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The ABA Model Statutory Close Corporation Act: A New Opportunity for "Made In Montana" Corporations

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THE ABA MODEL STATUTORY CLOSE CORPORATION ACT: A NEW OPPORTUNITY FOR "MADE IN MONTANA" CORPORATIONS

Steven C. Bahls* and Marcelle Compton Quist**

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I. Introduction

Effective October 1, 1987, all new Montana corporations and all existing Montana corporations with twenty-five or fewer shareholders may elect the special benefits of the Montana Close Corpo-

ration Act.[1] The Montana Close Corporation Act is virtually identical to the American Bar Association's Model Statutory Close Corporation Act. Benefits available to all corporations electing coverage under the MCCA include increased assurances against loss of shareholder's limited liability, statutorily sanctioned restrictions on transfer, and decreased corporate formalities. The MCCA also includes optional provisions which permit corporations to operate as a partnership, to abolish the board of directors, or to operate with a statutorily mandated repurchase of shares upon the death of shareholders. The MCCA is particularly suited for Montana because most Montana businesses are small businesses. This article analyzes (1) the problems faced by close corporations which are not adequately addressed by the Montana Business Corporation Act,[2] (2) how the MCCA addresses those problems and (3) describes when corporations should elect the benefits of the MCCA.

II. Problems of Close Corporations and Pre-MCCA Attempted Solutions

Close corporations are a special breed of corporations with a special set of problems. Although many commentators have offered different definitions of the term "close corporation," no one definition is universally accepted.[3] A common thread, however, through most definitions is that close corporations resemble "incorporated partnerships." The Montana Supreme Court definition of close corporation properly focuses upon the relationship between management and ownership: "a close corporation is one in which the management and ownership are 'substantially identical to the extent that it is unrealistic to believe that the judgment of directors will be independent of that of the stockholders.' "[4] The Supreme Court's definition of a close corporation highlights the fundamental problem of close corporations. Because close corporations usually have identical ownership and management, forcing close cor-

1. The Montana Close Corporation Act, for the sake of brevity, will be referred to as MCCA. MCCA has been codified as Mont. Code Ann. ch. 9, tit. 35 (1987).

2. Prior to the MCCA, all business corporations incorporated in Montana operated under the provisions of the Montana Business Corporation Act found at Chapter 1 of Title 35 of the Montana Code Annotated. Under MCCA, electing corporations will operate under Mont. Code Ann. ch. 9, tit. 35 (1987) and to the extent it has not been modified by chapter 9, Mont. Code Ann. ch. 1, tit. 35 (1987).

3. 1 F. O'Neal, Close Corporations § 1.02 (3d ed. 1987); *see also* Israels, *The Close Corporation and the Law*, 33 Cornell L. Rev. 488, 491 (1948).

4. Thisted v. Tower Mgmt. Corp., 147 Mont. 1, 14, 409 P.2d 813, 820 (1966) (quoting Symposium, *The Close Corporation*, 52 Nw. U.L. Rev. 345 (1957)). *See also* Gray v. Harris Land & Cattle Co., ___ Mont. ___, ___, 737 P.2d 475, 476 (1987); Skierka v. Skierka Bros., ___ Mont. ___, ___, 629 P.2d 214, 221 (1981).

porations to comply with the Montana Business Corporation Act is like trying to fit a square peg into a round hole.[5] Specifically, close corporations face these problems:

> *Potential loss of limited liability.* When owners of a corporation disregard corporate formalities and undercapitalize the corporation, there is a risk the courts will "pierce the corporate veil" by holding owners liable for the debts of the corporation.[6]
>
> *Shift of decisionmaking from a consensus of the owners to a majority of owners.* When the owners collectively own the corporations, they usually expect to make decisions by consensus. The Montana Business Corporation Act, however, gives the majority shareholders virtually all of the power to control the business, to the exclusion of the minority.[7]
>
> *Difficulty in retaining control within the original group of owners.* When all shareholders agree that each will have a voice in management, owners usually desire to limit transfers to outsiders. Stock in corporations, however, is usually freely transferable.[8]
>
> *Difficulty of shareholders to realize the value of their investment.* Because there is no established market for close corporation stock, shareholders and their estates have difficulty realizing the value of their investment.[9]
>
> *Difficulty in resolutions of owner deadlock.* Deadlock between directors and shareholders does not pose a significant problem for publicly held corporations as disgruntled shareholders can easily sell their shares. Because of the small number of shareholders and directors in most close corporations, deadlocks more frequently occur.[10] Unfortunately, the Montana Business Corporation Act does not provide courts with the necessary tools to resolve deadlocks.[11]

While courts and legislatures have been aware of these problems, until the passage of the MCCA, they have failed to remedy fully these problems.

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5. This comparison between close corporations and the state corporation laws was first noted in Wolens, *A Round Key—A Square Hole: The Close Corporation and the Law*, 22 Sw. L.J. 811 (1968).

6. *See infra* text accompanying notes 73-75.

7. *See infra* text accompanying notes 81-84.

8. *See infra* text accompanying notes 104-122.

9. *See infra* text accompanying notes 129-133.

10. In 1968, Montana adopted new corporation law "derived in large measure from the Model Business Corporation Act of the American Bar Association modified to meet the specific needs of this state." Note, *Introduction to the Montana Business Corporation Act*, 29 MONT. L. REV. 163 (1968) (authored by James A. Poore III).

11. *See infra* text accompanying notes 92-102.

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A. *Legislative Efforts to Address Problems of Close Corporations*

The authors of the Model Business Corporation Act and the Montana Legislature have attempted to provide for the problems of close corporations. The American Bar Association has promulgated changes in the Model Business Corporation Act to enable incorporators to tailor the governing documents of a close corporation to meet their special needs. These provisions, adopted in 1968 by the Montana legislature as part of the Montana Business Corporation Act, permitted the articles of incorporation to include provisions restricting the transfer of shares[12] and permitting actions by shareholders and directors without meetings.[13] The Model Business Corporation Act allows those drafting charter documents for close corporations the ability to tailor articles for some of the needs of the corporation. Prior to the MCCA, Montana had not opted for a separate statutory scheme for close corporations as had many other states.[14] While the authors[15] of the Model Business Corporation Act may have believed these special provisions adequately addressed the needs of close corporations,[16] experience demonstrates the deficiencies of the Model Business Corporation Act.[17]

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12. MONT. CODE ANN. § 35-1-202(1)(h) (1978). This provision was deleted in 1981 in favor of MONT. CODE ANN. § 35-1-617 (1987) which broadened the rules concerning restriction on transfers of shares.

13. MONT. CODE ANN. §§ 35-1-405, -509 (1987); *See* text, *supra* note 10.

14. *See* Israels, *The Close Corporation and the Law*, 33 CORNELL L. REV. 488 (1948); Rutledge, *Significant Trends in Modern Incorporation Statutes*, 22 WASH. U.L.Q. 305, 339 (1937); Weiner, *Legislative Recognition of the Close Corporation*, 27 MICH. L. REV. 173 (1929); Winer, *Proposing a New York "Close Corporation Law,"* 28 CORNELL L. REV. 313 (1943).

15. One might speculate those drafting the Model Business Corporation Act did not have the needs of close corporations in mind. The Act was largely drafted by three members of the Chicago bar, Garrett, *History, Purpose and Summary of the Model Business Corporation Act*, 6 BUS. LAW. 1 (1950), at least two of which practiced in the LaSalle Street financial district. *Id.* at i.

16. *See* MODEL BUSINESS CORP. ACT ANN. § 35 Special Comment—Close Corporation (2d ed. 1971). *See also* Karjala, *A Second Look at Special Close Corporation Legislation*, 58 TEX. L. REV. 1207, 1227 (1980).

It is interesting to note that by adopting the Model Business Corporation Act, the Montana legislature actually removed a provision of the then existing law tailored to the special needs of close corporations. The adoption of the Model Business Corporation Act cancelled Montana's close corporation special dissolution provision, REV. CODE MONT. § 15-1119 (1947), that allowed any shareholder who owned greater than 25 percent of the shares for more than six months to file for dissolution. This provision did not apply "to any corporation whose capital stock is offered to the public or to any corporation whose stock is listed on any established stock exchange."

