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ILLINOIS CLOSE CORPORATIONS:
ANALYSIS OF THE NEW ACT

Leslie J. Miller*

In September, 1977, Illinois joined the ranks of those states which have accorded separate statutory treatment to close corporations. In this Article, the author reviews the principal problem areas of close corporations and analyzes the Illinois Act's effectiveness in solving these problems. Because the Act may generate some new difficulties, the author points out how the statute could be improved by amendment.

Traditionally, courts and corporate statutes in the United States have not distinguished sharply between publicly held and close corporations. Consequently, legal principles developed for the former have been applied to the latter without adequate adjustment for the differences between the two forms of corporate enterprise. Often, the result of this tendency has been the denial to shareholders of close corporations of their right to enter into business arrangements which adequately protect their interests.

On September 15, 1977, Governor Thompson signed into law the Illinois Close Corporation Act.1 The Act, which became effective October 1, 1977, is designed to respond to the special problems of close corporations by allowing substantial flexibility in their management. If all of its provisions are utilized, the shareholders of such corporations would be able to arrange their business affairs as if they were partners while retaining the limited liability of corporate shareholders. The Act thus provides a useful tool to attorneys who represent close corporations or their shareholders. However, it also contains a number of ambiguities and potential traps for the unwary practitioner.

The purpose of this Article is to identify and analyze problems which may be faced by attorneys who organize close corporations under the Act. A secondary purpose is to suggest changes which might enhance the usefulness of the Act in dealing with the needs of close corporations. The Article will begin by reviewing the treatment

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1. The Close Corporation Act, Pub. Act No. 80-672, 1977 Ill. Legis. Serv. 1185 (West) (to be codified in ILL. REV. STAT. ch. 32, § 201) [hereinafter referred to in the text as the Close Corporation Act or the Act].
of close corporations in state law, and in particular, Illinois law in order to identify the problems which the Act presumably was intended to correct.\(^2\) It then will analyze the provisions of the Act in detail, comparing them where relevant, with other close corporation statutes.\(^3\)

I. TREATMENT OF CLOSE CORPORATIONS UNDER PRIOR LAW

A. Principles Justifying Distinct Treatment of Close Corporations

Many of the legal problems of close corporations stem from the fact that close corporations traditionally have been "governed by the same laws which were designed to provide for the wholly dissimilar needs of the public issue corporation."\(^4\) Because such laws were designed for publicly held corporations they prescribe a form of doing business unsuitable or even "seriously disadvantageous in a closely held enterprise."\(^5\) These laws often prevent the shareholders of a close corporation from reaching agreements which will protect their interests adequately, and may lead to such an agreement being held invalid should litigation occur.\(^6\) In order to understand how this situation

2. See notes 4-115 and accompanying text infra.
3. See notes 116-196 and accompanying text infra.
5. Not all corporations, of course, fit neatly into the "publicly held" or "close corporation" categories. For example, in a number of corporations, a large portion of the shares will be publicly held, but a majority or controlling block of shares will be held by a small number of individuals, often members of a single family, or by another corporation. Such a situation often results from a decision of a close corporation or its shareholders to "go public", that is, to issue new shares or sell a portion of the outstanding shares to the public, see, e.g., Marshel v. AFW Fabric Corp., 533 F.2d 1277, 1278-79 (2d Cir. 1976), vacated and remanded 429 U.S. 881 (1976); from market purchases of shares of a publicly held corporation as part of a takeover plan, see, e.g., Santa Fe Industries, Inc. v. Green, 429 U.S. 814 (1977); or from purchases of shares pursuant to a tender offer, see, e.g., Piper v. Chris-Craft Industries, Inc., 430 U.S. 1 (1977) (involving both tender offers and market purchases). In general, courts have treated such corporations more like publicly held than like close corporations. However, in the context of "going private" transactions, in which the controlling shareholders attempt to squeeze out the minority and gain (or regain) complete control of the corporation, a number of courts have imposed a fiduciary duty on the controlling shareholders. See note 95 and accompanying text infra. The duty is similar in some respects to the fiduciary duties which some recent cases have imposed on controlling shareholders of close corporations. See notes 78-95 and accompanying text infra.
6. O'Neal, Foreword to N.Y.U. Note, supra note 4, at 700.
7. See generally Latty, supra note 4, at 432-37; N.Y.U. Note, supra note 4, at 701, 718-20.
developed, it is necessary to review some of the attributes of the publicly held corporation and the ways in which they have shaped corporate law.

By definition, a publicly held corporation has a relatively large number of shareholders. The stock of such corporations generally is freely traded, either on an exchange or over-the-counter. Furthermore, many shareholders are investors whose primary interest in the corporation is the possibility of receiving dividends or profits from appreciation in the value of their shares. Therefore, most shareholders are not engaged actively in the management of the enterprise, and in many cases the corporation is managed "by persons who own little or no stock in the company." 

Because of the division between ownership and management of publicly held corporations, "legal regulation of public issue corporations has been focused on protecting investors against the excesses of management and affording investors an opportunity to have a real voice in corporate affairs." These goals are pursued by a number of means. A fundamental protection is periodic shareholder election of the directors who are responsible for the management of the affairs of the corporation. Both the shareholders and the directors normally reach decisions by majority vote, although larger votes

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8. Id.
9. Id. at 186.
10. Id.
11. Id. See also N.Y.U. Note, supra note 4, at 711.
12. N.Y.U. Note, supra note 4, at 711.
13. This Article does not purport to present a complete list of the means by which such goals are pursued. For example, one of the most important means by which the interests of investors in publicly held corporations are protected, is through federal and state securities regulation. These regulations are not directly relevant to the problems considered here and are therefore not discussed.
15. Most state corporation statutes contain a requirement that "[t]he business and affairs of a corporation shall be managed by a board of directors." Illinois Business Corporation Act, ILL. REV. STAT. ch. 32, § 157.33 (1975). Some recent corporation statutes, for example, CAL. CORP. CODE § 300 (West 1977), and recent amendments to older statutes, such as the Delaware General Corporation Law, DEL. CODE ANN. tit. 8, § 141(a) (1974), provide that the corporation's business shall be managed "by" or "under the direction of" the directors. For a discussion of cases applying this rule to close corporations, see note 32 infra..
may be required\textsuperscript{17} or permitted\textsuperscript{18} in certain circumstances. In general, courts have looked with disfavor upon unanimous voting requirements, both because such requirements deviate from the majority rule principle\textsuperscript{19} and because, as a practical matter, unanimity would be impossible to achieve and would make deadlock inevitable.\textsuperscript{20}

A second protection is the requirement of strict adherence to corporate formalities regarding such matters as the holding of meetings,\textsuperscript{21} quorums,\textsuperscript{22} taking decisions by formal resolutions,\textsuperscript{23} and re-

\textsuperscript{17} See, e.g., Illinois Business Corporation Act, ILL. REV. STAT. ch. 32 §§ 157.64, 157.76(c) (1975) (approval of holders of at least two-thirds of the outstanding shares necessary for consolidation, merger or dissolution of the corporation).


In most states, it is not clear whether statutory provisions authorizing articles or by-laws which require a larger than majority vote for shareholder or director action would authorize requiring an unanimous vote. A former New York statute which provided that action by the shareholders and directors would be by majority vote unless the articles provide otherwise was held to preclude, as a matter of public policy, unanimous vote requirements in either the by-laws, see Benintendi v. Kenton Hotel, 294 N.Y. 112, 60 N.E.2d 829 (1945), or the articles. Eisenstadt Bros. Inc. v. Eisenstadt, 89 N.Y.S.2d 12 (Sup. Ct. 1949). The present New York provision, N.Y. BUS. CORP. LAW § 616 (McKinney 1963 & Supp. 1977), was intended to overrule such decisions, see 1 F. O'NEAL, CLOSE CORPORATIONS: LAW AND PRACTICE § 3.76 (2d Ed. 1971) [hereinafter cited as O'NEAL], and the validity of unanimous vote requirements in the articles of incorporation of New York corporation seems well established. See Fromkin v. Merrill Realty, Inc., 30 Misc.2d 288, 295-96, 215 N.Y.S.2d 525, 532-34 (Sup. Ct. 1961). The Delaware Chancery Court has expressed doubt whether a provision similar to that in the present Delaware statute would authorize a unanimous shareholder vote requirement, Sellers v. Joseph Bancroft & Sons Co., 23 Del. Ch. 13, 26, 2 A.2d 108, 114 (1938). Two Illinois cases, Moss v. Waytz, 4 Ill. App.2d 296, 124 N.E.2d 91 (1955) and Fitzgerald v. Christy, 242 Ill. App. 343 (1926), have upheld unanimous vote requirements in shareholders' agreements. In Moss, the provision for a unanimous vote of the directors in a preincorporation agreement was upheld even though the by-laws provided for a majority vote. It thus appears likely that unanimous vote requirements in the articles of incorporation or by-laws of an Illinois corporation would be upheld.

\textsuperscript{19} See note 18 supra. The courts often have stated that the principle of majority rule is fundamental to the law of corporations. See, e.g., Gidwitz v. Lanzit Corrugated Box Co., 20 Ill.2d 208, 215, 170 N.E.2d 131, 135 (1960); Wheeler v. Fullman Iron & Steel Co., 143 Ill. 197, 207-08, 32 N.E. 420, 423 (1892); Benintendi v. Kenton Hotel, 294 N.Y. 112, 118-19, 60 N.E.2d 829, 831 (1945); Kaplan v. Block, 183 Va. 327, 335, 31 S.E.2d 893, 896 (1944) ("Corporations were invented to circumvent the unity required in partnerships."). Some courts have even been hostile, in the absence of specific statutory sanction, to requirements for less than unanimous, higher than majority votes. See, e.g., Berkowitz v. Firestone, 192 So.2d 298 (Fla. App. 1966).


\textsuperscript{21} See, e.g., Illinois Business Corporation Act, ILL. REV. STAT. ch. 32, §§ 157.26, 157.40 (1975); Delaware General Corporation Law, DEL. CODE ANN. tit. 8, §§ 141(b), 211 (1974 &
ports to shareholders.\textsuperscript{24} Such formalities serve two basic purposes. First, they provide a record of corporate action by which the shareholders can determine whether the directors and officers have been fulfilling their management functions adequately.\textsuperscript{25} Second, the requirement that decisions by directors be taken at formal meetings helps insure that there are "a consultation and interchange of views in order that the combined wisdom and business acumen of the directors may be utilized for the benefit of those whom they represent."\textsuperscript{26}

A third protection strictly limits the power of shareholders to run the corporation by favoring director management. Given the large number of shareholders in a publicly held corporation, direct management by the shareholders would be impractical. Furthermore, the typical shareholder is neither an expert in the business of the corpo-


\textsuperscript{25} This is one of the main reasons for allowing shareholders the right to inspect the corporation's books and records. \textit{Fletcher, supra} note 23 at § 2213.

