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SYMPOSIUM: THE NEW CALIFORNIA GENERAL CORPORATION LAW

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- CALIFORNIA'S NEW APPROACH TO DIVIDENDS
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For the Record

It would be nice to say that we planned this symposium issue. In fact, we began with a vague notion of soliciting an article or two about the new corporation law. The torrent of enthusiastic responses soon brought home to us the importance of the new provisions, and when the number of contributions threatened to strain our normal format, a symposium issue seemed the only answer. We believe this issue will be of lasting value to practitioners, courts, and scholars as they begin to scrutinize the new law, and to the legislature as it responds to that scrutiny. Indeed, several suggestions made in earlier drafts of these articles have already found their way into legislative amendments introduced this year.

This issue owes much to several men and women whose names do not appear as authors or editors. It has become traditional for each new board of editors to publish the last issue of the previous volume. Richard Harroch, Deri Obrzut, Cindy Low, and Sondra Berchin worked especially hard on the final stages of the issue. Finally, one man was indispensable: Roy Finkle, Consultant to the Assembly Select Committee on the Revision of the Corporations Code, was a never-failing source of expertise, preliminary drafts of bills, and sympathy.

Because so many articles refer to the same sources, we have decided to use uniform short citations for some materials. The terms "old law" and "new law" will generally be used throughout the text and footnotes to refer to the law pertaining to corporations before and after the effective date of the new General Corporation Law. Before its enactment, the new law went through various stages; since its passage by the Legislature, certain additional changes have been made. For ease of reference, and to avoid redundancy, we have established the following citation conventions:

CAL. CORP. CODE:

This is of course the traditional way of citing the California Corporations Code. It will be used to refer to the old law, effective until January 1, 1977, and to those sections of the Corporations Code not affected by the new law.

NEW CODE:

This convention will be used to refer to sections of the new law, effective January 1, 1977, as enacted by the California Legislature in Assembly Bill No. 376 (1975), which have not been subsequently amended.

TECHNICAL AMENDMENTS BILL:

This citation will refer to Assembly Bill No. 2849, most recently amended by the Senate on June 15, 1976. The bill embodies amendments to the new law which are primarily technical in nature, and are designed to cure ambiguity and eliminate inconsistency in the new law, and resolve limited substantive problems of drafting which scrutiny of the new law has uncovered. The bill was passed by the Legislature on August 18, 1976, and signed by the Governor on August 27, 1976, as Chapter 641 of the 1975-76 California Statutes. It will become effective at the same time as the original bill.

Although it will sometimes be true that certain subsections of a section have not been changed in any respect by the Technical Amendments Bill, we have thought it best to cite such subsections to the Technical Amendments Bill, since other subsections of the same section have been changed and may have affected the context in which the unchanged subsections should be read.

For example, while some subsections of section 1800 of the new law have been amended, others have not. All subsections of section 1800 will nonetheless be cited to the Technical Amendments Bill.

FIRST EXPOSURE DRAFT:

SECOND EXPOSURE DRAFT:

These conventions refer to early discussion drafts of the new law circulated by the Assembly Select Committee on Revision of the Corporations Code. The first draft was issued on July 12, 1974; the second was issued on October 4, 1974.

—*The Editors*
August 1976

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The *Review* has requested contributing authors to disclose any economic interests and affiliations which may have influenced the positions they have taken in leading articles. Pertinent information will be found in the author's footnote.

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INTRODUCTION[†]

Harold Marsh, Jr.*

California's new General Corporation Law, Chapter 682 of the Statutes of 1975, is a complete revision of the prior General Corporation Law, Division 1 of Title 1 of the Corporations Code as in effect prior to January 1, 1977.¹ Except with respect to certain private corporations organized under other laws, the new law replaces a statute which was enacted in 1931 and existed for some 45 years without major change.