17. For a detailed description of these deficiencies, *see supra* text accompanying notes 73-102.

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Faced with the growing awareness of the reality of shareholder management of a close corporation, in 1981 the Montana legislature adopted the American Bar Association endorsed amendments[18] to the Model Business Corporation Act that provided for some of the needs of close corporations. At the same time, the legislature enacted two significant deviations from the Model Business Corporation Act in order to further accommodate the special problems of close corporations.[19] The first provision,[20] based on New York Corporation Law,[21] allows shareholders to restrict the power of the board of directors to manage the corporation. The statute allows the shareholders to delegate board authority to themselves or one or more persons selected by the shareholders. Significantly, the provision modifies the common law rule that directors cannot delegate certain board powers.[22] This provision, however, does not adequately address the problems of close corporations.[23] It does not address the problem of keeping control of the business within the original shareholder group and does not provide the courts with broad equitable powers to resolve disputes. In addition, while the statute addresses the desire of certain shareholders to dispense with a board of directors, it also imposes liabil-

18. For example the Montana Business Corporation Act was amended to eliminate the requirement of three directors and replace it with a requirement of only one director. The new amendments also allowed private voting agreements between shareholders. *See also* Beed, Brown, & Wyse, *Significant Changes in the Montana Business Corporation Act and the Montana Limited Partnership Act*, 19 MONT. BUS. Q. 29 (Winter 1981).

19. In describing the need for one of these deviations from the ABA Model Act, the Official Comments to the Montana Business Corporation Act state:

> As most Montana corporations are closely held and have the shareholders serving directly as officers and directors, the formal distinction between directors and shareholders, as contemplated by present law, is meaningless. In addition, the present system in small corporations requires unnecessary special meetings of the board, properly documented, which typically are prepared after the fact, if at all.

Montana Legislative Council, MONT. CODE ANN. Annotations § 35-1-515, at 70 (1985).

20. MONT. CODE ANN. § 35-1-515 (1987).

> A provision in the articles of incorporation otherwise prohibited by law because it improperly restricts the board of directors in its management of the business of the corporations or improperly transfers to one or more shareholders . . . all or any part of such management, otherwise within the authority of the board under this chapter shall nevertheless be valid [if certain requirements are met].

21. N.Y. BUS. CORP. LAW. § 620 (McKinney 1986). The law in New York was defined as the "most important accommodation to the close corporation's peculiar needs." Kessler, *The Shareholder-Managed Close Corporation Under the New York Business Corporation Law*, 43 FORDHAM L. REV. 197 (1974). The provision expanded the common law created in Clark v. Dodge, 269 N.Y. 410, 199 N.E. 641 (1936) by upholding unanimous shareholder agreements that infringe on the board of directors' direct powers. The new provision also overruled the subsequent decision in Long Park, Inc. v. Trenton-New Brunswick Theatres Co., 297 N.Y. 174, 77 N.E.2d 633 (1948).

22. *See infra* note 40.

23. Kessler, *supra* note 21, at 215.

ity on those shareholders for the managerial acts (or omissions) of the delegatee.[24] Possibly as a result, this section of the statutes has almost gone unused by close corporations in Montana.[25]

In the second significant departure from the Model Business Corporation Act, the Montana legislature borrowed from Delaware law a provision which allows a corporation to restrict the transferability of stock.[26] This provision promulgates rules governing when restrictions on transfers of stock are allowed and explicitly permits, among other restrictions, rights of first refusal, consent restrictions and mandatory purchase upon death. The statute provides more certainty than the common law rule which enforces only reasonable restrictions.[27] These restrictions allow close corporations to keep the business "in the family" by restricting the ability of shareholders to transfer their stock to others without the consent of other shareholders or without first offering it to the corporation. Close corporations represented by attorneys experienced with business law commonly use these restrictions.

Recognizing a continuing need in Montana for a separate set of corporation laws specifically governing close corporations,[28] the Montana legislature adopted the new Montana Close Corporation Act in 1987. The MCCA is virtually identical to the American Bar Association Model Statutory Close Corporation Supplement,[29] ex-

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24. MONT. CODE ANN. § 35-1-515(5) (1987). This liability is imposed only if the shareholders voted for the delegation of power. As a result, inactive shareholders are hesitant to authorize the election of the provisions of MONT. CODE ANN. § 35-1-515 (1987) and if they do authorize the delegation of board powers, they may be liable, as directors, for actions taken by majority shareholders which are beyond the control of minority shareholders. The Montana Close Corporation Act, on the other hand, expressly states that shareholders are "not liable for [a director's] act or omission, even though a director would be, unless the shareholder was entitled to vote on the action." MONT. CODE ANN. § 35-9-302(3)(c) (1987).

25. Reliable statistics identifying the numbers of Montana corporations electing the benefits of MONT. CODE ANN. § 35-1-515 (1987) do not exist because these statistics are not compiled by the Secretary of State. The authors' review of all incorporations in January of 1985 failed to reveal any provision in any of the Articles of Incorporation authorizing the control of directors by shareholders as permitted by the statute.

26. MONT. CODE ANN. § 35-1-617 (1987). The Delaware provision has subsequently been substantially incorporated into the Revised Model Business Corp. Act (1984) at § 6.27.

27. See Arthur Murray Dance Studios v. Witters, ____ Ohio Misc. ____, 105 N.E.2d 685 (Ct. Common Pleas 1952) for a good discussion of the common law.

28. As second-year law students, Amy N. Guth and Marcelle Compton Quist successfully pursued the adoption of the American Bar Association's Model Statutory Close Corporation Act after a lecture in a corporations course at the University of Montana School of Law. Ms. Guth and Ms. Quist, with the support of Professor Steven C. Bahls, lobbied for the enactment of the Montana Close Corporation Act. Representative Gary L. Spaeth, of Silisea, sponsored the bill in the House. Senator Joseph P. Mazurek, of Billings, sponsored the bill in the Senate. The bill was easily approved by the legislature, was signed by the governor, and, on October 1, 1987, became law.

29. The American Bar Association Model Statutory Close Corporation Supplement,

cept that the MCCA provides that an *existing* corporation may elect its benefits if the corporation has twenty-five or less shareholders,[30] while the ABA Supplement uses fifty as the maximum number.[31] New corporations may have any number of shareholders and still elect the provisions of the Act.[32]

Currently only one other state, Wisconsin, has adopted the ABA Model Act. Twenty-three other states, however, have adopted either separate or integrated close corporation provisions.[33] Significantly, with the adoption of the MCCA, Montanans need not incorporate their business in another state in order to realize the flexibility and protections heretofore afforded only by those states adopting special provisions for close corporations.[34]

B. *Judicial Efforts to Address Problems of Close Corporations*

The Montana legislature was not alone in recognizing the special problems facing close corporations. Commentators, as well as the courts of Montana and other states, have recognized the need for flexibility in the application of corporate statutes to problems faced by close corporations.[35]

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for the sake of brevity, will be referred to as the ABA Supplement.

30. MONT. CODE ANN. § 35-9-103 (1987). At the request of Rep. Kelly Addy, of Billings, the bill was amended in the House Judiciary Committee to 25 shareholders to attempt to exclude any corporations that may not be "close corporations." No other changes were proposed or adopted in the legislative process.

Once a corporation elects statutory close corporation status, it is able to retain that status even if it has more than 25 shareholders. *See* 4 MODEL BUSINESS CORP. ACT ANN., Model Statutory Close Corporation Supplement (hereinafter referred to as the ABA SUPPLEMENT COMMENTS), § 3, comment at 1811 (1984) (corresponding to MONT. CODE ANN. § 39-9-103 (1987)).

31. ABA SUPPLEMENT COMMENTS, *supra* note 30, § 3 (1984).

32. MONT. CODE ANN. § 35-9-103(1) (1987).

33. 1 F. O'NEAL, *supra* note 3, § 1.15. These provisions are generally more detailed and comprehensive than MONT. CODE ANN. § 35-1-515 (1987).

34. The benefits of Montana based corporations incorporating in Montana rather than in another state include: (1) all fees and costs generate income to Montana, (2) only one report is required (foreign corporations doing business in Montana must be registered, produce annual reports and pay fees in both Montana and the other state) and (3) because foreign law governs foreign corporations, litigation involving those corporations is often brought in foreign courts. Although the defendants may argue the doctrine *forum non conviens* applies, courts in some states are quick to reject those arguments. Parvin v. Kaufmann, 43 Del. Ch. 461, 236 A.2d 425 (Sup. Ct. 1967). Some attorneys, however, regard the absence of an anti-takeover law as a disadvantage of incorporation in Montana.

35. 1 F. O'NEAL, *supra* note 3, § 1.20. *See also* Dickinson, *Partners in a Corporate Cloak: The Emergence & Legitimacy of the Incorporated Partnership*, 33 AM. U.L. REV. 559 (1984).