\textsuperscript{26} N.Y.U. Note, \textit{supra} note 4, at 711. Courts have often stated the principle that: 
[s]tockholders are entitled to the exercise of the free and honest judgment of their directors upon conditions as they arise and bear upon the interests of the company. To bargain away in advance for their own profit the judgment the law contemplates they shall exercise at subsequent official meetings for the company's interests on conditions as they arise for consideration, is incompatible with a faithful and just performance of their official duties, and with the fiduciary relationship of their position.

\textit{Teich v. Kaufman, 174 Ill. App. 306, 312 (1912).}

This principle often has been cited in cases holding agreements among directors invalid, \textit{id.} at 315; \textit{Odman v. Oleson, 319 Mass. 24, 25, 64 N.E.2d 439, 440 (1946); Burnett v. Word, Inc., 412 S.W.2d 792, 795 (1967), and in cases which hold invalid shareholder agreements infringing upon the management discretion of the directors. See, e.g., \textit{McQuade v. Stoneham, 263 N.Y. 323, 328, 189 N.E. 234, 236 (1934); Manson v. Curtis, 223 N.Y. 313, 322, 119 N.E. 559, 562 (1919). See note 32 infra.
ration nor sufficiently involved in the day to day operations of the business to be an effective manager.27 Therefore, the typical corporation statute limits the role of the shareholders to electing directors28 and voting on such fundamental changes as amendments to the articles of incorporation,29 consolidations and mergers,30 and dissolution of the corporation.31 Moreover, traditionally courts have held that statutes requiring management by the directors preclude agreements among shareholders restricting the discretion of directors.32

Few commentators would argue that the legal principles discussed above are inappropriate for the publicly held corporation. However, these principles are wholly inappropriate for the close corporation for

27. Covington, supra note 7, at 186.
30. See, e.g., Illinois Business Corporation Act, ILL. REV. STAT. ch. 32, § 157.64 (1975); Delaware General Corporation Law, DEL. CODE ANN. tit. 8, § 251(c) (1974).
32. See, e.g., Abercrombie v. Davies, 35 Del. Ch. 559, 608-11, 123 A.2d 893, 898-900 (1956), rev'd on other grounds, 36 Del. Ch. 371, 130 A.2d 338 (Sup. Ct. 1957); Long Park, Inc. v. Trenton-New Brunswick Theaters, Co., 297 N.Y. 174, 178-79, 77 N.E.2d 633, 634-35 (1948); McQuade v. Stoneham, 263 N.Y. 323, 329-30, 189 N.E. 234, 236-37 (1934). Similar results have been reached in other cases by holding an agreement void because it binds the shareholders in their capacity as directors (see cases cited in note 26 supra); by holding that the corporate shareholders may not enter into an agreement to be "partners inter sese and a corporation as to the rest of the world," Jackson v. Hooper, 76 N.J. Eq. 592, 598-99, 75 A. 568, 571 (Ct. Er. & App. 1910); by holding that an agreement which takes away from a stockholder freedom to exercise his judgment on behalf of the corporation is void, Odman v. Oleson, 319 Mass. 24, 25-26, 64 N.E.2d 439, 440 (1946); Hurlier v. Achorn, 255 Mass. 273, 280, 151 N.E. 305, 307 (1926); and by holding that the agreement was binding upon the parties in their capacity as shareholders, but not in their capacity as directors or officers, Bator v. United Sausage Co., 138 Conn. 18, 22, 81 A.2d 442, 444 (1951), or upon the corporation. Id. at 443-44. See also Hladovec v. Paul, 222 Ill. 254, 262-63, 78 N.E. 619, 622 (1906).

Even in the older cases, some courts have been willing to tolerate "slight" restrictions on the power of the directors, Clark v. Dodge, 269 N.Y. 410, 417, 199 N.E. 641, 643 (1936); Kaplan v. Block, 183 Va. 327, 336-37, 31 S.E.2d 893, 897 (1944) (dictum), so long as such agreements do not in effect legislate the directors out of office, id., or create a "sterilized" board of directors. Long Park v. Trenton-New Brunswick Theaters, Co., 297 N.Y. 174, 178-79, 77 N.E.2d 633, 634-35 (1948). See also E.K. Buck Retail Stores v. Harkett, 157 Neb. 867, 878-82, 62 N.W.2d 288, 297-99 (1954). The line between permissible and impermissible agreements under such cases is, however, difficult to determine. See Latty, supra note 4, at 436-37; N.Y.U. Note, supra note 4, at 707, 719-20, and shareholders can seldom be certain that a particular agreement will be upheld.

For a discussion of newer cases which adopt a more permissive attitude toward shareholders' agreements, see notes 60-64 and accompanying text infra.
a number of reasons. First, the division between ownership of the shares and management does not exist in a close corporation. The close corporation has relatively few shareholders—often only two or three\textsuperscript{33}—who frequently are also the directors and officers of the corporation.\textsuperscript{34} Often the shareholders are employees of the corporation and rely on such employment for a major portion of their income.\textsuperscript{35} Thus the reasons for limiting the management role of the shareholders of a publicly held corporation do not exist in the close corporation.\textsuperscript{36}

Second, unlike the shareholder of a public corporation, the shareholder in a close corporation is normally in a position to negotiate arrangements for management with the other shareholders. Such arrangements commonly include agreements that each shareholder will be permanently retained as a director or officer of the corporation, provisions giving minority shareholders a veto over certain corporate actions, restrictions on the transfer of shares of the corporation, and provisions governing division of profits and declaration of dividends.\textsuperscript{37} Such arrangements are particularly essential to protect the interests of minority shareholders,\textsuperscript{38} who would be completely at the mercy of the majority if subjected to unrestricted majority rule.\textsuperscript{39} Yet such arrangements often have been struck down by courts\textsuperscript{40} in the name of legal principles which were designed to protect the interests of minority shareholders in publicly held corporations.

Third, the shareholders and directors of close corporations often tend to ignore the corporate formalities prescribed for publicly held corporations.\textsuperscript{41} In general, the shareholders of close corporations

\textsuperscript{34} Galler v. Galler, 32 Ill.2d 16, 28-29, 203 N.E.2d 577, 584 (1965); Donahue v. Rodd Electrotype Co. of New England, Inc., 328 N.E.2d 505, 511 (Mass. 1975); N.Y.U. Note, \textit{supra} note 4, at 711.
\textsuperscript{35} Covington, \textit{supra} note 7, at 188; Ginsberg, \textit{supra} note 4, at 13.
\textsuperscript{36} Latty, \textit{supra} note 4, at 432-33; N.Y.U. Note, \textit{supra} note 4, at 712.
\textsuperscript{37} See generally, Covington, \textit{supra} note 7, at 188; O'Neal, \textit{Foreword} to N.Y.U. Note, \textit{supra} note 5, at 700-01.
\textsuperscript{38} Galler v. Galler, 32 Ill.2d 16, 27-28, 203 N.E.2d 577, 583-84 (1965); N.Y.U. Note, \textit{supra} note 4, at 718.
\textsuperscript{39} Latty, \textit{supra} note 4, at 435.
\textsuperscript{40} See note 4 \textit{supra}.
\textsuperscript{41} Ginsberg, \textit{supra} note 4, at 23; Latty, \textit{supra} note 4, at 453; Miller & Robinson, \textit{Requirements and Limitations Imposed by Corporate Law}, in \textit{CLOSELY HELD CORPORATIONS} 5-1, 5-45, 5-48 (Ill. Inst. for Continuing Legal Ed. 1977) [hereinafter cited as Miller & Robinson].
are, in their relation to each other, more like partners than like shareholders of a publicly held corporation. The shareholders are normally engaged in the business and in frequent contact with each other. Accordingly, there are seldom any outside directors to consult, and decisions typically are taken without formal meetings. Since the shareholders often have agreed that certain persons will be directors and officers, annual meetings of shareholders and directors may not be held. Given the partner-like relationship among the shareholders of the close corporation, such informality is appropriate. However, under existing law it can create problems because informality can contribute directly to a court's "piercing the corporate veil" and holding that the shareholders have lost the protection of limited liability.

B. Treatment of Close Corporations as Sui Generis

Increasingly, courts and legislatures have become aware of the need to develop legal norms suited to the distinct needs of the close corporation. This awareness is reflected in three significant legal trends: the increased willingness of courts to allow departures from traditional corporate norms in cases involving close corporations; the addition of provisions to the general corporation law of most states to deal with the problems of close corporations; and the adoption in several states of separate statutes for close corporations.

1. Case Law

The courts' liberalized attitudes toward close corporations can be seen in four areas. First, courts are becoming aware of the vulnerable position and corresponding need for special protection of shareholders in a closely held corporation. Second, courts are becoming more willing to uphold agreements among shareholders which infringe upon the management discretion of directors. Third, courts are beginning to impose greater fiduciary duties upon majority share-

42. See generally authorities cited in note 4 supra.
43. See notes 33-35 and accompanying text supra.
44. Even if there is an outside director, the shareholders will often make decisions informally without consulting him. Miller & Robinson, supra note 41, at 5-43.
45. Id. at 5-48.
46. See N.Y.U. Note, supra note 4, at 711.
47. See generally 1 O'Neal, supra note 18, at § 1.10.
48. See notes 51-106 and accompanying text infra.
49. See notes 107-118 and accompanying text infra.
50. See notes 119-123 and accompanying text infra.
51. See notes 55-59 and accompanying text infra.
52. See notes 60-67 and accompanying text infra.
holders in close corporations. Fourth, the courts are allowing departure from rigid corporate formalities in cases involving close corporations.

The extreme vulnerability of minority shareholders in close corporations has been noted in a number of recent cases. This vulnerability stems from the fact that a substantial portion of the minority's assets often are invested in the corporation. It also appears in the minority's frequent dependence upon employment by the corporation for their livelihood. Finally, they remain vulnerable because the shares of most close corporations lack marketability. Unless restrained by an agreement among the shareholders or by a judicial concept of fiduciary duty, the majority may deprive the minority of any substantial return on its investment by discharging them from corporate employment and withholding dividends. And, since there generally is no market for the shares, the minority shareholder who is dissatisfied with corporate management may be unable to liquidate his investment and reinvest in another business, unless he is willing to accept whatever price the majority offers for his shares.