Section 16 of the Bill enacting the new law generally provides that the prior law continues in effect with regard to private corporations organized under other laws which incorporate by reference any sections or portions of the General Corporation Law. The purpose of this section is to provide time for a review, by persons expert in the particular type of corporation, of other incorporation statutes to determine precisely which provisions of the new law should be made applicable to them and where a special provision is needed because of the special nature of the corporate enterprise. The major problem in this connection should be eliminated soon by the current project to revise the General Nonprofit Corporation Law being undertaken by the California Law Revision Commission and the Assembly Select Committee on Revision of the Corporations Code.

The primary objective in drafting the new law was "to modernize and streamline the General Corporation Law so as to embody principles and procedures designed to facilitate the conduct of business in a modern economy while maintaining and expanding upon this state's traditional protection of the rights of share-

[†] Copyright © 1976 by Harold Marsh, Jr.

* Principal draftsman of the California General Corporation Law revision (Chapter 682, California Statutes of 1975); member of the California bar.

¹ Division 1 of Title 1 of the Corporations Code as in effect prior to January 1, 1977 is hereinafter referred to as the "prior law"; Division 1 of Title 1 of the Corporations Code as in effect on and after January 1, 1977 is hereinafter referred to as the "new law."

holders and creditors."² Although considerable attention was given to the prior law and to the case law of this state in drafting the new law, the changes in both substance and form contained in the new law are so comprehensive that the revision must be viewed as new legislation.³ There was no intent merely to amend the prior law.

Any legislative enactment is responsive to the problem for which a solution is sought. Therefore, in order to understand the new law, it is useful to review briefly the history of California's General Corporation Law. Similarly, the history of the revision project is instructive in comprehending the new law.

A Brief History of the General Corporation Law.

In the early nineteenth century, corporations were formed either by specific legislative act or pursuant to corporation statutes which authorized the organization of corporations for a particular type or several types of enterprises. Examples include a 1795 North Carolina statute permitting incorporation for the purpose of cutting canals and an 1811 New York statute applicable only to corporations formed to manufacture textiles, glass, metals and paint.⁴ Gradually, all American jurisdictions adopted general incorporation statutes authorizing the formation of corporations for any lawful business purpose (with certain exceptions still governed by special statutes).

California's first constitution, the Constitution of 1849, provided that "[c]orporations may be formed under general laws, but shall not be created by special act, except for municipal purposes."⁵ The first session of the Legislature enacted "An Act Concerning Corporations" which provided for the formation, financing, operation and dissolution of corporations.⁶ However, under this act corporations could be formed only for specified purposes set forth in the chapters dealing with particular types of corporations. For instance, insurance companies, railroad companies, companies to construct turnpike roads or plank roads and companies for manufacturing, mining, mechanical or chemical purposes were specifically dealt with.

Although many of these specific provisions relating to particular types of corporations were later repealed, they were replaced

² Report of the Assembly Select Committee on Revision of the Corporations Code 1-2 (1975).

³ *Id.* at 2.

⁴ 1 MODEL BUS. CORP. ACT ANN. 2d § 3, ¶ 2 (1971).

⁵ CAL. CONST. art. IV, § 31 (1849).

⁶ Law of April 22, 1850, ch. 128, [1850] Cal. Stat. 347.

by statutes providing even more comprehensive treatment of corporations for particular purposes. The following description of this period is illustrative of the trend and the ensuing problem created thereby.

Although there were general statutes authorizing the formation and providing for the powers of corporations, a large number of amendments and independent supplementary provisions had been enacted, many of them being of an overlapping nature; and there was scarcely a legislative session during this entire period which had not adopted one or more statutes specifically authorizing the formation of corporations for particular purposes. The provisions of many of these statutes differed in significant details such as the number of incorporators required, necessary contents of articles of incorporation, requirements with regard to capitalization, and other details.⁷

This wide array of diverse provisions was consolidated by the Civil Code of 1872 which provided, in Division First, for a law of corporations embracing both general rules and specific statutory provisions relating to the formation and powers of, and limitations upon, particular types of corporations. The intent of the draftsmen of the Civil Code with respect to the field of corporation law was "to consolidate the best portions of the several statutes into a single codified general corporation law which, as to matters common to all, would 'place all corporations on an equal footing and under a general system of uniformity.'"⁸ Whenever necessary the Civil Code retained as separate subtitles special provisions relating to particular corporations.