1. *Judicial Trends Generally*

The two most significant trends in common law regarding close corporations are the recognition of a fiduciary duty owed by majority stockholders to minority shareholders and the sanctioning of agreements among the shareholders to limit the power of the board. Numerous courts have determined that controlling shareholders in a close corporation owe a fiduciary duty to minority shareholders, just as partners in a partnership owe each other fiduciary duties.[36] For example, although Massachusetts statutes did not explicitly provide for a fiduciary duty between shareholders, the Massachusetts Supreme Judicial Court, in the landmark case of *Donahue v. Rodd Electrotype Co.*[37] held that shareholders in close corporations owe one another a fiduciary duty. Generally, at common law, shareholders in their capacity as shareholders did not owe a fiduciary duty to others and could act in their own self interest.[38] Likewise, the Montana Business Corporation Act does not provide for a fiduciary duty between shareholders, but only provides for a fiduciary duty of directors to the corporation and its shareholders.[39] Cases like *Donahue* create a fiduciary duty between shareholders not found in most state statutes.

In the second trend, the courts enforce agreements between shareholders which effectively restrict the power of the board. Under previous law, courts were hesitant to enforce agreements which unduly restricted the power of management.[40] Typical of the

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36. H. HENN & J. ALEXANDER, LAWS OF CORPORATION § 268 (3d ed. 1983).

37. 367 Mass. 578, 593, 328 N.E.2d 505, 515 (1975). The court held stockholders in the close corporations owe one another substantially the same fiduciary duties in the operation of an enterprise that partners owe to one another. *Id. See also* Holms v. Duckworth, 249 F.2d 482, 486-87 (D.C. Cir. 1957); Gord v. Iowana Farms Milk Co., 245 Iowa 1, 60 N.W.2d 820 (1953).

38. Litwin v. Allen, ___ A.D. ___, ___, 25 N.Y.S.2d 667, 677-78 (Sup. Ct. 1940). *See* Tarver, *The Arrogance of Corporate Power: A Study of the Evolution of Fiduciary Duty Owed by Management to the Corporation or its Shareholders*, 42 TUL. L. REV. 155 (1967); Note, *Fiduciary Duties of Majority or Controlling Stockholder*, 44 IOWA L. REV. 734 (1959).

39. MONT. CODE ANN. § 35-1-401(2) (1987).

40. *See* HENN & ALEXANDER, *supra* note 36, § 275, at 744-45. *See also* Hornstein, *Stockholders' Agreements in the Closely-Held Corporation*, 59 YALE L.J. 1040 (1950). *See also* Dillon v. Berg, 326 F. Supp. 1214 (D.C. Del. 1971); Abercrombie v. Davies, 35 Del. Ch. 599, 123 A.2d 893 (Ch. Ct.), *modified*, 36 Del. Ch. 102, 125 A.2d 588 (Ch. Ct. 1956), *rev'd on other grounds*, 136 Del. Ch. 371, 130 A.2d 338 (Sup. Ct. 1957). Long Park, Inc. v. Trenton-New Brunswick Theatres Co., 297 N.Y. 174, 77 N.E.2d 633 (1948); McQuade v. Stoneham, 263 N.Y. 323, 189 N.E. 234 (1934); Fells v. Kutz, 256 N.Y. 67, 175 N.E. 516 (1931); Redmond v. Redmond, 42 A.D.2d 542, 345 N.Y.S.2d 12 (1973); *In re* Hirshon's Will, 220 A.D.2d 451, 221 N.Y.S.2d 583 (1961), *aff'd*, 233 N.Y.S.2d 1018 (Sup. Ct. 1962), *modified*, 13 N.Y.2d 787, 192 N.E.2d 173, 242 N.Y.S.2d 218 (1963). *But see* Zion v. Kurtz, 50 N.Y.2d 92, 405 N.E.2d 681, 428 N.Y.S.2d 199 (1980); Adler v. Svingas, 80 A.D.2d 764, 436 N.Y.S.2d 719 (1981); Gazda v. Kalinski, 91 A.D. 860, 458 N.Y.S.2d 387 (1982).

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new trend, in *Galler v. Galler*,[41] the Illinois Supreme Court upheld a shareholder agreement specifying numerous dividends and a salary to an employee's widow.[42] The court determined that the need of the close corporation for flexibility outweighed a firmly entrenched policy of the board of directors exclusively making policy decisions requiring dividends and salaries. Noting that "there has been a definite, albeit inarticulate, trend toward eventual judicial treatment of the close corporations as *sui generis*,"[43] the court concluded that it could "no longer fail to expressly distinguish between close and public-issue corporations where confronted with problems relating to others."[44] The court reached this conclusion even though the Illinois business corporations statutes do not distinguish between close corporations and publicly held corporations. The *Galler* case demonstrates the trend toward courts upholding shareholder agreements which deprive the board of managerial powers.[45] It is not safe, however, to conclude that shareholder agreements are always enforceable as several courts have not followed this trend.[46]

2. *Judicial Trends in Montana*

Montana courts have followed the trend of fashioning special rules to meet the unique needs of close corporations. The Montana Supreme Court in *Skierka v. Skierka Bros. Inc.*,[47] *Fox v. 7L Bar Ranch, Inc.*,[48] and *Maddox v. Norman*,[49] demonstrated its willingness to treat close corporations by different standards than publicly held corporations.[50] In recent years, the Montana Supreme Court has addressed the treatment of shareholders in a close corporation more often than virtually any other state supreme court.

In *Skierka*, a widow and her daughter brought an action

41. 32 Ill. 2d 16, 203 N.E.2d 577 (1964).

42. *Id.* at 34, 203 N.E.2d at 587.

43. 32 Ill. 2d at 28, 203 N.E.2d at 584.

44. 32 Ill. 2d at 31, 203 N.E.2d at 585.

45. Cressy v. Shannon Cont. Corp., 170 Ind. App. 224, 378 N.E.2d 941 (1978); Hallahan v. Holton Corp., 7 Mass. App. Ct. 68, 385 N.E.2d 1033 (1979); Henderson v. Joplin, 191 Neb. 827, 217 N.W.2d 920 (1974); Zion v. Kurtz, 50 N.Y.2d 92, 405 N.E.2d 681, 428 N.Y.S.2d 199 (1980); Jones v. Wallace, 48 Or. App. 213, 616 P.2d 575 (1980).

46. *See supra* note 40. The Montana Supreme Court has not yet directly addressed this issue since the beginning of this trend.

47. ___ Mont. ___, 629 P.2d 214 (1981).

48. 198 Mont. 201, 645 P.2d 929 (1982).

49. ___ Mont. ___, 669 P.2d 230 (1983).

50. In an additional recent case, Gray v. Harris Land & Cattle Co., ___ Mont. ___, 737 P.2d 475 (1987), where the case validated stock transfer restrictions, the court again dealt with the rights of shareholders in a close corporation.

against her brother-in-law, who controlled the corporation, for oppressive acts, among other things. The Montana Supreme Court sustained the trial court's holding that the following acts amounted to oppression:

•the brother-in-law dominated the management of the corporation;
•the brother-in-law refused to create an executive vice president position for the widow with power equal to his as president; and
•the brother-in-law refused to agree to reasonable stock valuation required by stock transfer restriction in the bylaws.

The defendant undoubtedly argued, because he was the majority shareholder, that there was no statutory or common law duty to allow the minority shareholders to participate equally.[51] The court, without determining whether the decisions made by the majority shareholder were in fact in the best interest of the corporation, held that the majority shareholder oppressed other shareholders. The court found oppression, as defined by section 35-1-921 of the Montana Code Annotated,[52] based solely on its finding that the minority shareholders were excluded from management.[53] Although all shareholders were board members, the court concluded that the majority shareholders still excluded the minority shareholders from management by consistently defeating their proposals. Candidly, the court held that "[o]ppression may be more easily found in a close-held, family corporation than in a larger public corporation."[54] The court justified the ruling, stating that "[b]y its very nature, intracorporate problems arising in a close corporation demand the unusual and extraordinary remedies available only in a court of equity."[55] The "intracorporate problem" referred to by the court was the problem caused by common management and ownership. Although the shareholders expect to manage the corporation by consensus, the statute forces the shareholders to operate with a board of directors acting on majority vote.[56] The court con-

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51. There was a separate issue whether there was fraud and mistake in the formation of the corporation and whether plaintiffs really understood they would be minority stockholders. ___ Mont. at ___, 629 P.2d at 218-20.

52. MONT. CODE ANN. § 35-1-921(i)(a), (ii) (1987) provides the court may liquidate the corporation if oppression is found.

53. ___ Mont. at ___, 629 P.2d at 221.

54. *Id.*

55. *Id.* (quoting Thisted v. Tower Mgmt. Corp., 147 Mont. 1, 14, 409 P.2d 813, 820 (1966)).