53. See notes 72-84 and accompanying text infra.
54. See notes 89-92 and accompanying text infra.
59. See authorities cited in note 57 supra. One possible means for a majority shareholder to reclaim his investment is by judicial dissolution of the corporation. Under Illinois law, such a remedy is available, inter alia, when "the acts of the directors or those in control of the corporation are illegal, oppressive or fraudulent." ILL. REV. STAT. ch. 32, § 157.86(a)(3) (1975). Illinois courts, however, consider judicial dissolution to be "a drastic remedy" that "must not be lightly invoked." Central Standard Life Ins. Co. v. Davis, 10 Ill.2d 566, 567, 141 N.E.2d 45, 51 (1957). In Central Standard, the court held dissolution improper, even though the minority preferred shareholders had been paid no dividends since 1931 and dividend arrearages totaled over $1,000,000. Id. at 569, 141 N.E.2d at 47. In Polikoff v. Dole & Clark Bldg. Corp., 37 Ill. App.2d 29, 184 N.E.2d 792 (1962), dissolution was denied even though the corporation had incurred substantial losses over the past several years, the motion picture theater which was the corporation's major asset had been closed, the controlling shareholder was paid $6,000 per year as president of the corporation, and his wife held a mortgage on the corporation's real estate. Id. at 33-34, 184 N.E.2d at 794. It thus appears that, despite the granting of dissolution in some recent cases, see C. MURDOCK, THE ILLINOIS BUSINESS CORPORATION ACT ANNOTATED 488-89 (3d ed. 1975), judicial dissolution should be considered too "uncertain, expensive and painful" to be a satisfactory solution. Howe, Corporate Divorce: Deadlocks in the Close Corporation, 22 BUS. LAW 469, 476 (1967).
One of the ways in which minority shareholders can receive protection is by a shareholder agreement as to various aspects of corporate policy.\(^6\) In recent years, the courts have been increasingly willing to uphold such agreements. Perhaps the leading case is *Galler v. Galler*,\(^6\) in which the Illinois Supreme Court upheld a shareholders' agreement which specified the directors, provided for payment of minimum annual dividends, and directed the corporation to continue salary payments to the surviving spouse of either shareholder.\(^6\) The court noted that “shareholder agreements similar to that in question here are often, as a practical consideration, quite necessary for the protection of those financially interested in the close corporation.”\(^6\) Therefore, it concluded that where

no injury to a minority interest appears, no fraud or apparent injury to the public or creditors is present, and no clearly prohibitory statutory language is violated, we can see no valid reason for precluding the parties from reaching any agreements concerning the management of the corporation which are agreeable to all.\(^6\)

Cases such as *Galler* are a definite improvement over the older cases in which shareholders’ agreements restricting the directors’ management discretion routinely were held invalid. Even under *Galler*, however, the shareholders may not be completely free to reach advance agreement on how to run the corporation. In *Somers v. AAA Temporary Services, Inc.*,\(^6\) the Illinois appellate court held that while “[s]light deviations from corporate norms may be permitted” under *Galler*, “action by the shareholders which is in direct contravention of the statute cannot be allowed.”\(^6\) Therefore, the *Somers* court voided a by-law amendment passed by the shareholders rather than by the directors.\(^6\) In addition, there is still judicial op-

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60. See text accompanying note 37 supra.
61. 32 Ill.2d 16, 203 N.E.2d 577 (1965).
62. Id. at 20-22, 203 N.E.2d at 580-81.
63. Id. at 27, 203 N.E.2d at 583.
64. Id. at 30, 203 N.E.2d at 585. See also Glazer v. Glazer, 374 F.2d 390 (5th Cir.), cert. denied, 389 U.S. 831 (1967) (similar agreements upheld under the laws of Florida, Tennessee and Ohio); and Holden v. Construction Mach. Co., 202 N.W.2d 348 (1973) (Iowa Supreme Court held that an agreement between two sole shareholders that they would continue to be employed by the corporation and receive equal compensation “was effected for and on behalf of” the corporation and was therefore “binding upon the corporation.”).
65. 5 Ill. App.3d 931, 284 N.E.2d 462 (1st Dist. 1972).
66. Id. at 935, 284 N.E.2d at 465.
67. Id. It should be noted that the requirement that directors rather than shareholders amend by-laws does not appear on the face of the statute to be more mandatory than the requirement, that the corporation’s business be managed by the directors, which was arguably violated by the agreement in *Galler*. 
position to agreements restricting the management discretion of directors and agreements among directors.\textsuperscript{68} Such opposition may resurface in future Illinois cases. Thus the extent to which agreements among shareholders are permissible is still not entirely clear, and statutory clarification is desirable.

A third way in which courts have liberalized their treatment of close corporations has been by imposing greater fiduciary duties upon controlling shareholders\textsuperscript{69} and, in one case,\textsuperscript{70} directors of close corporations. Although often it has been held that a majority shareholder has a fiduciary duty to the corporation,\textsuperscript{71} absent special circumstances\textsuperscript{72} courts have been reluctant to hold that a majority shareholder has a fiduciary relationship \textit{vis-a-vis} minority shareholders.\textsuperscript{73} Thus it has been held that a majority shareholder does not owe a fiduciary duty to minority shareholders merely because of his stock ownership.\textsuperscript{74} Nor are shareholders restricted in their freedom to vote stock in accordance with their own interests.\textsuperscript{75} Where such a fiduciary duty has been held to exist, the duty imposed has been considerably less strict than that imposed on partners and parties to joint ventures.\textsuperscript{76} As a result,

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\textsuperscript{68} See note 26 supra.

\textsuperscript{69} In general, such duties will be imposed upon a shareholder or shareholders owning the majority of the corporation's voting shares. \textit{But see} \textit{Helms v. Duckworth,} 249 F.2d 482, 496-87 (D.C. Cir. 1957), in which the minority shareholder of a close corporation was held to have violated a fiduciary duty to the majority shareholder. \textit{See also} \textit{Donahue v. Rodd Electrotype Co. of New England, Inc.,} 328 N.E.2d 505, 515 n.17 (Mass. 1975).


\textsuperscript{71} \textit{See, e.g., Pepper v. Litton,} 308 U.S. 295, 306-07 (1939); \textit{Bayliss v. Rood,} 424 F.2d 142, 146 (4th Cir. 1970).

\textsuperscript{72} \textit{See Fletcher, supra} note 23, at § 5811 (rev. perm. ed. 1970).

\textsuperscript{73} \textit{See generally, Comment, The Expanding Scope of the Controlling Shareholder's Fiduciary Duty to the Minority Shareholders: Jones v. H.F. Ahmanson and Co.,} 1969 U. Ill. L.F. 534 [hereinafter cited as Ill. Comment].


\textsuperscript{76} \textit{Donahue v. Rodd Electrotype Co. of New England, Inc.,} 328 N.E.2d 505, 515-16 (Mass. 1975).
the traditional theories of fiduciary obligation as tests of majority shareholder responsibility to the minority . . . have failed to afford adequate protection to minority shareholders and particularly to those in closely held corporations whose disadvantageous and often precarious position renders them particularly vulnerable to the vagaries of the majority.  

A recent trend, however, is to impose on controlling shareholders, particularly in close corporations, a fiduciary duty toward other shareholders. Some courts have even held that such a duty is equivalent to that between partners. In some cases, this result is reached by holding that the parties are conducting "a joint venture in corporate form," and therefore have the same duties to each other as do partners.  

In other cases, the holding has been stated in a more general form applicable to all close corporations.  

*Jones v. H.F. Ahmanson & Company* is an example. The majority shareholders of a closely held savings and loan association organized a holding company to which they transferred their shares. They then arranged a public offering of the holding company shares, leaving the minority with shares of the operating company for which there was no market. Under the traditional rules, the minority would not have been able to obtain relief. This was particularly true because the transactions did not alter the minority's position with regard to marketability of the shares and control of the corporation. However, the *Jones* court held that the appropriate standard was whether the majority had acted with "inherent fairness from the viewpoint of the corporation and those interested therein." It found that the majority had violated this duty by disposing of its own stock on terms not made available to the minority.

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79. 1 Cal.3d 93, 460 P.2d 464, 81 Cal. Rptr. 592 (1969).
80. *Id.* at 102-03, 460 P.2d at 467, 81 Cal. Rptr. at 595.
81. *Id.* at 105, 460 P.2d at 469, 81 Cal. Rptr. at 597.
82. *Id.* at 112, 460 P.2d at 474, 81 Cal. Rptr. at 602.
83. See Ill. Comment, *supra* note 73, at 540.
84. 1 Cal.3d 93, 110, 460 P.2d 464, 472, 81 Cal. Rptr. 592, 600 (1969).
85. *Id.* at 115, 460 P.2d at 476, 81 Cal. Rptr. at 604. It should be noted that, although, the standard of conduct promulgated by the *Jones* court is applicable to "officers, directors and controlling shareholders" of all corporations, *id.* at 110, 460 P.2d at 472-73, 81 Cal. Rptr. at 600-01, its actual holding was limited to close corporations: We do not suggest that the duties of corporate fiduciaries include in all cases an obligation to make a market for and to facilitate public trading in the stock of the corporation. But when, as here, no market exists, the controlling shareholders may...
In Donahue v. Rodd Electrotype Co., the minority shareholders of a close corporation challenged the corporation’s purchase of the shares of the former controlling shareholder. The court began by noting that, for those reasons discussed previously, minority shareholders of close corporations are in particular need of protection from oppression by the majority. Because of this need for protection, the court held that “stockholders in the close corporation owe one another substantially the same fiduciary duty . . . that partners owe to one another.” This duty required the controlling shareholders to afford the minority the opportunity to sell their shares on the same terms as those extended to the majority.

Cases such as Jones and Donahue provide substantial protection for minority shareholders in close corporations. Cases in other jurisdictions, however, still deny that such duties exist or impose lesser duties on the minority. In Tanzer v. International General Industries, Inc., for example, the Delaware Supreme Court held that although a merger caused by a majority shareholder solely for the purpose of squeezing out the minority for cash would violate the majority’s fiduciary duty, such a merger would not violate the duty if, in addition to squeezing out the minority, it served a bona fide business purpose of the majority. Thus it is uncertain in light of such cases not to use their power to control the corporation for the purpose of promoting a marketing scheme that benefits themselves alone to the detriment of the minority.

Id. at 115, 460 F.2d at 476, 81 Cal. Rptr. at 604. It thus appears that the recognition that shareholders of close corporations require a greater degree of legal protection than those of publicly held corporations was an important element in the court’s decision. See text accompanying note 77 supra.

86. 328 N.E.2d 505 (Mass. 1975).
87. Id. at 508-09.
88. See notes 55-59 and accompanying text supra.
89. 328 N.E.2d at 512-15.
90. Id. at 515-16.
91. Id. at 520-21.
92. See cases cited in note 73 supra.
93. 379 A.2d 1121 (Del. 1977).
94. Id. at 1123.
95. Id. at 1124. The court previously had decided in Singer v. The Magnavox Co., 380 A.2d 969 (1977), that a merger solely for squeeze-out purposes would violate the majority’s fiduciary duty. It left open the question of whether the business purpose served by the merger must be that of the corporation or whether it could be a business purpose of the majority.