Subsequent to the enactment of the Civil Code of 1872, the statutory provisions dealing with corporations, both general and relating to particular types of enterprises, were subject to various amendments, additions and deletions. However, most changes were limited to those sections dealing with specific types of corporations. For instance, a major revision was effected in 1891 in provisions relating to building and loan associations.⁹ In 1905, a new chapter was added to the Civil Code dealing with foreign corporations.¹⁰

In 1928, a project was initiated by the California State Bar Committee on Corporations to prepare a complete revision of the California General Corporation Law.¹¹ At the legislative session

⁷ Van Alstyne, *The California Civil Code*, CAL. CIV. CODE 14 (West 1955) (footnotes omitted).

⁸ *Id.*

⁹ Law of March 31, 1891, ch. 174, [1891] Cal. Stat. 252.

¹⁰ Law of March 21, 1905, ch. 471, [1905] Cal. Stat. 630.

¹¹ *Deficiencies in California Corporation Law*, 2 CALIF. ST. B.J. 252 (1928).

in 1929, the legislators proposed to the voters the repeal of the outmoded constitutional provisions which prevented the adoption of a modern corporation law, such as the provisions relating to proportional liability of the shareholders of a corporation. These constitutional amendments were adopted by the voters at the 1930 general election, effective November 4, 1930.¹² At the same 1929 legislative session a large number of amendments were adopted to the General Corporation Law based upon preliminary drafts of the revision being undertaken by the State Bar Committee on Corporations.¹³ This effort culminated in 1931 when an entirely new General Corporation Law proposed by the State Bar Committee on Corporations was adopted by the Legislature.¹⁴ (Subsequently, extensive technical amendments were made to the new statute at the 1933 session to correct ambiguities and oversights.)¹⁵

The purpose and intent of the 1931 General Corporation Law were stated by Professor Henry W. Ballantine, the principal draftsman for the State Bar Committee on Corporations, in language which retains its pertinency in connection with the latest revision, if changes in circumstances in the intervening 45 years are taken into account.

It has been the work of the committee of The State Bar to make a courageous, thorough revision of the Constitution and the laws relating to corporations, seeking to improve the code in language and substance, to do away with crude, antiquated and burdensome restraints upon the corporate mechanism, and reconstruct it as a modern business instrumentality. These efforts have lasted over a period of more than three years and have been carried on in the light of the work done recently in Ohio and other states. . . . There has been no slavish copying of the statutes of Delaware or Ohio or any one or more states, but each provision has been carefully worked over, revised and tested independently. The committee has recognized the necessity of exposing its work to the intelligent criticism of the bar and has published drafts and reports and has sought the support and cooperation of all those interested in corporations. An extensive correspondence has been carried on with experts within and without the state and many valuable criticisms and suggestions were obtained and utilized.

We have finally achieved a code of corporation laws as liberal and favorable in all substantial respects as the corporation laws of Delaware or any other state, but more concisely

¹² Gorrill, *What the State Legislature Did for Corporation Law Revision*, 3 CALIF. ST. B.J. 262 (1929); Ballantine, *Progress in Revision of the Corporation Laws*, 6 CALIF. ST. B.J. 3 (1931).

¹³ See authorities cited in note 12 *supra*.

¹⁴ Law of June 12, 1931, ch. 862, [1931] Cal. Stat. 1762.