56. The board of directors' powers, however, may be restricted (MONT. CODE ANN. § 35-1-515 (1987)) and provisions can be made altering a pure majority vote (such as a unanimous vote or super majority). MONT. CODE ANN. § 35-1-405 (1987).

cluded that unless the parties could agree to the appropriate division of the corporation's property, the proper remedy for oppression was the draconian remedy of liquidation.[57]

In a second case, *Fox v. 7L Bar Ranch*,[58] the Montana Supreme Court again treated close corporations differently than their publicly held counterparts. *Fox* involved a dispute between family members over the operation of a close corporation. The court held that one faction of the family oppressed the other by excluding them from the management of the corporation. This oppression, according to the court, justified a dissolution of the corporation. The case is significant because it developed a " 'fiduciary duty' of good faith and fair dealing owed by a majority shareholder to the minority."[59] Oppression, the court held, should be measured by the "reasonable expectations of the minority shareholders in light of the particular circumstances of each case."[60] Because disputes are analyzed on a case-by-case basis, the court stated that it would consider the "special circumstances" underlying close corporations, including the shareholders' expected right to management and right to dividends.[61]

Specifically, the court noted:

> [t]he logic which supports judicial reluctance to interfere with dividend policies in large corporations does not apply to close corporations. Management in large corporations has no incentive to deny adequate dividends, for such a policy would result in lowered stock prices and the danger of a proxy fight or a takeover. However, in close corporations the dividend policy often reflects the personal financial needs of the controlling shareholders, and no market exists to reflect the dissatisfaction of other sharehold-

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57. ___ Mont. at ___, 629 P.2d at 222.

58. 198 Mont. 201, 645 P.2d 929 (1982).

59. *Id.* at 209, 645 P.2d at 933 (citing Fix v. Fix Material Co., 538 S.W.2d 351, 358 (Mo. App. 1976); Baker v. Commercial Body Builders, Inc., 264 Or. 614, 629-30, 507 P.2d 387, 394 (1973)).

60. *Fox*, 198 Mont. at 209-10, 645 P.2d at 933 (quoting *In re* Topper, 107 Misc. 2d 25, ___, 433 N.Y.S.2d 359, 365 (N.Y. Sup. Ct. 1980); O'Neal, *Close Corporations: Existing Legislation and Recommended Reform*, 33 Bus. Law. 873, 886 (1978); Afterman, *Statutory Protection for Oppressed Minority Shareholders: A Model for Reform*, 55 Va. L. Rev. 1043, 1063-64 (1969)). This type of standard was subsequently used by the court in defining the implied covenant of good faith and fair dealing in commercial transactions. *See* Nicholson v. United Pac. Ins. Co., ___ Mont. ___, 710 P.2d 1342 (1985).

61. *Fox*, 198 Mont. at 210-11, 645 P.2d at 933-34. Traditionally courts have been hesitant to order corporations to pay dividends, even though the shareholders may expect payment. *See* Brudney, *Dividends, Discretion, and Disclosure*, 66 Va. L. Rev. 85 (1980); Fischel, *The Law and Economics of Dividend Policy*, 67 Va. L. Rev. 699 (1981). *See also* Santarelli v. Katz, 270 F.2d 762, 768 (7th Cir. 1959); Kohn v. Birmingham Realty Co., 352 So. 2d 834, 836 (Ala. 1977). *But see* Miller v. Magline, Inc., 76 Mich. App. 284, 256 N.W.2d 761 (1977) (case discusses special dividend considerations in close corporations).

ers with this policy.[62]

Because the relationship of shareholders in a close corporation resembles the relationship of partners,[63] the court determined that the majority faction of the family had improperly excluded other family members from a voice in management and denied them a financial return.[64] The court, citing *Skierka*, articulated reasons for the rationale that oppression may be more easily found in close corporations.[65] When a public market exists, a dissatisfied shareholder may always sell his or her shares. Because shares in a close corporation do not have a public market, shareholders' oppression is more likely to exist. Without a public market, dissatisfied shareholders are left with little recourse other than petitioning a court for dissolution under the provisions of the Montana Business Corporation Act.[66] Hence, unless the minority shareholders' dissolution option is viable, the law enables unscrupulous majority shareholders to squeeze out minority shareholders.[67]

A year after *Fox*, the Montana Supreme Court decided the final case in the trilogy of close corporation cases. In *Maddox v. Norman*,[68] the court considered the problems of another ranch corporation where family members had split into factions. Again, the plaintiff argued that one faction was oppressing the other faction and requested a dissolution pursuant to the provisions of the Montana Business Corporation Act. In this case, the court refused to order a liquidation[69] because the ranch was an ongoing business and the court feared that the majority shareholders would lose the full value of their investment upon liquidation. Instead, in an extraordinary step, it fashioned a remedy not contemplated by the dissolution provisions of the Montana Business Corporation Act.[70] The court ordered the corporation to purchase the minority shareholders' stock to allow the majority shareholders to benefit from

62. *Fox*, 198 Mont. at 212, 645 P.2d at 934-35 (quoting Manne, *Our Two Corporation Systems: Law and Economics*, 53 VA. L. REV. 259, 280 (1967)).

63. *Fox*, 198 Mont. at 212, 645 P.2d at 935 (citing *In re* Topper, 107 Misc. 2d 25, ___, 433 N.Y.S.2d 359, 363-66 (N.Y. Sup. Ct. 1980); O'NEAL, OPPRESSION OF MINORITY SHAREHOLDERS § 7.14, at 521-22 n.7 (2d ed. 1975)).

64. *Id.* at 210, 645 P.2d at 934.

65. *See supra* text accompanying note 54.

66. MONT. CODE ANN. § 35-1-921 (1987).

67. *Fox*, 198 Mont. at 209, 645 P.2d at 933. *See also* F. O'NEAL, OPPRESSION OF MINORITY SHAREHOLDERS § 2.15; Exadaktilos v. Cinnaminson Realty Co., 167 N.J. Super. 141, 154-55, 400 A.2d 554, 560-61 (1979). *See also* MONT. CODE ANN. § 35-9-404 (1987).

68. ___ Mont. ___, 669 P.2d 230 (1983). This case was remanded and subsequently reviewed by the court on a related issue. ___ Mont. ___, 697 P.2d 1368 (1985).

69. *Id.* at ___, 669 P.2d at 237-38.

70. MONT. CODE ANN. § 35-1-921 (1987).

"the rightful fruits of their labors on the ranch while still allowing for a full accounting for corporate funds."[71] The court properly justified this extraordinary action by relying on its power to elect from a broad range of equitable remedies. Again, as in *Skierka*, it noted that by their "very nature, intracorporate problems arising in a close corporation demand the unusual and extraordinary remedy available only in a court of equity."[72]

C. *Problems Not Adequately Addressed by the Legislature and Courts Until the MCCA*

While the Montana legislature and the Montana Supreme Court have, prior to the MCCA, sheared the corners from the peg by taking positive steps to recognize and remedy the problems of close corporations, they remain unable to force the square peg into the round hole. Three problems remained until passage of the MCCA: (1) the failure of the statutes to deal with the core problems of close corporations; (2) the failure of corporations to use the protections provided by statute; and (3) the lack of guidance for the court as to equitable remedies available to resolve shareholder disputes.

1. *Failure of the Model Business Corporation Act to Take Into Account the Needs of Close Corporations*

Before the adoption of the MCCA, the Montana Business Corporation Act failed to address all of the special needs of a close corporation. Although the authors of the Model Business Corporation Act later updated the Model Business Corporation Act to address some attributes of an incorporated partnership, it still fell far short of addressing three concerns of a close corporation. The Montana Business Corporation Act never fully considered the needs in a close corporation for (1) retaining limited liability for shareholders even though corporate formalities are not strictly followed, (2) managing the corporation by consensus rather than an elected board of directors, and (3) providing a mechanism to keep control with the original group of owners.

a. *Failure to Follow Formalities*

Most close corporations neglect to follow all of the formalities required by the Montana Business Corporation Act. While most

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71. *Maddox*, ___ Mont. at ___, 669 P.2d at 238.

72. *Id.* at ___, 669 P.2d at 237 (quoting Thisted v. Tower Mgmt. Corp., 147 Mont. 1, 14, 409 P.2d 813, 820 (1966)).

close corporations do elect a board of directors and officers, many of these corporations fail to hold the required routine and formal meetings of directors and shareholders. In addition, these close corporations often informally and unlawfully delegate power away from the board and into the hands of the shareholders. By acting without formal authorization from the board of directors, the officers compound the problem of disregarding the statutory requirements. The result of these actions is twofold: an increased risk that the court will pierce the corporate veil, and increased confusion about whether corporate acts are effective because the acts are the result of unlawful delegation of corporate power.