At present, it is not entirely clear what overall effect the “going private” cases, such as Tanzer and Singer, will have on the fiduciary duties of controlling shareholders. A number of such cases have held that a merger solely for the purpose of squeezing out the minority would violate state law. See, e.g., Bryan v. Brock & Blevins Co., Inc., 490 F.2d 563, 570-71 (5th Cir.), cert. denied, 419 U.S. 844 (1974) (Georgia law); People v. Concord Fabrics, Inc., 83 Misc.2d 120, 371 N.Y.S.2d 550 (Sup. Ct.), aff’d per curiam, 50 A.2d 787, 377 N.Y.S.2d 84 (1975). In both Tanzer Econ. Assoc., Inc. Profit Sharing Plan v. Universal Food Specialties, Inc., 87 Misc.2d 167, 180-82 363 N.Y.S.2d 472, 492-93 (Sup. Ct. 1976) and Schulwolf v. Cerro Corp.,
whether Jones and Donahue can be relied on in jurisdictions such as Illinois where the courts have not yet subjected shareholders in close corporations to such strict fiduciary obligations.

Finally, various courts have upheld actions taken by persons owning all or substantially all of the stock of the corporation despite non-compliance with corporate formalities. Such cases tend to recognize, as discussed above, that formalities are unnecessary when stockholders are also the directors and officers of the corporation. Note, however, that such cases often involve the validity of corporate obligations to third parties, and a different result might be reached if the corporation were seeking to enforce an obligation owed to it or if the controversy involved a dispute among shareholders.

In conclusion, the cases discussed in this section go a long way toward liberalizing the law governing close corporations. So far, however, their number is small and their scope is not always clearly defined. In addition, most jurisdictions, including Illinois, do not yet have cases which liberalize the law in all of the areas discussed above, and there is still substantial contrary authority from other jurisdictions.

86 Misc.2d 292, 297-98, 380 N.Y.S.2d 957, 962-63 (Sup. Ct. 1976), the court held that the increased business efficiencies which would result from merging two companies in similar lines of business would provide a sufficient business purpose to justify such a merger. In both cases, the merger was found to benefit the corporation as well as the controlling shareholder, and in Tanzer, the court strongly implied that a merger "solely for the benefit of controlling shareholders" would be disallowed. Id. at 176, 383 N.Y.S.2d at 479.

In Marshel v. AFW Fabric Corp., 533 F.2d 1277, 1280-82 (2d Cir.), vacated, 429 U.S. 881 (1976), and Green v. Santa Fe Indus., Inc., 533 F.2d 1283, 1289-91 (2d Cir. 1976), rev'd, 429 U.S. 814 (1977), the Second Circuit Court of Appeals held that a squeeze-out merger that lacks corporate purpose would also violate § 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) (1970), and Rule 10b-5, 17 C.F.R. § 240.10b-5 (1977). Despite the Supreme Court's reversal of Green on this point, these cases provide indirect support for state law requirements that squeeze-out mergers promote a business interest of the corporation as well as the controlling shareholders. It thus appears that the Delaware Supreme Court's position on this issue is the minority view at this time.

Except for Bryan v. Brock & Blevins Co., Inc., the "going private" cases have not involved close corporations in the strict sense. See note 4 supra. Thus such cases, although relevant, may not be controlling in cases involving fiduciary duties of controlling shareholders of close corporations.


97. See text accompanying notes 41-46 supra.

98. But see Grover v. Garn, 23 Utah 2d 441, 445-46, 464 P.2d 598, 601 (1970), in which the court, although recognizing that "the trend of authority is to uphold as binding on the corporation acts or contracts on its behalf by a person or persons owning all or practically all the stock" quoting 19 C.J.S. Corporations § 1004 at 471 (1940), stated that it did "not approve the method employed here and certainly denounce it as a pattern to be followed by corporations generally."

which has not been overruled. Therefore, such cases do not remove
the need for statutory treatment of the problems of close corpora-
tions.

2. General Corporation Laws

A second way in which corporate law has been adapted to the
needs of the close corporation is by the inclusion of provisions in
general corporation statutes which also are of great utility to close
corporations. Among the most common provisions are those which
permit: higher than majority voting and quorum requirements for
both shareholders and directors; provisions for informal director
and shareholder action by written consent or by conference tele-
phone call; broad power to delegate to committees; broad
power to restrict the transfer of shares; provisions for one incorporator;
permission for one or two, instead of the traditional three, directors;
and broader provisions for dissolution, such as by unanimous consent of the share-
holders. Such provisions afford considerable flexibility in arranging the af-
fairs of a close corporation. In the opinion of some commentators,
they even render specific close corporation statutes unnecessary. Such provisions generally do not, and as a matter of public policy probably should not, include provisions authorizing management

101. See, e.g., ILL. REV. STAT. ch. 32, §§ 157.147, 157.147.1 (1975); DEL. CODE ANN. tit. 8, §§ 141(0, 228(a) (1974).
103. ILL. REV. STAT. ch. 32, § 157.38 (1975); DEL. CODE ANN. tit. 8, § 141(c) (1974).
108. ILL. REV. STAT. ch. 32, § 157.75 (1975); DEL. CODE ANN. tit. 8, § 275(c)(1974).
110. See, e.g., Preface, MODEL BUSINESS CORPORATION ACT at iii (1969 rev.).
111. One commentator stated:

[1]Inclusion of provisions drafted primarily for the benefit of close corporations in a single statutory scheme covering all corporations may prove dangerous. Without statutory recognition of the close corporation, public issue corporations could avail themselves of provisions which for reasons of public policy should not be applicable to such enterprises.

N.Y.U. Note, supra note 4, at 708.
by the shareholders rather than by a board of directors. Thus if such
provisions are desirable, separate statutory provisions applicable
solely to close corporations still appear necessary.

3. Close Corporation Statutes

The third way in which corporate law has been adapted to the
needs of close corporations is by means of statutory provisions appli-
cable only to close corporations. Such provisions are of two types.
The first type is the separate close corporation statute,\(^1\) such as the
Illinois Act.\(^2\) The second provision is contained in the general corpo-
ration law and either authorizes agreements among shareholders or
permits articles of incorporation to restrict the management discretion
of the board. This latter form will be permitted if the shares of the
corporation are not listed on a securities exchange or regularly traded
or quoted in an over-the-counter market.\(^3\) Such a provision also
generally shifts liability for managerial acts from the directors to the

\(^1\) The oldest close corporation statutes, which date from the nineteenth century, are the
1783.01-.12; Pa. Stat. Ann. Tit. 15 §§ 12701-93 (Purdon 1966). The Pennsylvania statute was
repealed in 1966 "except as to associations of professional persons not authorized by law to
practice their profession as a corporation." Id. § 2203(g)(1)-(5). Such statutes require adherence
to the traditional corporate formalities, including a minimum of three partners and three direc-
tors. They thus have no practical advantage over the general corporation laws of such states and
are not widely used. Latty, supra note 4, at 456, n.90.

§§ 608.70-.77 (West 1973). However, this statute generally was considered to be so poorly
drafted as to create "unnecessary uncertainties as to what corporations are governed by its
provisions and what powers such corporations may possess." Dickson, The Florida Close Corp-
oration Act: An Experiment That Failed, 21 U. Miami L. Rev. 842 (1967). The statute was

In addition to Illinois, close corporation statutes are currently in effect in Arizona, Ariz. Rev.
Stat. §§ 10-201 to -218 (1977); Delaware, Del. Code Ann. tit. 8, §§ 341-56 (1974); Kansas,
1977); and Texas, Tex. Corp. & Ass'n Code Ann. Art. 2.30-1 to 2.30-5 (Vernon 1956). Provi-
sions applicable only to close corporations and similar to those of the typical close corporation
statute are found at various places in the new California General Corporation Law. Cal. Corp.
Code §§ 158, 186, 204(a), 300, 418(c), 421, 706(a), 1111, 1201(e), 1800(a), 1904 (West 1977). See
also Me. Rev. Stat. tit. 13-A, §§ 102.5, 701.2 (1974), which authorize shareholder manage-
ment of corporations with not more than 20 shareholders.

113. See note 2 and accompanying text supra.

N.J. Rev. Stat. § 14A:5-21 (1969); N.Y. Bus. Corp. Law § 620(b) (McKinney 1964); N.C.
Code § 12-16.22 (1970). A similar provision regarding shareholders' agreements in the Tennes-
see General Corporation Act, Tenn. Code Ann. § 48-714 (Supp. 1977) is not limited to
shareholders of close corporations.
shareholders "to the extent that and so long as the discretion or powers of the board . . . are controlled by any such agreement." 115

Provisions of various close corporation statutes will be discussed further in connection with the analysis of the Illinois Act in the next section.

II. ANALYSIS OF THE ILLINOIS CLOSE CORPORATION ACT

This section of this Article will examine the provisions of the Illinois Act in detail, for three purposes: to introduce Illinois attorneys to the Act by indicating ways in which the Act may prove useful to their practice; to identify ambiguities and problems in the drafting of the Act; and to make suggestions for improvements which might be adopted by future legislatures. Such examination will include both an analysis of the specific provisions of the Act and comparison with alternative provisions in close corporation acts of other states.

A. Relationship to the Business Corporation Act

The Close Corporation Act does not entirely displace the Business Corporation Act as the law governing close corporations, nor does it apply to all "close corporations" as that term generally is understood, 116 but only to those corporations that elect to be subject to the Act. 117 In addition, corporations which do not elect to be subject to the Act, and close corporations which have voluntarily or involuntarily terminated close corporation status, remain subject to the Business Corporation Act "except insofar as this Act otherwise provides." 118 Unfortunately, as will be discussed below, it is not always clear to what extent the Act "otherwise provides." 119

B. Definition of Close Corporation 120

The Act defines a "close corporation" as follows:

Section 3. Close Corporation Defined; Contents of Articles of Incorporation.

115. See Miller & Robinson, supra note 41, at 5-35.
118. Close Corporation Act § 2(b).
119. See the discussion of the provisions regarding judicial dissolution, notes 143-152 and accompanying text infra.
120. Several commentators have cited the difficulty of defining a close corporation as a major reason for not adopting a separate close corporation statute. Folk, The Model Act and the South
(a) A close corporation is a corporation organized under or electing to be subject to this Act the articles of incorporation of which contain the provisions required by Section 47.1 through 47.15, inclusive, of The Business Corporation Act, as now or hereafter amended, and, in addition, provide that all of the issued shares of each class shall be subject to one or more of the following restrictions on transfer which restrictions shall be uniform within each class:

(1) Obligates a shareholder to offer to the corporation or to one or more shareholders of the corporation or to any designated person or to any combination of the foregoing, a prior opportunity to acquire such shares; or

(2) Requires the corporation or the holders of shares of any class of the corporation to consent to any proposed transferee of the shares; or

(3) Prohibits the transfer of such shares to designated persons or classes of persons, and such designation if not manifestly unreasonable; or

(4) Prohibits a transfer of the shares if the transfer would cause the corporation to lose its status as an electing small business corporation under subchapter S of the United States Internal Revenue Code; or

(5) Imposes any other lawful restriction on transfer or registration of transfer of shares.