¹⁵ Law of May 24, 1933, ch. 533, [1933] Cal. Stat. 1358.

expressed and more conveniently classified, and with more protection of the rights of preferred shareholders and other investors. We have not attempted to out-Delaware Delaware. The law of Delaware is in some respects unconscionably lax, particularly in such matters as the purchase of shares and the payment of dividends out of paid-in surplus, which may prejudice creditors and mislead the investing public.¹⁶

The 1931 General Corporation Law, as fine-tuned in 1933, was codified without substantial change in 1947 at the time of the enactment of the Corporations Code, thereby transferring it from the Civil Code to the Corporations Code. Except for numerous amendments from time to time of detailed provisions (including some significant substantive changes), which frequently resulted in inconsistencies between different portions of the law, the General Corporation Law as enacted in 1931 and codified in 1947 remained on the whole substantially the same until it was replaced by the new law.

A Brief History of the Revision Project.

The revision project which will result in a new General Corporation Law in 1977 was, like the 1931 project, to a large extent the result of the efforts of the State Bar Committee on Corporations, although this time it was done in cooperation with a special committee of the California Legislature—the Assembly Select Committee on the Revision of the Corporations Code, chaired by Assemblyman John T. Knox of Richmond and having as its other members Assemblymen Beverly, Kapiloff, McAlister and Maddy (Vice-Chairman).

When Anthony R. Pierno became Chairman of the State Bar Committee on Corporations in 1971, he conceived the idea of having the Committee work on a complete revision of the General Corporation Law and later secured authority from the Board of Governors for the Committee to undertake that project. The Committee was enlarged and its membership revised in light of this major project to be undertaken. Mr. Pierno interested Assemblyman Knox in the project and Knox secured authorization from the Speaker of the Assembly in 1973 for the creation of the Assembly Select Committee mentioned above.

The major detailed work on the revision commenced in January, 1974 after the author was designated by the State Bar Committee as the principal draftsman of the new statute, and R. Roy Finkle was employed as a Consultant to the Assembly Select Committee to work full-time on this project.

¹⁶ Ballantine, *Major Changes in California Corporation Law*, 6 CALIF. ST. B.J. 159, 160-61 (1931).

During the course of the following year and nine months, until the Bill enacting the new General Corporation Law was signed by the Governor on September 12, 1975, the State Bar Committee and the Assembly Select Committee held joint meetings to review successive drafts of portions of the new statute and consider proposals and suggestions from all interested parties, together with their comments on the preliminary drafts circulated. Altogether these meetings occupied 20 full days, with some of the meetings lasting two or three days.

In order to solicit the assistance and the comments of all interested attorneys and others in the project, a succession of exposure drafts and printed Bills was distributed. Each local bar association was requested by the State Bar to appoint a liaison representative to follow the progress of the project and to furnish the input of his local association to the State Bar Committee. In addition, each law school in the state was requested to designate a faculty representative as liaison with the Committee; and the assistance of the individual members of the American Bar Association's Committee on Corporate Laws was actively solicited. On July 12, 1974 an Exposure Draft of the entire text of the proposed new statute was distributed, and a revised Exposure Draft No. 2 was distributed on October 4, 1974. Then, a "Preprint Bill" in printed form was distributed in November, 1974. Finally, the Bill as introduced in January, 1975 was given the same distribution, as well as subsequent versions of the Bill reflecting amendments made during its progress through the Legislature.

During the course of the current year (1976), the State Bar Committee has been engaged in considering proposed technical amendments to the statute as enacted in 1975 for the purpose of curing ambiguities and oversights, as was found to be necessary in 1933. It was with a recognition that such a review would be required that the effective date of the Bill signed by the Governor on September 12, 1975 was postponed to January 1, 1977. The amendatory Bill (A.B. No. 2849) was enacted and signed by the Governor on August 27, 1976, as Chapter 641 of the 1975-76 California Statutes. It will become effective at the same time as the original Bill.

Summary of the Major Changes Accomplished by the New General Corporation Law.