Courts scrutinize a corporation's failure to follow all corporate formalities when analyzing whether the corporation is an alter ego or a mere instrumentality of its owners.[73] A finding by the court that one or more persons controlled or influenced the corporation is not enough to justify piercing the corporate veil.[74] Rather, "it is [also] necessary to demonstrate that the corporate cloak is utilized as a subterfuge to defeat public convenience, to justify wrong or to perpetrate fraud."[75] Under the MCCA, a provision specifically states that failure to follow the corporate formalities will not expose the corporation to liability from piercing the corporate veil,[76] thereby reducing the risk that a court will disregard the corporate veil.

Shareholders create a second problem when they unlawfully delegate the powers statutorily reserved to the board of directors, shareholders or others. Arguably, because the law prohibits a board of directors from delegating its powers, actual contracts purporting to transfer the power are invalid.[77] As a result, contracts made by individuals without lawful power may not be enforceable unless made with apparent authority or by actions subsequently ratified

73. *See* Comment, *Piercing the Corporate Veil in Montana*, 44 MONT. L. REV. 91, 96 (1983) (authored by Jody J. Brewster). *See also* E.C.A. Envtl. Management Servs., Inc. v. Foenyes, ___ Mont. ___, 679 P.2d 213 (1984); Scott v. Prescott, 69 Mont. 540, 561, 223 P. 490, 497 (1924); Hanson Sheep Co. v. Farmers & Traders State Bank, 53 Mont. 324, 336, 163 P. 1151, 1154-55 (1917).

74. Meridian Minerals Co. v. Nicor Minerals, Inc., ___ Mont. ___, 742 P.2d 456 (1987); State *ex. rel.* Monarch Fire Ins. Co. v. Holmes, 113 Mont. 303, 309, 124 P.2d 994, 996 (1942).

75. *E.C.A. Envtl. Management Servs., Inc.*, ___ Mont. ___, 679 P.2d 213 (1984); Monarch Fire Ins. Co. v. Holmes, 113 Mont. 303, 308, 124 P.2d 994, 996 (1942). *See also* Wortman v. Griff, 200 Mont. 528, 535-36, 651 P.2d 998, 1004 (1982).

76. MONT. CODE ANN. § 35-9-306 (1987).

77. *See* Kennerson v. Burbank Amusement Co., 120 Cal. App. 2d 157, 260 P.2d 823 (1953); Wheeler v. Layman Found., 188 Ga. 267, 271, 3 S.E.2d 645, 648 (1939).

by the contract.[78]

While the corporation may delegate much of the authority of the board to executive committees or to a designated individual,[79] close corporations usually fail to formally delegate the authority as required. By allowing shareholders to operate the corporation without a board of directors (or with a board of directors with limited power), the MCCA simply codifies the common corporate practices into the statute.[80]

b. *Management by Consensus*

Although the Montana Business Corporation Act mandates that the board of directors manage the corporation,[81] in practice the shareholders in a close corporation usually manage the corporation. As in a partnership, the owners expect to operate the business by consensus and expect that they will be operating the business with those people they know and trust. Partnership law allows the shareholders to realize their expectations of consensus decision-making, because if partners do not operate by consensus, any one partner is able to dissolve the partnership at will.[82] Partners can expect to continue doing business with those they know and trust because all partners must consent to the admission of a new partner.[83] Unfortunately, these expectations of the owners are frustrated in a close corporation. Absent an enforceable shareholder agreement, virtually all decisions are made by the will of the majority.

At common law, attempts to transfer control from directors to shareholders were often voided because they were against public policy.[84] Although section 35-1-515 of the Montana Code Annotated allows the articles of incorporation to provide for a diminished role of a board, the statute is seldom used because of the liability it imposes upon shareholders who consent to the transfer of management power.

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78. MONT. CODE ANN. § 28-10-403 (1987).

79. MONT. CODE ANN. §§ 35-1-407, -515 (1987).

80. MONT. CODE ANN. § 35-9-301(2)(b) (1987).

81. MONT. CODE ANN. § 35-1-401 (1987).

82. MONT. CODE ANN. § 35-10-603(1)(b) & (2) (1987). While the partnership law provides for control by majority vote (MONT. CODE ANN. § 35-10-401(8) (1987)), a disgruntled individual partner is able to dissolve the partnership. As a result, in order to hold the partnership together, there is an incentive to reach a consensus.

83. MONT. CODE ANN. § 35-10-401(7) (1987).

84. *See supra* note 40.

c. *Limitation on Transfer of Stock*

Absent an agreement, shareholders may convey stock voluntarily, by bequest, or involuntarily by court order in divorces, foreclosures and bankruptcies. These conveyances may result in incompatible owners, which can be potentially disastrous to the corporation. A shareholder agreement, while often complex and expensive to draft, may include an adequate provision to restrict share transfer. The MCCA, by taking into account the specific needs of a close corporation, severely curtails the ability to transfer shares,[85] and thus insures control of the corporation within the original group of shareholders.

2. *Failure of Close Corporations to Use the Montana Business Corporation Act to Structure Properly Incorporated Partnerships*

Many attorneys, before the enactment of the MCCA, could structure a close corporation to operate as an "incorporated partnership" through the use of shareholder agreements and special provisions in the articles and by-laws. While once hesitant to enforce the agreements forcing corporations to act like partnerships,[86] the courts are now less hesitant to do so.[87] Unfortunately, not all clients follow their attorney's advice to enter into the appropriate shareholder agreements at the time of incorporation. Clients too often request only "bare bones" articles of incorporation from their attorneys to minimize the costs.[88] Clients, anxious to file articles of incorporation, do not heed warnings of potential problems that may arise later. Unfortunately, the next visit to the attorney is often prompted by a problem that could have been avoided by the proper agreements.

The formation of a corporation by owners of a business without consulting a lawyer is even more problematic than the "bare

85. MONT. CODE ANN. § 35-9-202 (1987).

86. HENN & ALEXANDER, *supra*, note 36, § 275, at 744-45. *See* Sensabaugh v. Polson Plywood Co., 135 Mont. 562, 342 P.2d 1064 (1959); Abercrombie v. Davies, 35 Del. Ch. 599, 608, 123 A.2d 893, 898, *modified*, 36 Del. Ch. 102, 125 A.2d 588 (Ch. 1956), *rev'd on other grounds*, 136 Del. Ch. 371, 130 A.2d 338 (Sup. Ct. 1957); Long Park, Inc. v. Trenton-New Brunswick Theatres Co., 297 N.Y. 174, 179, 77 N.E.2d 633, 634-35 (1948).

87. *See also* HENN & ALEXANDER, *supra* note 36, § 275, at 745-46; Clark v. Dodge, 269 N.Y. 410, 199 N.E. 641 (1936); Zion v. Kurtz, 50 N.Y.2d 92, 405 N.E.2d 681, 684, 428 N.Y.S.2d 199, 203 (1980). *See* note 40 *supra*.

88. In a study of 900 South Carolina articles of incorporation, only 26.8 percent used any of these optional provisions allowed by law in the articles. *See* Haynsworth, *The 1981 Revision of the South Carolina Corporation Business Act: A Critique and Agenda for Further Reform*, 33 S.C.L. REV. 449, 461 n.49 (1982).

bones" incorporation by an attorney.[89] Airline magazines and financial publications offer "do-it-yourself" incorporation kits that do not even begin to protect the interests of shareholders in a close corporation. These publications often fail to inform shareholders-to-be of special problems of operating a close corporation like an "incorporated partnership."

The corporations which are unwilling to accept or pay for the qualified legal advice benefit from the MCCA. By merely electing the MCCA, these corporations adopt many of the provisions of the Act which effectively permit operation of an "incorporated partnership." The MCCA, specifically designed for the particular needs of close corporations, addresses important considerations of management and succession of ownership.[90] The MCCA also provides protection for those who disregard the corporate formalities by operating the corporation like a partnership.[91]

3. *Failure of Montana Business Corporation Act to Provide Guidance to Courts When Applying Equitable Remedies*

The Montana Supreme Court in *Maddox* went beyond the remedy described by the Montana Business Corporation Act when it ordered the defendant majority shareholders to purchase the shares of the plaintiff minority shareholders. In that case, although the plaintiff vigorously argued that the court lacks the power to compel a stock sale, the court relied on rulings of out-of-state cases to fashion an equitable remedy.[92]

While the Montana Supreme Court appears willing to order one shareholder to repurchase the shares of another, the court has not provided a clear list of alternative equity remedies to consider when owners of corporations do not get along.[93] Although courts in other jurisdictions have sanctioned alternative equitable remedies such as the appointment of provisional directors or removal of duly elected directors who are not acting in the interest of the corpora-

89. According to a recent study conducted in the state of Wisconsin, 27 percent of those who incorporate businesses do not consult lawyers. Comment, *Assessing the Utility of Wisconsin's Close Corporation Statute*, 1986 WIS. L. REV. 811, 828 n.91 (1986) (authored by Mike Harris).