(b) The articles of incorporation of a close corporation may set forth the qualifications of shareholders, either by specifying classes of persons who shall be entitled to be holders of record of shares of any class, or by specifying classes of persons who shall not be entitled to be holders of shares of any class, or both.

This definition differs substantially from those in other close corporation statutes. Other statutes generally provide that the shares of a close corporation may be held of record by no more than a specified number of persons. In addition, some states prohibit a "public offering" within the meaning of the United States Securities Act of 1933" of the corporation's shares.
The Illinois Act has both advantages and disadvantages in this respect. Tying close corporation status to the private offering exemption under section 4(2) of the Securities Act of 1933 may, given the uncertain limits of the exemption, create substantial uncertainty as to whether some corporations can qualify for such status. Placing a limit on the number of shareholders also makes possible the loss of close corporation status due to an increase in the number of shareholders. Such an increase may be caused by factors completely extraneous to the corporation's business. These include "the transfer of shares on distribution by will or pursuant to the laws of descent and distribution, the dissolution of a partnership or corporation or business association or the termination of a trust which holds shares, [or the] dissolution of a marriage . . . ." However, the absence of

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124. The private offering exemption exempts from the registration provisions of the Securities Act "transactions by an issuer not involving any public offering." Id. The term "public offering" is not defined in the Securities Act, and its content has been the subject of considerable litigation and commentary. In the leading case, Securities Exch. Comm'n v. Ralston Purina Co., 346 U.S. 119 (1953), the Supreme Court stated that the purpose of the Securities Act "is to protect investors by promoting full disclosure of information thought necessary to informed investment decisions." Id. at 124. In light of such purpose, the Court ruled that the applicability of the section 4(2) exemption "should . . . turn on whether the particular class of persons affected needs the protection of the Act. An offering to those who are shown to be able to fend for themselves is a transaction 'not involving any public offering.'" Id. at 125. The Court further noted that the number of persons to whom an offering is made is not the decisive factor, but that the registration requirement would "apply to a 'public offering' whether to few or many." Id. See also Andrews v. Blue, 489 F.2d 367 (10th Cir. 1973), which held that a sale of a total of 20 shares to three investors was a public offering.

Whether a potential investor is able "to fend for himself" depends upon his access to information concerning the issuer, his degree of knowledge and experience in finance and business, and whether he is able to bear the economic risks of the investment. See generally S.E.C. Rule 146, 17 C.F.R. § 230.146 (1977). Since the levels of wealth and business sophistication which offeres must possess for the offering to qualify for the exemption are not clearly defined, the exemption's applicability will be subject to doubt in a substantial number of cases. See generally Alberg & Lybecker, New SEC Rules 146 and 147: The Nonpublic and Intrastate Offering Exemptions, 74 COLUM. L. REV. 622 (1974); Carney, Exemptions From Securities Registration for Small Issuers: Shifting From Full Disclosure—Part I: The Private Offering Exemption, Rule 146 and an End to Access for Small Issuers, 10 LAND & WATER L. REV. 507 (1975); A.B.A. Section of Corporation, Banking and Business Law, Federal Regulation of Securities Committee, Section 4(2) and Statutory Law, 31 BUS. LAW. 485 (1975).

125. According to Professor Folk, the Delaware definition was chosen because it was "substantially more certain and predictable in application and administration" than the generally traded in the over-the-counter market test of the North Carolina statute. E. FOLK, THE DELAWARE GENERAL CORPORATION LAW: A COMMENTARY AND ANALYSIS 505 (1972). In light of the uncertainty of the § 4(2) exemption, such certainty does not appear to have been achieved.

126. CAL. CORP. CODE § 138(e) (West 1977). While other statutes are not as explicit as the California statute in setting forth such contingencies, the problem is nonetheless real. Such statutes typically provide that shares held jointly by a husband and wife "shall be treated as held by one stockholder." DEL. CODE ANN. tit. 8, § 342(c) (1974); KAN. STAT. § 17-2202(c) (1974); PA. STAT. ANN. tit. 15, § 1372(c) (Purdon Supp. 1977). The Texas Act provides that
such restrictions may allow corporations with a substantial number of shareholders and whose shares are fairly widely traded to elect close corporation status under the Act.\textsuperscript{127} For example, a corporation whose articles of incorporation prohibit transfer of shares to "persons not bona fide residents of the State of Illinois"\textsuperscript{128} conceivably may elect close corporation status. Of course, it is possible that Illinois courts would hold that the Act is not applicable to such corporations. Also, the Secretary of State might refuse to file articles of incorporation for a close corporation with such open-ended transfer restrictions. Otherwise, if problems of this sort develop, it may be necessary to amend the Act so as to restrict the number of shareholders,\textsuperscript{129} or to prevent a public offering.

The Act contains several provisions which serve to backstop the effectiveness of the restrictions on transfer. Every certificate representing shares issued by the corporation must

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conspicuously set forth upon the face or back of the certificate [either] a full statement of all the restrictions on transfer and qualifications of shareholders [or] that such statement ... will be furnished by the corporation to any shareholder upon request and without charge.\textsuperscript{130}
\end{quote}

Any person to whom a certificate so legended is issued or assigned is "conclusively presumed to have notice ... of his ineligibility to be a

\begin{quote}
shares shall be considered as held by one person if held by a husband and wife jointly or as community property, "by an estate of a decedent or incompetent," or "by an express trust, partnership, association, or corporation created or organized and existing other than for the primary purpose of holding shares ... in a close corporation." TEX. BUS. CORP. ACT ANN. art. 2.30-1(4) (Vernon Supp. 1978). It is thus possible under all of such statutes for an event which may not significantly change the business relationships among the parties to cause loss of close corporation status.
\end{quote}

\textsuperscript{127} Ginsberg, \textit{supra} note 4 at 20, commenting on the proposed version of the Illinois Act, stated that "[t]here is nothing in the Act which prohibits the corporation or a shareholder from making a public offer or distribution of his shares without sacrificing the close corporation qualifications."


\textsuperscript{129} Some of the disadvantages of a numerical restriction could be alleviated by providing that an increase of up to a specified number over the normal limit due to certain specified events would not cause loss of close corporation status, or that shareholder agreements would remain enforceable under such circumstances. Also the number of shareholders allowed could vary depending on the provision of the statute involved. For example, a larger number of shareholders could be allowed where there is a shareholders' agreement regarding the management of the corporation rather than where the corporation is managed by the shareholders. See text accompanying note 158 \textit{infra}.

\textsuperscript{130} Close Corporation Act § 8(a). See also Uniform Commercial Code, ILL. REV. STAT. ch. 26, § 8-204 (1975).
shareholder [or] that he has acquired shares in violation of a restriction on transfer.”\textsuperscript{131} Moreover, “the corporation may, at its option, refuse to register transfer of the shares into the name of the assignee.”\textsuperscript{132} Such provisions, in conjunction with the judicial proceedings to prevent involuntary loss of close corporation status, should provide adequate protection against transfer of shares to unauthorized persons.\textsuperscript{133}

It is unclear whether the requirement that some restrictions on transfer be included in the articles of incorporation is intended to preclude restrictions in the by-laws or a shareholders’ agreement.\textsuperscript{134} Until this point is clarified by either the courts or the legislature, all restrictions on transfer should be included in the articles unless there are very strong reasons for placing such restrictions in some other document.

C. Acquisition and Termination of Close Corporation Status

A newly formed corporation may acquire close corporation status by filing articles of incorporation in accordance with the Business Corporation Act. The articles must include the restrictions on transfer of its shares as required by the Act and “a heading stating the name of the corporation and that it is being organized as a close corporation.”\textsuperscript{135} An existing corporation may become a close corporation by amending its articles of incorporation in accordance with the Close Corporation Act to include such restrictions on transfer and a “heading stating the name of the corporation and that it is reorganized as a close corporation.”\textsuperscript{136} Such an amendment must be approved by “the holders of record of all the outstanding shares of the corporation.”\textsuperscript{137}

These provisions are similar to those found in other close corporation statutes. Prior to its amendment in 1975, the Texas statute applied to all corporations which met specified criteria, obviating the

\textsuperscript{131} Close Corporation Act § 8(b).

\textsuperscript{132} Id. § 8(c). The Act provides that this provision is not applicable if all the shareholders have consented to the transfer or the corporation has voluntarily terminated close corporation status. Id. § 8(d). See notes 140-142 and accompanying text infra. The Act does not state whether the provision would be applicable after close corporation status has been involuntarily terminated. See notes 143-152 and accompanying text infra.

\textsuperscript{133} See notes 146-147 and accompanying text infra.

\textsuperscript{134} Such agreements were generally upheld under prior Illinois law. See cases cited in note 191 infra.

\textsuperscript{135} Close Corporation Act § 4.

\textsuperscript{136} Id. § 5.

\textsuperscript{137} Id.
necessity of an election by the corporation or the shareholders. Such an approach may be preferable to the Illinois approach. It makes available the protections of the Act to shareholders of all close corporations and avoids confusion as to what law is applicable to those close corporations that do not elect close corporation status under the Act. This question will be discussed further in a later section of this Article.  

Close corporation status under the Act may be terminated in one of two ways. Voluntary termination occurs whenever a close corporation amends its articles to delete the restrictions on transfer required by the Act. Such an amendment must be approved by "the holders of record of at least two-thirds of the outstanding shares of each class of the corporation," unless the articles of incorporation require a larger vote.  

Involuntary termination of close corporation status occurs whenever there is a breach of one of the restrictions on transfer and "neither the corporation nor any of its shareholders proceeds under Section 9 of this Act to prevent such loss of status or to remedy such breach." Upon the discovery of any breach, "the corporation shall promptly notify all of the shareholders in writing" both of the breach and of the shareholders' right to commence an action in the "Circuit Court of the County in which the registered office of the corporation is located" to prevent loss of or to restore close corporation status. If the breach is not remedied or such a proceeding commenced within 90 days after notice, or, if notice is not given, within one year of the discovery of the breach, the corporation's status as a close corporation shall terminate.  

There are a number of ambiguities in the involuntary termination provisions of the Act. It gives the court jurisdiction "to issue all orders necessary . . . to restore its status as a close corporation by . . . setting aside acts" inconsistent with the transfer restrictions or shareholder qualification provisions. Therefore, such a proceeding apparently could be commenced after termination of close corporation status.