The major revisions made by the new statute in California corporation law were outlined by the author in a memorandum which was presented to the Assembly Judiciary Committee and (with changes to reflect amendments in the Assembly) to the Senate Judiciary Committee in connection with their consideration of

the legislation. As indicated above, there were also innumerable other changes of greater or lesser significance, but the ones outlined in this memorandum were considered by the committees to be the most significant. In view of the fact that this memorandum constitutes a portion of the legislative history of the new General Corporation Law, I am setting it forth below.

However, paragraph two of the memorandum discussing cumulative voting has been omitted, since the Legislature did not adopt the recommendation of a majority of the State Bar Committee that cumulative voting be made optional, but voted to retain the mandatory cumulative voting requirement of prior California law. The only other significant substantive change with respect to the major policy decisions discussed in this memorandum, relating to the maximum number of shareholders in a close corporation, is noted at the appropriate place in the memorandum. The page references in the memorandum to the Bill as originally introduced have also been deleted.

“1. *The ‘Close Corporation’ Provisions.*

“The Bill contains a number of provisions applicable only or primarily to a newly defined category of corporations identified as ‘close corporations.’ There are no such provisions in the present law, which treats all corporations in exactly the same manner, whether the corporation is in effect an incorporated partnership of two shareholders or a corporation with the size and number of shareholders of General Motors. The general intention of the new provisions is to permit a corporation which is within this new category, and which elects to be treated as such, to be operated without rigid corporate formalities and restrictions, more or less in the manner of a partnership.

“Section 158 of the Bill defines a close corporation as one which has 35 or fewer shareholders [this maximum number of shareholders in a statutory close corporation was later changed to 10] and which includes in its Articles a statement that the corporation is a close corporation. Section 300 provides that by a shareholders’ agreement, which is defined in Section 186 as a written agreement among *all* of the shareholders of a close corporation, the owners may regulate the affairs of that corporation with respect to management of its business, division of profits, distribution of assets on liquidation and in other respects as they see fit. Such an agreement may not, however, alter the restrictions on the payment of dividends or distribution of assets which are for the protection of creditors or change the rights of the shareholders with respect to initiating a dissolution of the corporation as provided in Chapter 18.

"Section 418(c) requires that the certificates representing shares in such a close corporation contain a legend which will warn any prospective purchaser as to the special nature of the corporation.

"Section 706 provides that two or more of the shareholders of a close corporation may enter into a voting agreement, without restriction as to the duration of such agreement. Section 705(e) validates a proxy which is given to vote shares pursuant to such an agreement entered into by the shareholders of a close corporation.

"The general intent and effect of these provisions is to permit the shareholders of a close corporation to regulate their relationships in a manner which is negotiated among them, without being prohibited by what has been called the 'corporate norm' from accomplishing perfectly proper and legitimate business objectives.

"Section 1800 dealing with involuntary dissolution contains provisions designed to protect the shareholder of a close corporation from oppression as a result of the greater freedom which is permitted with respect to private arrangements, such as those referred to above. That section provides that any one shareholder of a close corporation may file a complaint for involuntary dissolution, although the normal requirement is that one-third of the shareholders must petition for such a dissolution. The section also provides that in the case of a corporation with 35 or fewer shareholders (which would include all close corporations), a ground for dissolution may be merely that liquidation of the corporation is reasonably necessary for the protection of the rights or interests of the complaining shareholder. This permits the court in an appropriate case to intervene to protect the interests of a shareholder of a close corporation where conditions have so changed since the original arrangement was entered into by him that it has become oppressive or highly inequitable.

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"3. '*Pseudo-Foreign*' Corporations.

"The present General Corporation Law generally applies only to corporations which are incorporated in California. Those provisions, with the exception of a very few relating to inspection of records and the like, are not applicable to any corporation which is incorporated in another State, even though all of its business may be done in California and all of its shareholders reside in California, so that its only contact with the State of its incorporation is the existence of a piece of paper in the Secretary of State's office.