90. MONT. CODE ANN. §§ 35-9-202 to -204 (1987) essentially provide a right of first refusal on the transfer of stock. A single statement in the articles of incorporation may also provide for a compulsory purchase of shares after death. *See* MONT. CODE ANN. §§ 35-9-205 to -208 (1987).

91. MONT. CODE ANN. § 35-9-306 (1987).

92. Maddox v. Norman, ___ Mont. ___, ___, 669 P.2d 230, 237-38 (1983).

93. It has, however, cited the Oregon case of Baker v. Commercial Body Builders, Inc., 264 Or. 614, 507 P.2d 387 (1973) which enumerates various equitable remedies such as appointment of a provisional director. *See Maddox*, ___ Mont. ___, 669 P.2d 230.

tion,[94] Montana courts have not yet done so. By enacting the MCCA, the legislature is directing the court to consider other equitable powers in resolving disputes in close corporations. These broad powers enable the court to consider the needs and expectations of the shareholders without resorting to the drastic options of compelling share purchase or liquidation. These options, provided in the MCCA, include cancellation or alteration of provisions in the articles of incorporation or by-laws, the appointment of a provisional director, or the appointment of an individual as officer or director.[95] While the courts conceivably have these powers already, the MCCA will minimize any qualms the court might have in invoking these equitable remedies.[96]

In addition to providing a list of the type of relief the court may order, the law grants the court some guidance in applying the relief in two significant respects.[97] First, the legislation states that a court may fashion the equitable remedies if those in control of the corporation act illegally, oppressively, fraudulently or with unfair prejudice. The Montana Business Corporation Act dissolution provision on its face does not allow the court to dissolve a corporation if the majority shareholders' acts are unfairly prejudicial.[98] As a result of the addition of the term "unfairly prejudicial," courts will no longer be required to stretch the definition of oppression to include action which is more easily characterized as "unfairly prejudicial."[99] Some scholars objected to the addition of the term "unfairly prejudicial" because the MCCA fails to define the term.[100] The law, however, should not attempt a rigid definition, but rather the courts should determine what is unfairly prejudicial by consid-

94. *See* Baker v. Commercial Body Builders, Inc., 264 Or. 614, 507 P.2d 387 (1973); Roach v. Margulies, 42 N.J. Super. 245, 126 A.2d 45 (1956). *See* Comment, *The Custodian Remedy for Deadlocks in Close Corporations*, 13 U.C. DAVIS L. REV. 498 (1980) (authored by Cheryl Jean Lew).

95. MONT. CODE ANN. §§ 35-9-502, -503 (1987).

96. *See* ABA SUPPLEMENT COMMENTS, *supra* note 30, § 40, at 1852-55 (corresponding to MONT. CODE ANN. § 35-9-502 (1987)). For a discussion of how legislation affects the equitable powers of a court to settle disputes between shareholders, *see* G. Hornstein, *A Remedy for Corporate Abuse—Judicial Power to Wind Up a Corporation at the Suit of a Minority Shareholder*, 40 COLUM. L. REV. 220, 243-49 (1940).

97. MONT. CODE ANN. § 35-9-501(1)(a) (1987).

98. MONT. CODE ANN. § 35-1-921 (1987).

99. The term "unfairly prejudicial" is not found in the provisions of the Montana Business Corporations Act. The MCCA only authorizes the court to exercise equitable jurisdiction. MONT. CODE ANN. § 35-1-921(1)(a)(ii) (1987) allows the Court to liquidate a corporation if "the acts of the directors or those in control . . . are illegal, oppressive or fraudulent."

100. Kessler, *The ABA Close Corporation Statute*, 36 MERCER L. REV. 661, 692 (1985) suggests it has "somewhat lower pain threshold than 'oppression'—although perhaps only the difference between a thumb screw and the 'iron maiden.' "

ering the facts and circumstances in each individual case.[101]

The forced buy-out and dissolution provisions of the MCCA provide a second, but no less significant area of guidance by providing that a forced buy-out or dissolution is only appropriate when less drastic forms of relief are ineffective in providing relief.[102] The Model Business Corporation Act grants the courts only the remedy of dissolution. Those courts willing to consider other equitable remedies had no guidance for determining whether dissolution or some other less drastic equitable remedy should be applied. Pursuant to the MCCA, courts are directed not to order a dissolution or buy-out if remedies such as appointment of a provisional director, cancellation of corporate actions or bylaw provisions, and payment of dividends are appropriate.

III. Impact and Proper Use of the MCCA

A. *Share Transfer Restrictions*

The share transfer restrictions of the MCCA provide a right of first refusal to the corporation when a shareholder desires to transfer any shares.[103] The restrictions become automatically effective when the provisions of the MCCA are adopted.[104] Simply put, the restrictions require all shareholders to offer their stock to the corporation before they sell the stock to a nonqualifying transferee,[105] as defined by the MCCA. The corporation then has the option to purchase the shares from the shareholder for the same price and terms as offered to the third party.

The right of first refusal generally provides an excellent way to insure that the control of the corporation remains within the original group of owners or their relatives. The Montana Business Corporation Act permits other ways of accomplishing the same goal, such as restrictions on transfers of stock without the consent of the other shareholders or absolute restrictions on the transfer of stock to certain classes of potential shareholders.[106] Although allowed by the Montana Business Corporation Act,[107] practitioners do not favor absolute restrictions and consent restrictions because the restriction makes the stock almost impossible to transfer and se-

101. ABA Supplement Comments, *supra* note 30, § 40, at 1852-55.
102. Mont. Code Ann. §§ 35-9-503, -504 (1987).
103. Mont. Code Ann. § 35-9-203 (1987).
104. Mont. Code Ann. § 35-9-202(1) (1987).
105. A nonqualifying transferee is any person who fails to qualify under Mont. Code Ann. § 35-9-202(2) (1987).
106. Mont. Code Ann. § 35-1-617 (1987).
107. Mont. Code Ann. § 35-1-617(3)(c), (d) (1987).

verely impacts the value of the stock.

1. *Problems With Using Rights of First Refusal*

The right of first refusal described in the statute, like all rights of first refusal, has inherent weaknesses. Many of those weaknesses have been mitigated by the statute. Attorneys may further mitigate the problems through proper planning.

a. *Difficulty in Locating Buyers For The Stock in a Close Corporation*

As a closely knit group, owners of close corporations find it difficult to encourage third parties to invest in a corporation where they might be viewed as outsiders and have little control in management. Any right of first refusal, including that found in the MCCA, creates difficulties for a shareholder who desires to sell his or her shares because the burden remains on the shareholder to find a buyer. If shareholders desire to sever their connection with the corporation, they are often unable to find a market for their stock. This inability to find a buyer frequently leaves shareholders with no alternative but to enter into an agreement with the corporation whereby the corporation buys the stock at a bargain price.[108] The MCCA mitigates this problem when a shareholder dies by permitting an election to allow the shareholder's estate to compel the corporation to purchase the deceased shareholder's stock at a market price. Shareholders may further ameliorate the problem by entering into a shareholder agreement providing that upon the retirement of a shareholder, the corporation will purchase the shareholder's shares.[109]

b. *Difficulty in Obtaining a Firm Offer For Stock Subject to The Right of First Refusal*

Any buyer interested in purchasing the stock of a close corporation must invest significant time and expense investigating the business and assessing its value. Frequently the prospective transferee hires an attorney or accountant to assist with the analysis. If the possibility exists that their efforts will only result in fixing the

108. Often, at the same time, the corporation does not pay dividends or employ the shareholder, making it easier to squeeze out a minority shareholder. *See* 1 F. O'NEAL, OPPRESSION OF MINORITY SHAREHOLDERS § 2.15, at 2-38 and -39 (2d ed. 1985).

109. Care must be taken when defining the term retirement. Some agreements allow shareholders to retire before age sixty-five, but at a substantial reduction in the purchase price for the shares.