138. See Covington, supra note 7, at 193-94.
139. See notes 185-196 and accompanying text infra.
140. Close Corporation Act § 7(a).
141. Id. § 7(b).
142. Id. § 7(a).
143. Id.
144. Id. § 9(a), (b).
145. Id. § 9(a).
146. Id. § 9(b).
status. The Act does not state whether there is any time limit for commencing such a proceeding after termination of close corporation status. Nor does it indicate whether such a proceeding can be commenced by a shareholder who received timely notice of a breach or became a shareholder subsequent to the breach. The Act is silent concerning the court’s authority to set aside transfers that are “contrary to [the] articles of incorporation” and to restore close corporation status includes authority to set aside transfers occurring subsequent to the termination of close corporation status. It is unclear whether a transfer which is set aside is void ab initio or is merely voidable.147

Finally, it is not clear what constitutes discovery of a breach of restriction on transfer. For example, a corporation might register a transfer of shares without realizing until some years later, if ever, that the transfer violated a restriction in the articles. The Act gives no indication whether such violation would be discovered constructively at the time of the transfer or only discovered when some corporate agent in fact becomes aware of the violation. This ambiguity will make it difficult for attorneys to give opinions as to close corporation status or the validity of shareholders agreement. The ambiguity should be removed by adding a definition of discovery to the Act.

Another area of uncertainty is the effect that loss of close corporation status has on the corporation.148 As previously mentioned, the Act does not state whether restrictions on transfer of shares remain in effect after termination.149 In addition, it does not state whether shareholder agreements authorized by the Act150 are voided by such termination, or how corporations managed by the shareholders151 may comply with the Close Corporation Act.152 These are serious omissions which, hopefully, the legislature will remedy in the near future.

In a proceeding to prevent loss or restoration of close corporation status if the court holds a restriction on transfer invalid, the corporation shall have an option “to acquire the restricted shares at a price

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147. If a transfer is merely voidable, it may result in disqualification of the corporation under Subchapter S, I.R.C. §§ 1371—1379, by causing the corporation to have an ineligible shareholder or more than ten shareholders.
148. Presumably, although the Act does not say so, termination of close corporation status would not result in termination of the corporation’s existence or revocation of its certificate of incorporation. But see Ginsberg, supra note 4, at 35-36.
149. See note 32 supra.
150. See text accompanying note 154 infra.
151. Id.
152. See Ginsberg, supra note 4, at 36.
which is agreed upon by the parties.” In the absence of such an agreement, it may acquire the shares at a price and upon terms determined by the court.\textsuperscript{153} Although the Act does not discuss this question, the judgment holding a restriction invalid would appear to cause a termination of close corporation status if the articles of incorporation contain no other explicit restrictions. A possible solution to this problem would be to give the shareholders a specified period of time in which to amend the articles to include alternative restrictions. Pending such an amendment to the Act, provisions to this effect probably can be included in any decree in which restrictions are held to be invalid.

D. Management of the Close Corporation

Perhaps the most important provisions of the Act relate to the management of the corporation. Such provisions explicitly authorize shareholders to enter into agreements concerning all aspects of the management of the corporation. This includes a provision in the articles of incorporation that the shareholders rather than the directors shall manage the business of the corporation.

Section 11. Written Agreements as to Conduct of Certain Affairs of Corporation.

(a) All shareholders of a close corporation may enter into a written agreement, relating to any phase of the affairs of the corporation, including, but not limited to, the following:

1. Management of the business of the corporation.
2. Declaration and payment of dividends or division of profits.
3. Who shall be officers or directors, or both, of the corporation.
4. Restrictions on transfer of shares permitted by Section 3 of this Act.
5. Voting requirements, including the requirements of unanimous voting of shareholders or directors.
7. Arbitration of issues as to which the shareholders are deadlocked in voting power or as to which the directors are deadlocked and the shareholders are unable to break the deadlock.

(b) No written agreement to which shareholders of a close corporation have actually assented, whether embodied in the articles of incorporation or by-laws of the corporation or in any separate

\textsuperscript{153} Close Corporation Act § 10. Since a restriction could also be declared invalid in other types of proceedings, the Act should perhaps be amended to provide such an option in all judicial proceedings.
written agreement and which relates to any phase of the affairs of the corporation, whether to the management of its business or division of its profits or otherwise, shall be invalid as between the parties thereto, on the ground that it is an attempt by the parties thereto to treat the corporation as if it were a partnership or to arrange their relationships in a manner that would be appropriate only between partners.

(c) If the business of a close corporation is managed by a Board of Directors, an agreement among all of the shareholders, whether solely among themselves or between all of them and a party who is not a shareholder, is not invalid, as among the parties thereto, on the ground that it so relates to the conduct of the affairs of the corporation as to interfere with the discretion of the Board of Directors, but the making of such an agreement shall impose upon the shareholders the liability for managerial acts that is imposed by the laws of this State upon directors.

Section 12. Management by Shareholders.

(a) The articles of incorporation of a close corporation may provide that the business of the corporation shall be managed by the shareholders of the corporation rather than by a board of directors. So long as this provision continues in effect,

(1) No meeting of shareholders need be called to elect directors;

(2) Unless the context clearly requires otherwise the shareholders of the corporation shall be deemed to be directors for purposes of applying provisions of The Business Corporation Act, as now or hereafter amended; and

(3) The shareholders of the corporation shall be subject to all liabilities of directors.

(b) Such a provision may be inserted in the articles of incorporation by amendment if all incorporators and subscribers or shareholders of record authorize such a provision. An amendment to the articles of incorporation to delete such provision shall be adopted by a vote of the holders of record of at least two-thirds of all the outstanding shares of each class of the corporation. If the articles of incorporation contain a provision authorized by this Section 12, the existence of such provision shall be noted conspicuously on the face or back of every certificate representing shares issued by the corporation.\textsuperscript{154}

These provisions effect a major change in Illinois law governing close corporations. The provisions governing shareholders' agreements appear to go well beyond what was authorized by \textit{Galler v. Galler},\textsuperscript{155} especially as limited by \textit{Somers v. AAA Temporary Services, Inc.},\textsuperscript{156} in authorizing shareholder control over the management

\textsuperscript{154} Agreements under § 11 must also be noted on certificates representing the corporation's shares. \textit{Id.} § 8(a).

\textsuperscript{155} 32 Ill.2d 16, 203 N.E.2d 577 (1964).

\textsuperscript{156} 5 Ill. App.3d 931, 284 N.E.2d 462 (1st Dist. 1972).
of the corporation.\textsuperscript{157} This is particularly true of section 11(c), which appears to authorize an agreement delegating the management of the corporation to a person or persons who are neither shareholders nor directors. Section 12 goes even further by allowing elimination of the board of directors altogether. Using such provisions, it should be possible by careful drafting to achieve practically any arrangement for the control of the corporation which the parties desire.

There are, however, a number of potential problems in the use of these provisions of which counsel for close corporations should be aware. First, there is a serious ambiguity in the provision which shifts liability from the directors to shareholders when an agreement among the shareholders interferes with the discretion of the directors. If read literally, section 11(c) seems to say that the making of any shareholders' agreement which "interfere[s] with the discretion of the Board of Directors" imposes upon the shareholders all "liability for managerial acts that is imposed by the laws of this State upon directors."\textsuperscript{158} This may be true, even if there is only slight interference with the director's discretion. What most close corporation statutes provide,\textsuperscript{159} and what the drafters probably intended, was to impose liability on shareholders to the extent that such an agreement interferes with the discretion of the directors. Until this provision is clarified, by either amendment of the Act or judicial construction, counsel for close corporations should be cautious in using shareholders' agreements. This is especially true in situations in which some shareholders will not also be directors and the parties do not intend these shareholders to share directors' liability.

\textsuperscript{157} In one respect, the \textit{Galler} rule may be less restrictive than the Act. Sections 11(a) and 11(c) of the Act authorize agreements among all shareholders of a close corporation. In \textit{Galler}, approximately five percent of the shares were owned by a shareholder who was a party to neither the agreement nor the litigation. 32 Ill.2d at 17-18, 203 N.E.2d at 579. It is thus arguable, that agreements regarding corporate management among shareholders of corporations subject to the Act must be unanimous, whereas less than unanimous agreements among shareholders of other corporations may be upheld under the \textit{Galler} rule. Such inconsistency would not, however, be desirable, and it is likely that the courts would find some way to avoid such a result. One possibility, especially since section 11(b) of the Act appears to authorize less than unanimous shareholder agreements \textit{quaere} whether this is consistent with the unanimity requirements of sections 11(a) and (c), and whether it is possible to distinguish agreements authorized by one section from those authorized by the others), is to hold that such agreements may be upheld at least where the interests of the other shareholders would not be prejudiced. Or the courts might hold that, despite section 16 of the Act, see text accompanying note 86 \textit{infra}, the legislature intended to abolish less than unanimous agreements concerning corporate management among shareholders of all corporations.

\textsuperscript{158} It is unclear from the Act whether the directors also remain liable for such acts.

\textsuperscript{159} Miller & Robinson, supra note 41, at 5-35. The wording of the Illinois Act seems to have been taken from \textit{TENN. CODE ANN.} § 48-714 (Supp. 1977).
The imposition of directors' liability on shareholders under sections 11(c) and 12(a)(3) of the Act creates additional dangers for unsuspecting shareholders. Perhaps the most serious danger is the possibility that shareholders who do not participate directly in the management of the corporation will become liable for acts of the managing shareholders. In order to avoid or minimize this danger, attorneys for close corporations should be extremely careful in drafting shareholder agreements. Counsel probably should avoid management by the shareholders when there will be non-managing shareholders. It also seems likely that a shareholder who attends a meeting at which illegal action is taken must dissent in the manner prescribed for directors by the Business Corporation Act to avoid liability for such action.

Another potential problem is that a shareholders' agreement regarding control of the corporation may cause disqualification of the corporation as a "small business corporation" under Subchapter S of the Internal Revenue Code. A small business corporation is defined as a domestic corporation which does not "have more than one class of stock." According to the regulations under this section,

[i]f the outstanding shares of stock of the corporation are not identical with respect to the rights and interest which they convey in the control, profits, and assets of the corporation, then the corporation is considered to have more than one class of stock. Thus, a difference as to voting rights, dividend rights, or liquidation preferences of outstanding stock will disqualify a corporation. However, if two or more groups of shares are identical in every respect except that each group has the right to elect members of the board of directors in a number proportionate to the number of shares in each group, they are considered one class of stock. At one time, the Internal Revenue Service took the position that differences in voting rights stemming from shareholders' agreements, irrevocable proxies and voting trusts would create a second class of stock and disqualify the corporation. Following the Tax Court's decision in the Parker Oil case, however, the Service changed its position and now holds that differences in voting rights create a sec-

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160. Ill. Rev. Stat. ch. 32, § 157.42.9 (1975). On the other hand, it is likely, although the Act does not say so, that shareholders with director's liability would be entitled to contribution from other shareholders and/or directors pursuant to id. § 157.42.11, and could use the good faith reliance on financial statements defense of id. § 157.42.10.


