive rule, even if its terms did not accord with that to which the participants would have agreed absent transaction costs.

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[113]See Prentice, *supra*, note 8 at 60-61 and Bradley, *supra*, note 89 at 840.

[114]Karjala, *supra*, note 20 at 1250-51.

[115]It might be thought more appropriate to characterize the oppression remedy, like tort law doctrines, in liability rule terms. However, it is increasingly being recognized that corporate law doctrines which impose constraints on managers are more satisfactorily analyzed as state generated terms which lower the cost of contracting. This analysis also seems to be the most helpful in relation to the oppression remedy. See generally Buckley & Connelly, *supra*, note 2 at 754; Fischel & Bradley, *supra*, note 91 at 264-66; and C.J. Goetz, "A Verdict on Corporate Liability Rules and the Derivative Suit: Not Proven" (1986) 71 Cornell L. Rev. 344 at 344-45. These issues are considered in greater detail in B.R. Cheffins, "Economic Analysis of the Oppression Remedy: Towards a More Coherent Picture of Corporate Law", U.T.L.J. (forthcoming).

[116]This approach has been advocated in relation to the oppression remedy by Prentice, *supra*, note 8 at 81, 91. The reasonable expectations analysis which is being applied with increasing frequency in interpreting U.S. dissolution/oppression provisions could also be quite easily adapted to a bargaining analysis. See Hillman, *supra*, note 56 at 83-88; O'Neal & Thompson, *supra*, note 7, para. 7.20; and Hetherington, *supra*, note 81 at 21-29.

It is possible to argue that the existence of an open-ended oppression remedy could be counterproductive in terms of bargaining because the participants' knowledge of the courts' open-ended jurisdiction to deal with corporate problems will dull the incentive to negotiate.[117] There should not be a great deal of concern about this possibility since applying to a court is not a costless option. The parties will have to pay legal expenses and the losing party will have to pay a portion of the winner's costs.[118] Further, costs arise for the participants because of the uncertainty and delay involved with a court application.[119] Avoidance of these costs will provide a strong incentive for the parties to bargain and establish terms in the corporate constitution or a shareholders' agreement which will resolve potential disputes in a less costly manner.[120]

IV. Conclusion

Important differences exist between close corporations and other corporations, one being the nature of the relationship between the participants. General corporate legislation in the United States traditionally did not give sufficient expression to this fact. Consequently, participants in close corporations found it costly to depart from traditional corporate law structures when this was desired

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[117]See Easterbrook & Fischel, *supra*, note 5, at 286-89, 291 and J.W. Welch, "Shareholder Individual and Derivative Actions: Underlying Rationales and the Closely Held Corporation" (1984) 9 J. Corp. L. 147 at 177-78. Even abandoning planning in favor of litigation would not be a problem if the parties internalize the costs of litigation. They could then decide which was the most cost effective way for them to proceed. However, if the costs of litigation are not fully internalized, then a decision to rely on the judicial process will be partly borne by the public. See Goetz & Scott, *supra*, note 96 at 310.

[118]This arises by virtue of the jurisdiction of Canadian courts to award costs. See, for example, British Columbia, *Rules of Court*, r. 57, appendixes B and C. The courts generally do not have this jurisdiction in the U.S. However, Weinberg, who supports the introduction of a broadly based oppression remedy in his home state of Ohio, recommends that judges should be given the discretion to award attorney's fees on oppression applications. He says this jurisdiction could be used to encourage voluntary observance of high standards of conduct and to discourage nuisance litigation. See *supra*, note 27 at 205-06.

[119]Haynsworth, *supra*, note 70 at 294, 299-300 and H.J. Haynsworth, "The Effectiveness of Involuntary Dissolution Suits as a Remedy for Close Corporation Dissension" (1987) 35 Clev. St. L. Rev. 25 at 91-92.

[120]The courts should facilitate this process by giving significant weight to terms which have explicitly been negotiated by the parties. See Hillman, *supra*, note 56 at 84. English courts have indeed been prepared to give substantial weight to the corporate constitution in oppression applications and commentators have recognized that this provides an incentive for the parties to bargain. See *Re Postgate & Denby (Agencies) Ltd.* (1986), [1987] 1 W.W.R. 102, [1987] B.C.L.C. 8 (Ch. D.); *Re A Company (No. 004377 of 1986)* (1986), [1987] B.C.L.C. 94 (Ch. D.); *Re A Company* [1986] B.C.L.C. 362 (Ch. D.); Prentice, *supra*, note 8 at 76; and B. Hannigan, "Section 459 of the Companies Act 1985 — A Code of Conduct for the Quasi-partnership" [1988] Lloyds. Mar. and Comm. L.Q. 60 at 81. Canadian courts have been inconsistent in terms of placing weight on what the parties have agreed upon. Contrast, for example, *Re Bury* (1984), 48 O.R. (2d) 57, 12 D.L.R. (4th) 451 (H.C.) with *Bernard* v. *Montgomery* (1987), 60 Sask. R. 20, 36 B.L.R. 257 (Q.B.).

and minority shareholders in particular were vulnerable because of the illiquidity of their investment.

A number of states in the U.S. have responded to these problems through the introduction of elective close corporation chapters. The case for following this approach in Canada is weak. This is indicated by the lack of use of these chapters in the U.S which suggests that the provisions do not achieve cost savings for the parties because they do not reflect the bargain which would have been reached absent transaction costs. Further, it is unlikely that elective close corporation chapters will be made more attractive by the inclusion of provisions relating to a wider variety of issues which are relevant to close corporations. Most of the issues which would be dealt with are too complex to allow the development of a single rule which will be suitable for most close corporations. The difficulty with formulating detailed terms which will accurately match the bargains which will be reached in close corporations is also an important argument against taking the more ambitious approach of introducing presumptive rules for close corporations. Participants in most close corporations would have to absorb the costs involved with contracting out of the presumptive rules or would have disputes governed by rules which did not accord with the bargain the parties would have reached absent transaction costs.

The foregoing suggests that corporate law should take a less ambitious role with respect to close corporations. This does not mean that allowances cannot be made for the differences between close corporations. In certain instances, it may be appropriate to allow close corporations to waive the use of certain monitoring devices. In addition, corporate law should encourage participants in close corporations to reach the bargain respecting governance of the corporation which most closely meets their intentions. Finally, corporate law can impose safeguards to prevent minority shareholders from having their investment expropriated. The *C.B.C.A.* statutes achieve these objectives to a significant extent. Some differences are recognized to reflect the fact that monitoring is less difficult, as distinctions are made on the basis of the type of corporation involved in relation to some corporate formalities. Also, departures from traditional corporate law rules are expressly authorized through use of unanimous shareholders' agreements. Finally, the oppression remedy is a response to the problem of exploitation of the minority.

The treatment of close corporations under Canadian corporate law could be improved. For example, some savings in transaction costs could probably be gained if the *C.B.C.A.* statutes stated more clearly that shareholders' agreements can be used to reallocate managerial control in corporations and explicitly signalled more areas where advance planning can take place. The *A.B.C.A.* illustrates that both of these types of reform can take place in a *C.B.C.A.* type statute. Thus, consideration should be given to amending the *C.B.C.A.* statutes along the lines of the *A.B.C.A.* Nevertheless, unless new evidence emerges which indi-

cates clearly that U.S. close corporation legislation meets the expectations and needs of participants in close corporations, the present approach of having the internal affairs of corporations regulated under a single statute should be retained.