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stock price for someone else, the prospective buyer will resist incurring this expense. The MCCA cannot provide a mechanism to resolve this problem because it is inherent in the right of first refusal. Shareholders should be aware of the problem, but the advantages of allowing the original group of owners to retain control of the corporation usually outweigh this disadvantage.

c. *Possibility of Collusion Between Transferor and Transferee May Defeat the Right of First Refusal*

The possibility exists with most rights of first refusal that a transferor and transferee will agree on a high transfer price, which could effectively prevent the beneficiary of the right of first refusal (the corporation in the case of the MCCA) from exercising its option. If a shareholder and transferee collude to create an artificially high price, the effectiveness of a right of first refusal might be frustrated. For example, if the fair market value of the share to be transferred is $10,000, and a shareholder wishes to convey the shares to his friend, the shareholder might obtain a $20,000 offer (paid in two yearly installments of $10,000) from his friend. The high purchase price may serve to discourage the beneficiary of the right of first refusal from purchasing the stock. Later the shareholder may "forgive" the last $10,000 installment. The actual purchase price, then, was only $10,000 and the beneficiary could have purchased the shares had it known of the actual purchase price. To avoid this problem, the terms of the right of first refusal could require the purchaser to make a cash offer. The disadvantage of requiring a cash offer, however, is that a shareholder desiring to sell his or her stock may not be able to find a cash offer or the corporation may not be able to match the cash offer.

The MCCA does not specify the remedies available if a shareholder and proposed transferee engage in the type of collusion described, but presumably an action would be available against the colluding shareholders based on theories of fraud[110] or constructive fraud.[111] In Montana, this type of collusion could support an argu-

110. "One who fraudulently makes a misrepresentation of fact, opinion, intention or law for the purpose of inducing another to act or to refrain from action in reliance upon it, is subject to liability to the other in deceit for pecuniary loss caused by his justifiable reliance upon the misrepresentation." RESTATEMENT (SECOND) OF TORTS § 525 (1977).

111. If the element of fraudulent intent is difficult to prove, the beneficiaries of the right of first refusal might rely on MONT. CODE ANN. § 28-2-406 (1987) which provides that constructive fraud consists of "any breach of a duty which, without an actually fraudulent intent, gains an advantage to the person in fault . . . by misleading another to his prejudice or to the prejudice of anyone claiming under him." For a further discussion of constructive fraud, see McGregor v. Mommer, ___ Mont. ___, ___, 714 P.2d 536, 543 (1986); Mends v.

ment that the shareholders breached the implied covenant of good faith and fair dealing both pursuant to the Uniform Commercial Code[112] and the separate tort action recognized by the Montana Supreme Court[113] and by statute.[114] The statutory right of first refusal conceivably creates a right similar to a contract right between the parties, thus invoking the implied covenant of good faith and fair dealing to govern the transaction. If the selling shareholder colludes with another, the selling shareholder's conduct departs from the justifiable expectation of the beneficiaries of the option and violates the seller's duty to act with honesty-in-fact and with commercial reasonableness. Conceivably, the beneficiary of the right of first refusal could actually recover possession of the shares under theories of a constructive trust.[115]

d. *Inability to Transfer Shares to Children*

A right of first refusal, which does not provide for exceptions, makes it impossible to maintain equal ownership among families in a multiple family corporation. When the members of one family die, without modification of the right of first refusal, the corporation maintains the option to buy the stock. Accordingly, the family may lose, against its will, its ownership interest in the corporation. A simple solution to this problem, adopted by the MCCA, is to allow transfers, free of restrictions, to certain family members.[116]

Attorneys and clients should appreciate that share transfer restrictions in the form of a right of first refusal are no panacea. Nonetheless, rights of first refusal may represent the best balance between the need to restrict transfers of shares to outsiders and the need to allow disgruntled shareholders to realize a market for their shares. All things considered, the MCCA has gone about as far as possible in eliminating or mitigating the problems with a

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Dykstra, 195 Mont. 440, 637 P.2d 502 (1981); Moschelle v. Hulse, ___ Mont. ___, ___, 622 P.2d 155, 159 (1980). The duty breached, of course, is the fiduciary duty between shareholders of a corporation described in Fox v. 7L Bar Ranch, 198 Mont. 201, 209, 645 P.2d 929, 933 (1982).

112. See MONT. CODE ANN. §§ 30-1-201(19), -203 (1987).

113. *See* Dunfee v. Baskin-Robbins, Inc., ___ Mont. ___, ___, 720 P.2d 1148, 1152-53 (1986); McGregor v. Mommer, ___ Mont. ___, ___, 714 P.2d 536, 542-43 (1986); Thiel v. Johnson, ___ Mont. ___, ___, 711 P.2d 829, 832-33 (1985); Nicholson v. United Pac. Ins. Co., ___ Mont. ___, ___, 710 P.2d 1342, 1346-48 (1985).

114. MONT. CODE ANN. § 28-1-211 (1987).

115. *See* B.J. McAdams, Inc. v. Boggs, 439 F. Supp. 738, 752, (E.D. Penn. 1977); Higgins v. Shenango Pottery Co., 279 F.2d 46, 52-54 (3d Cir.), *cert. denied*, 364 U.S. 899 (1960). *See also* RESTATEMENT OF RESTITUTION §§ 172, 194, 201 (1937); Raestle v. Whitson, 119 Ariz. 524, 528, 582 P.2d 170, 174 (1978).

116. MONT. CODE ANN. § 35-9-202(2)(b) (1987).

right of first refusal.

2. *Drafting Considerations of Share Transfer Restrictions*

Although the right of first refusal provisions apply to all corporations electing the coverage of the MCCA, the articles of incorporation may contain provisions altering the terms of the right of first refusal included in the MCCA.[117] Likewise, if the shareholders or their attorney feel more comfortable with share transfer restrictions which are entirely different than the statutory scheme, the corporation's articles of incorporation may provide that the statutory scheme does not apply.[118]

Those organizing corporations under the MCCA should consider the following modifications to the right of first refusal provisions contained in the MCCA. These modifications are most appropriately made in the articles of incorporation.[119]

(a) *Exceptions to Restrictions*

Commentators have appropriately criticized the MCCA for allowing too many transfers free from the right of first refusal.[120] One target of their criticisms is the provision which allows free transfers between shareholders. Attorneys and clients may not desire this exemption because such intrashareholder transfers may

117. MONT. CODE ANN. § 35-9-202 (1987).

118. MONT. CODE ANN. § 35-9-202(1) (1987). At least one author has criticized the provisions of the ABA Supplement because it may "lead away from thoughtful planning on an ad hoc basis." Bradley, *An Analysis of the Model Close Corporation Act and A Proposed Legislative Strategy,*" 10 J. CORP. L. 817, 834 (1985). Professor Bradley also argues the MCCA may "influence inexperienced planners to take the lure of the minor cost saving in reliance on the representation that the substance of the statutory restriction adequately meets the needs and expectations of the shareholder." Professor Bradley's comments are well taken, *if* attorneys do not customize the restrictions of MONT. CODE ANN. §§ 35-9-201 to -203 (1987) to the needs of their clients. The restrictions contained in MONT. CODE ANN. §§ 35-9-201 to -203 (1987), however, are better than no restrictions on transfer and are a good starting point for drafting restrictions. *See also* Haynsworth, *Competent Counseling of Small Business Clients,* 13 U.C. DAVIS L. REV. 401 (1980).

119. The MCCA provides that transfers of stock may not be made except as permitted by the MCCA or "permitted by the articles of incorporation." MONT. CODE ANN. § 35-9-202(1) (1987). The MCCA also provides that the restrictions do not apply to certain classes of transferees "[e]xcept to the extent the articles of incorporation provide otherwise." MONT. CODE ANN. § 35-9-202(2) (1987). Any doubt that the statutory provision can be modified should be dispelled by the Comments to the ABA Supplement: "The statutory prohibition can be limited or modified simply by stating in the articles of incorporation that it does not apply or by specifying in the articles of incorporation *the changes from the statutory language*" (emphasis added). ABA SUPPLEMENT COMMENTS, *supra* note 30, § 11, at 1817. The provision is drafted, according to the Comment, to "facilitate alteration in order to fit the special needs of the shareholders in a particular corporation." *Id.* at 1816.

120. *See* Bradley, *supra* note 118, at 682.

alter the control of the corporation between shareholders or groups of shareholders.[121]

Another potentially troublesome exception, found at section 35-9-202(2)(b) of the Montana Code Annotated, allows unencumbered transfers to shareholders' family members. Frequently, shareholders from different families intend to operate the corporation "in partnership" only with those individuals they know and trust. The original shareholders may not feel comfortable doing business with their fellow shareholder's spouse or child. Incorporators should seriously consider limiting the relatives to whom shares may be transferred to a specified group or to those relatives already employed by the business.[122]

(b) *Alteration of Payment Terms*

The provisions of the MCCA requiring the corporation to match the terms of the proposed transferee's offer could cause cash flow problems for the corporation desiring to exercise the option. The problem becomes particularly acute when the proposed transferee offers to pay for the transferor's stock with cash at closing. If the corporation elects to purchase the stock, it must also pay cash at closing. To avoid a cash flow problem within the corporation, incorporators should consider allowing the corporation a period of time, perhaps three to five years, to pay the purchase price. Incorporators might provide for the corporation to pay the purchase price over a specified number of years or over the time period proposed by the transferee, whichever is longer. Of course, adequate provisions should also provide for the payment of interest. The corporation, however, may not grant a security interest in the corporation's assets to secure payment to the selling shareholder pursuant to the terms of section 35-1-711(4) of the Montana Code Annotated.