162. Id. § 1371(a)(4).

163. Treas. Reg. § 1.1371-1(g) (emphasis added).


165. 58 T.C. 985 (1972).
ond class of stock only if they arise out of the articles of incorporation.\textsuperscript{166} No shift has occurred in the Service's position regarding dividend rights and liquidation preferences. Therefore, any such differences would appear to create a second class of stock whether they arise from the articles of incorporation or from a separate agreement. If the shareholders of a close corporation wish to make an election under Subchapter S, all differences among the shares as to dividend rights and liquidation preferences should be avoided. Moreover, any differences in voting rights should be contained in a shareholders' agreements rather than in the articles of incorporation.

In addition to the provisions authorizing shareholders' agreement and management by the shareholders, the Act provides that:

\begin{quote}
the articles of incorporation of any close corporation may include a provision granting to any shareholder, or to the holders of any specified number or percentage of shares of any class, an option to have the corporation dissolved at will or upon the occurrence of any specified event or contingency.\textsuperscript{167}
\end{quote}

Such a provision may be included in the articles by an amendment if adopted by the unanimous vote of all the shareholders,\textsuperscript{168} and is ineffective "[u]nless noted conspicuously on the face or back of [every] share certificate."\textsuperscript{169} The use of such a provision, in conjunction with management by the shareholders, would enable the shareholders to arrange their affairs in all respects as if they were partners, while maintaining the limited liability of corporate shareholders. The provi-

\begin{footnotes}
  \footnotetext[166]{Rev. Rul. 73-611, 1973-2 C.B. 312. The apparent purpose of the one class of stock requirement was to prevent administrative difficulties stemming from "complication as to the reporting of income by the stockholders." Parker Oil Co., 58 T.C. 985, 990 (1972). The Parker Oil case can be read as holding that differences in voting rights are entirely irrelevant to the achievement of such purpose, see id., and it is possible that differences in voting rights stemming from the articles of incorporation would, in at least some types of cases, be held not to create a second class of stock. But see id. at 989; Pollack v. Commissioner, 392 F.2d 409, 411 (5th Cir. 1968).
  
  So far, there is no authority as to whether management of the corporation by the shareholders rather than by the directors would create a second class of stock. It is at least arguable that, if the shareholders hold unequal numbers of shares but each have one vote on corporate management, a difference in voting power would have arisen from the articles of incorporation and created a second class of stock. Such a result would appear to be contrary to the policy behind the Parker Oil case, especially since such a situation would be in substance the same as if the shareholders had agreed in a separate contract to elect themselves directors. In the absence of specific authority on this point, however, the position which the Service would take cannot be accurately foreseen.
  
  \footnotetext[167]{Close Corporation Act § 13(a).}
  \footnotetext[168]{Id. § 13(b).}
  \footnotetext[169]{Id. § 13(c).}
\end{footnotes}
tion adds substantially to the management flexibility provided by the Act.

E. Judicial Dissolution of the Close Corporation

The provisions on judicial dissolution in the Act raise serious questions concerning the relationship of such provisions to the comparable provisions in the Business Corporation Act. Section 14(a) provides that:

The Circuit Court of the County in which the registered office of the corporation is located may entertain a petition of any shareholder for involuntary dissolution of any close corporation and, at the hearing, may appoint a receiver or trustee of the corporation and order it dissolved when it is made to appear that

(1) the directors or shareholders of the corporation are deadlocked in the management of the corporate affairs and, in the case of directors, the shareholders are unable to break the deadlock, or that the shareholders are otherwise deadlocked; and

(2) any remedy, including arbitration, provided in any written agreement of the shareholders upon deadlock has failed to eliminate such deadlock; and

(3) there is such internal dissension among the shareholders of the corporation that the business and affairs can no longer be conducted in the best interests of the shareholders.

These provisions differ substantially from section 86 of the Business Corporation Act, which provides, in relevant part, that:

Circuit courts have full power to liquidate the assets and business of a corporation:

(a) In an action by a shareholder when it appears:

(1) That the directors are deadlocked in the management of the corporate affairs and the shareholders are unable to break the deadlock, and that irreparable injury to the corporation is suffered or threatened by reason thereof; or

(2) That the shareholders are deadlocked in voting power, and have failed, for a period which includes at least 2 consecutive annual meeting dates, to elect successors to directors whose term has expired or would have expired upon the election of their successors; or

(3) That the acts of the directors or those in control of the corporation are illegal, oppressive or fraudulent; or

(4) That the corporate assets are being misapplied or wasted.

Such differences raise the question whether section 14(a) is intended to provide the only procedure by which a shareholder of a close cor-

poration may seek judicial dissolution of a close corporation. It is unclear whether he may also seek liquidation of its assets and business pursuant to section 86 of the Business Corporation Act. Unfortunately, there is no readily apparent answer.

The first source of confusion stems from the fact that the Business Corporation Act speaks of “power to liquidate the business and assets of a corporation,” whereas the Close Corporation Act speaks of “involuntary dissolution” of the corporation. Under Illinois law, liquidation refers to the process by which a corporation collects its assets, pays or provides for its obligations, and distributes its remaining assets among its shareholders. Dissolution refers to the termination of the corporation’s legal existence, which normally occurs only after liquidation is completed. Furthermore, under the Business Corporation Act a court can order involuntary dissolution only “upon complaint filed by the Attorney General,” and not in an action by a shareholder. Thus by giving the court power to dissolve a close corporation in a suit by a shareholder, the Act makes a definite change from prior Illinois law. The practical effect of such change will probably be slight, since liquidation would, of necessity, precede judicial dissolution and dissolution in most cases would occur following judicial liquidation. But the difference in terminology between the two statutes makes it possible to argue that there are two different proceedings between which a shareholder may choose.

A comparison of the grounds of dissolution/liquidation in the two statutes creates further confusion. Both section 14(a)(1) of the Act and section 86(a)(1) of the Business Corporation Act list deadlock among the directors as grounds for dissolution/liquidation. Sections 14(a)(2) and (3) also require, respectively, that any remedy provided in a shareholders’ agreement must have failed to eliminate such deadlock and that there be such dissension among the shareholders “that the business and affairs can no longer be conducted in the best interests of the shareholders.” It is unclear whether the latter requirement is intended to be the same as the section 86(a)(1) requirement “that irreparable injury to the corporation is suffered or threatened by reason of the deadlock. In any event, the inclusion of section 14(a)(2), in

171. Id.
174. Id. §§ 157.80, 157.81.
175. Id. § 157.82. See also id. §§ 190-97.
176. The distinction is further blurred by the fact that the courts generally use the term “dissolution” rather than “liquidation” in cases brought under § 86. See, e.g., Central Life Ins. Co. v. Davis, 10 Ill.2d 566, 141 N.E.2d 45 (1957).
the absence of a similar provision in section 86(a)(1), strongly supports the argument that section 14(a) was intended to be exclusive and that shareholders of close corporations should not be allowed to evade this requirement by suing for liquidation under section 86.

On the other hand, it seems unlikely that the drafters of the Act intended to deprive shareholders of close corporations of the grounds for liquidation provided in sections 86(a)(2), (3) and (4). Thus the absence of corresponding provisions in section 14(a) argues strongly for allowing such shareholders to sue for liquidation under such provisions.

In conclusion, Illinois courts probably will interpret the Act so as to allow shareholders of close corporations to sue for liquidation under sections 86(a)(2)(3) and (4), and possibly under section 86(a)(1), of the Business Corporation Act. Such a result is not certain, however, and the legislature would be well advised to amend the Act so as to eliminate the confusion on this question.

Section 14(b) of the Act provides that, in any proceeding under section 14(a):

> [A]ny one or more shareholders desiring to continue the business of a close corporation may avoid the dissolution of the corporation or the appointment of a trustee or receiver under this Section 14 by electing in a written instrument filed in the proceeding to purchase the shares of stock owned by the petitioner at a price equal to their fair value. If a shareholder or shareholders making such election are unable to reach an agreement with the petitioner as to the fair value of his shares within 30 days after the filing of such election, the court shall, upon said electing shareholders giving bond or other security in an amount fixed by the court, stay the proceeding and proceed to determine the fair value of such shares as of the close of the business on the day on which the petition for the dissolution was filed. Upon determining the fair value of such shares, the court shall set forth in its order directing that the shares be purchased, the purchase price and the time within which the payment shall be made, and may decree such other terms and conditions of sale as it determines to be appropriate, including payment of the purchase price in installments over a period of time and the allocation of shares among shareholders electing to purchase them. The petitioner shall be entitled to interest at the legal rate on the purchase price of his shares from

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177. Illinois courts have traditionally been more willing to liquidate corporations under these provisions than under § 86(a)(1). W. MURDOCK, ILLINOIS BUSINESS CORPORATION ACT ANNOTATED 481-83 (2d ed. 1975). Thus denial of the grounds contained in such provisions would substantially diminish the usefulness of the dissolution remedy.
the date of filing of the election for a determination of fair value and all other rights of the petitioner as an owner of the shares shall terminate at such date. Upon full payment of the purchase price, under the terms and conditions specified by the court, or at such other time as may be ordered by the court, the petitioner shall surrender the shares of stock to the purchasing shareholder or shareholders.178

It is not entirely clear from the wording of this provision whether the election to purchase the petitioner's shares can be made only if the court finds that dissolution is appropriate, or whether the election may be made prior to a final decision on the dissolution issue.179 By providing for staying the proceeding to determine the fair value of the shares, the statute implies the latter interpretation. This interpretation also appears desirable as a matter of policy. Buying out a shareholder who wishes to obtain his share of the corporate assets rather than continue in the business will reconcile in an equitable manner the interests of such a shareholder with the interests of the remaining shareholders, regardless of the appropriateness of judicial dissolution.

Section 14(b) also raises an interesting question concerning the valuation of the petitioner's shares in a dissolution proceeding. Questions concerning the value of corporate shares have arisen most frequently in the context of appraising the shares of shareholders who have dissented from a merger or other change in corporate status.180 In such cases, the courts generally consider three major factors in determining the value of the dissenter's shares: the per share value of the corporation's net assets, the market value of the shares, and their investment, or earnings, value.181

178. This provision appears to be based on MD. CORP. & ASS'NS CODE ANN. § 4-603 (1974). Similar provisions are found in ARIZ. REV. STAT. § 10-216.A.3 (1977) (purchase of petitioner's shares may be ordered at the court's discretion); CONN. GEN. STAT. ANN. § 33-394 (1958) (not limited to close corporations). For a discussion of the Maryland provision, see Bradley, A Comparative Evaluation of the Delaware and Maryland Close Corporation Statutes, 1968 DUKE L.J. 525, 545-47.

179. Compare § 14(b) of the Act with ARIZ. REV. STAT § 10-216.B (1977), which explicitly provides that the court may grant relief, including ordering purchase of the petitioners shares, "even though the court does not find any of" the grounds for dissolution to be present.


In general, the least weight is placed on the asset value of the shares. This stems from the principle that "in an appraisal proceeding . . . the shares must be valued on a going concern basis." It is also grounded on the fact that the dissenting shareholders are "entitled to be paid for that which has been taken from . . ." them by the corporate action from which they are dissenting, namely their "proportionate interest in a going concern." In the context of a going concern, the liquidation value of assets is normally less important to a shareholder than the market value or earnings value of his shares because it is only through payment of dividends or sale of the shares that he can realize a return on his investment.

In a dissolution proceeding under the Act, however, the petitioner whose shares are purchased is being deprived not of his "proportionate interest in a going concern," but of his right to a pro-rata distribution of the corporate assets. In such a case, the court should not follow the method of valuation generally used in appraisal cases, but should rely primarily on the value of the corporation's assets in valuing the petitioner's shares. Any other approach might result in the petitioner receiving substantially more or less for his shares than he would have received on dissolution.

Perhaps the greatest weakness of section 14(b) of the Act is that it provides the option to purchase the petitioner's shares only in actions brought under section 14(a) of the Act. The value of section 14(b) lies in the fact that it allows both the shareholders who wish to continue the business and those who wish to withdraw from the business and recover the value of their investment an opportunity to do so in an equitable manner. Such a procedure is equally desirable regardless of the grounds upon which dissolution is sought. The right to purchase the petitioner's shares should not depend on whether the petitioner alleges deadlock under section 14(a) or one of the grounds listed in section 86(a) in his petition for dissolution or liquidation.

F. Effect on Close Corporations Not Electing to Be Subject to the Act

As mentioned previously, the Act is applicable only to corporations which elect to be subject to it. This raises a number of questions

concerning the law applicable to close corporations which do not
make such an election.
A basic question is whether a shareholder agreement among
shareholders of a corporation not subject to the Act, such as that up-
held in Galler v. Galler, would still be valid. It can be argued that
the legislature, by authorizing such agreements for only a specific
class of corporations, implicitly denied the use of such agreements to
shareholders of other corporations. Since, however, the Act provides
that "[t]he provisions of this Act shall not be deemed to repeal,
amend or modify any statute or rule of common law which is or
would be applicable to any corporation which is not a close corpora-
tion as herein defined," it appears likely that such an agreement
still would be upheld.

This conclusion, however, merely raises more questions. Under the
terms of the Act, any such agreement must be noted on the face or
back of every certificate representing shares of the corporation. Shareholders of corporations subject to the Act who enter into an
agreement which restricts the discretion of the directors become
subject to "the liability for managerial acts that is imposed by the
laws of this State upon directors." Do agreements among
shareholders not subject to the Act create similar shareholder liabil-
ity? Must such agreements be noted on the certificates representing
the corporation's shares? The Close Corporation Act itself does not
impose such conditions. However, a court might do so on the
grounds of public policy, because either shareholder liability or nota-
tion of shareholder agreements on certificates is deemed necessary to
protect the shareholders, the public or the corporation's creditors.
Alternatively, such disclosure might be deemed necessary to prevent
corporations from evading such requirements by not electing to be
subject to the Act.

Another source of confusion is the listing of permissible restrictions
on transfer in section 3 of the Act. The Business Corporation Act
contains no similar list of permissible restrictions, but merely states
that shares may be issued "with such designations, preferences, qual-
ifications, limitations, restrictions, and special or relative rights as
shall be stated in the articles of incorporation." Thus the listing of

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185. 32 Ill.2d 16, 203 N.E.2d 577 (1964). See notes 61-64 and accompanying text supra.
186. Close Corporation Act § 16.
187. Id. § 8(a).
188. Id. § 11(c).
189. Id. § 3(a). See text accompanying note 120 supra.
permissible restrictions in the Act can be read as being more permissi-
vie than prior law. It may imply that some or all of the restrictions
listed are unavailable to corporations not subject to the Act.191

This confusion could have been avoided if the Act had been made
applicable to all close corporations as defined therein without requir-
ing such corporations to elect to be subject to the Act. Such an ap-
proach would have had several advantages. First, it would remove all
doubts as to whether, and to what extent, shareholders of various
corporations would be able to enter into agreements concerning the
management of the corporation. Second, it would clearly impose vari-
ous protective provisions, such as legended certificates and
shareholder liability for managerial acts, upon all persons who elect to
take advantage of such provisions. Third, it would indicate more
clearly that the other provisions of the Act, such as management by
the shareholders, the shareholders' option to dissolve the corporation
and the option to purchase the petitioner's shares in a dissolution
proceeding, are available only to close corporations and not to pub-
licly held corporations.192 At present, some close corporations can-
ot take advantage of such provisions because they have not elected
to be subject to the Act. In contrast, a publicly held corporation,
by placing restrictions on its shares and electing to be subject to the Act,
might be able to utilize them.193 By defining the term "close corpo-
ration" more precisely194 and by making such corporations subject to
the Act without the necessity of an election, the legislature could

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191. Since restrictions on transfer have generally been upheld under Illinois law, see, e.g. Clayton v. James B. Clow & Sons, 327 F.2d 382, 388 (7th Cir. 1964); Vogel v. Melish, 31 Ill.2d 620, 625, 203 N.E.2d 411, 413 (1964), rehearing denied 31 Ill.2d 620, 203 N.E.2d 411 (1965); Eggerson v. Brower Mfg. Co., 27 Ill. App.3d 963, 327 N.E.2d 468 (1975) (abstract only), such an argument appears unlikely to succeed, at least in cases involving types of restrictions which have been previously upheld. Nevertheless, it would have been preferable to draft the statute so as to avoid such confusion.

192. The need to "indicate clearly that statutes which have been enacted to provide for the peculiar needs of the close corporation are absolutely unavailable to the public issue corporation" has been cited as a major reason for enacting a separate close corporation statute rather than adding provisions useful to close corporations, but applicable to all corporations, to the general corporation law. N.Y.U. Note, supra note 4, at 706.

193. See notes 128-129 and accompanying text supra.

194. Such a definition probably would specify a maximum number of shareholders for a close
corporation, place a restriction on public trading or offerings of its shares or both. See notes
122-129 and accompanying text supra. The definition need not necessarily be the same for all
purposes. For example, the Act could allow agreements concerning the management of the
corporation among the shareholders of any corporation whose shares are not listed on a stock
exchange or regularly traded over the counter, see statutes cited in note 114 supra, and restrict
management by the shareholders to corporations with no more than a specified number of
shareholders.
establish clearly that, as a matter of public policy, the provisions of the Act should be available only to corporations which are in fact close corporations as that term is normally understood.

Nor does there appear to be any overwhelming policy reason for requiring that a corporation elect to be subject to the Act and include a statement that it is a close corporation in its articles of incorporation. According to one commentator, the policy behind including such requirements in the Maryland and Delaware close corporation statutes was "... to require notice to outsiders by charter announcement and to insure some degree of consent by shareholders to fundamental changes in managerial structure." Notice to outsiders, however, can be provided by other means. For example, the inclusion of a provision for shareholder management, in the articles of incorporation, puts outsiders on notice to the same degree as a statement that a corporation is a close corporation. Moreover, the shareholders can be protected adequately by legended certificates and high or unanimous vote requirements for fundamental changes whether or not an election to be a close corporation is required.

For all of the above reasons, the legislature should give serious consideration to amendment of the Act so as to eliminate the requirement that corporations taking advantage of its provisions must elect to be subject to the Act and to make the Act applicable to all close corporations as therein defined.

III. Conclusion

In many respects, the Illinois Act is an admirable attempt to deal with the legal problems of the close corporation. The provisions authorizing shareholders' agreements concerning the management of the corporation, management by shareholders rather than the board of directors, and granting shareholders an option to dissolve the corporation at will or upon the occurrence of a specified contingency,

195. Covington, supra note 7, at 194.
196. This would not, of course, provide notice to third parties of shareholders' agreements not included in the articles of incorporation. Such notice is not, however, provided under the Act, and, since such agreements are probably valid among shareholders of corporations not subject to the Act, see text accompanying notes 185-186 supra, the Act's election procedures do not even provide notice as to which corporations might have such agreements. Thus if notice to third parties of shareholders' agreements is deemed desirable, it will be necessary to amend the Act irregardless of whether the election requirement is eliminated.
197. See text accompanying note 154 supra.
198. Id.
199. See notes 167-169 and accompanying text supra.
allow substantial flexibility in adjusting the corporate structure to the needs and desires of the specific persons involved. In particular, such provisions make it possible to protect the interests of minority shareholders either by agreeing in advance as to corporate policy or by giving such shareholders a veto over some or all corporate decisions. The Act does not impose more stringent fiduciary duties on controlling shareholders of close corporations except to the extent that they assume directors' liability. However, it may contribute to such a development by "encouraging more realistic and sympathetic judicial treatment" of close corporations. The grant to other shareholders of an option to purchase the shares of the petitioner in a judicial dissolution proceeding should add substantially to the ability of the courts to provide equitable solutions to conflicts among shareholders of close corporations.

However, the Act also has serious deficiencies. A number of its provisions are extremely vague. The provisions governing judicial dissolution, in particular, create considerable confusion as to what law is applicable to corporations which elect to be subject to the Act. Furthermore, by requiring that corporations elect to be subject to its provisions, the Act creates unnecessary confusion as to what law is applicable to close corporations which do not elect to be subject to it.

These deficiencies are particularly ironic in that one of the major purposes of close corporation legislation is to "clarify the uncertainties that still persist in certain areas of the law which vitally affect the close corporation." Rather than clarifying uncertainties, the Act has to a large extent created new ones.

Fortunately, none of the problems of the Act appear to be insoluble. In some cases, such as the ambiguity regarding the extent to which the parties to a shareholders' agreement assume the liabilities of directors, a relatively minor amendment would be sufficient. In other cases, more extensive revisions may be necessary. Hopefully, the legislature will be able to make the necessary changes in the near future. Even in its present form, the Act should prove to be a valu-

200. See notes 69-95 and 158-160 and accompanying text supra.
201. N.Y.U. Note, supra note 4, at 706.
202. See notes 178-184 and accompanying text supra.
203. See notes 170-179 and accompanying text supra.
204. See notes 116-120 and accompanying text supra.
205. See notes 185-196 and accompanying text supra.
206. N.Y.U. Note, supra note 4, at 706.
207. See notes 158-160 and accompanying text supra.
able tool to attorneys seeking more flexibility in adjusting the corporate structure to the needs of shareholders of close corporations. If amended so as to eliminate the present ambiguities, the Act will prove to be an even more valuable contribution to Illinois corporate law.