B. *Compulsory Purchase of Shares After Death of Shareholder*

To conform the structure of a close corporation more closely

121. For example, if A, B, and C each own one-third of the stock in ABC Corporation and A transfers his or her stock to B, then B suddenly becomes a majority shareholder without C's consent. The articles of incorporation found at Appendix II of this article correct this problem by providing that the restrictions on transfer *do* apply to intrashareholder transfers. *See infra* text accompanying note 241.

122. At first blush, it may be tempting to undo the exception which allows transfers to administrators of estates free from restriction under MONT. CODE ANN. § 35-9-202(2)(d) (1987). Those administrators, however, are prohibited from making further transfers to nonexempted persons. ABA SUPPLEMENT COMMENTS, *supra* note 30, § 11, at 1816.

to that of a partnership, the MCCA allows statutory close corporations to elect to provide a deceased shareholder's estate with the option of compelling the corporation to purchase the deceased's shares.[123] The right provided by the MCCA is similar to the right of the estate of a partner to require partners desiring to continue the business to purchase the estate's interest for fair value.[124] The MCCA provides the option to sell to the estate of the deceased shareholder without providing the corporation with a similar option to purchase the deceased's shares. In addition, the MCCA also includes a mechanism whereby the estate and corporation bargain for a mutually agreeable purchase price. If the parties are unable to agree upon a price, the court will fix the amount of the price of the shares.[125] In addition, the by-laws or a shareholder agreement may also fix the price.[126]

The threshold question faced by attorneys and their clients is whether the close corporation should elect these mandatory purchase provisions.[127] If the parties' sole desire is to prohibit transfers of the shares to undesirable parties upon the death of an owner, the election of the mandatory purchase provisions is unnecessary because the right of first refusal provision adequately protects shareholders.[128]

The primary reasons to elect a mandatory purchase option are to provide (1) a market for the owner's stock upon his or her death[129] and (2) a method for an orderly termination of the relationship between the continuing shareholders and the estate and heirs of the deceased shareholder.[130] A substantial amount of litigation is generated in the state of Montana between heirs of a deceased shareholder and continuing shareholders.[131] Rarely does a shareholder contemplate his or her own death, so all too often the

123. MONT. CODE ANN. § 35-9-205 (1987) provides that administrators of the estate of a shareholder, may require repurchase of the deceased's share upon the shareholder's death.

124. MONT. CODE ANN. § 35-10-614 (1987).

125. MONT. CODE ANN. § 35-9-207(2) (1987).

126. MONT. CODE ANN. § 35-9-206(5) (1987).

127. The election must be included in the articles of incorporation. MONT. CODE ANN. § 35-9-205(1) (1987).

128. MONT. CODE ANN. § 35-9-205(1) (1987) grants the option to compel purchase to the estate, not the corporation. As such, the estate remains bound by the share transfer restrictions for sale of shares to others than the corporation. *See also* ABA SUPPLEMENT COMMENTS, *supra* note 30, § 14, at 1824.

129. This allows the estate to realize the value of the decedent's portion of the business. *See* Younger, *Death and the Close Corporation*, 34 BROOKLYN L. REV. 1 (1967).

130. ABA Supplement § 14 (corresponding to MONT. CODE ANN. § 35-9-205 (1987)). *See* ABA SUPPLEMENT COMMENTS, *supra* note 30, § 14, at 1824.

131. Maddox v. Norman, ___ Mont. ___, 669 P.2d 230 (1983) and Skierka v. Skierka Bros., ___ Mont. ___, 629 P.2d 214 (1981).

shareholders face a fellow shareholder's death without any agreement about the relationship between shareholders after the death.[132] Often the deceased shareholder was the glue holding the corporation together. After the shareholder dies, the positions of the remaining shareholders might harden, communications may break down and litigation may be the result.[133]

Like the right of first refusal provisions, attorneys and their clients should not adopt the mandatory buyout provisions without consideration of the appropriateness of the provisions for the individual corporation. Instead of the MCCA mandatory buyout provisions, a shareholder agreement may more appropriately meet the needs of the shareholders.

The primary disadvantage created by a mandatory purchase option is that the purchase may create a substantial financial burden on the corporation. Frequently, small corporations are not liquid. The corporation may have difficulty borrowing money to finance the purchase of a deceased shareholder's stock if the corporation does not have assets to pledge. Lenders may also balk at financing and harbor concern about the continued viability of the corporation.

Life insurance on an owner's life or a key employee of the business provides the easiest solution to the problem of financing the acquisition of the stock upon a shareholder's death. In some situations, obtaining life insurance is easier said than done. Insurance companies may refuse to insure shareholders because of age or health. Insurance coverage may also be prohibitively expensive for the fledgling corporation. Without life insurance, the corporation might solve the problem by agreeing to pay the repurchase price over a period of years to an estate upon the death of a shareholder. Often a three to five year period will frequently allow enough time for the corporation to generate enough cash from earnings to satisfy the obligation to the deceased shareholder's estate.

While the mandatory purchase provisions of the MCCA provide benefits that are usually provided by shareholder agreements, they do not replace shareholder agreements which contain death provisions tailored to the needs of a corporation. The mandatory buy out provisions are best thought of as a "back up" when share-

132. "Persons who have been active or dominant in the affairs of a business corporation may find it difficult to contemplate the termination of their influence even after death." Younger, *Death and the Close Corporation*, 34 BROOKLYN L. REV. 1, 12 (1967). The death of the shareholder may also mean the loss of a major asset of talent, business skills or expertise.

133. *See* J. Bahls, *Preventing Partnership Disputes*, FARM FUTURES 29 (March, 1987).

holders fail to enter into the appropriately negotiated shareholder agreement.[134] Attorneys should consider not electing the provisions of sections 35-9-205 to -207 of the Montana Code Annotated and instead customizing the shareholder agreement to the specific corporation. Specifically, attorneys may want to include the following provisions in shareholder agreements that are often more appropriate for a close corporation:

> (1) A provision allowing the corporation to compel the estate to sell the shares of the corporation to the corporation. Currently the MCCA merely provides that the shareholder maintains the option.[135]
>
> (2) A provision granting the corporation or shareholders the option to compel a purchase of stock upon other events such as the shareholder's retirement, termination of employment, disability or loss of professional license.[136] Retirement provisions are particularly appropriate for a business engaged in personal service in order to reward long-term employees. At the same time, these provisions encourage senior employees to retire at the appropriate age, so younger employees might have management opportunities.
>
> (3) A provision allowing payment over time (with interest) if life insurance proceeds are not enough to fund the purchase. Without this provision in the agreement, pursuant to the MCCA, the court may order that this purchase be made either immediately or over time.[137] If the parties agree in advance to make the payment over time, then it is wise to avoid the risk that the court will require cash payments.
>
> (4) A provision defining some method, other than a court determination, to determine the value of the shares. Methods to establish price might include formulas,[138] book value, adjusted book

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134. The Official Comments to the ABA Supplement state that the mandatory buy-out provisions are appropriate in the event the shareholders have "failed" to enter a shareholder agreement, "failed" to agree on a price or "neglected to provide" necessary terms. ABA SUPPLEMENT COMMENTS, *supra* note 30, § 14, at 1825.

135. MONT. CODE ANN. § 35-9-205(1) (1987).

136. Providing for these contingencies may easily be done within the framework of the MCCA and without a separate agreement. The mandatory purchase provisions of the MCCA may be expanded by amending the articles of incorporation to provide coverage for these contingencies. ABA SUPPLEMENT COMMENTS, *supra* note 30, § 14, at 1823.

137. MONT. CODE ANN. §§ 35-9-207, -503(2)(b) (1987).

138. Not all businesses, of course, are capable of being valued in accordance with a formula. Trade associations gather information about appropriate formulas. Addresses and phone numbers of these trade associations may be found in GALE RESEARCH CO., ENCYCLOPEDIAS OF ASSOCIATIONS (20th ed. 1986).

Clients must use care when using formulas because accepted formulas for valuing business in a specified industry may change as competitive conditions change. Further, the client's business may not be a typical business in the industry. For example, competitive conditions and markets in Montana may be different from these businesses in urban areas from

value,[139] non court-appointed appraisers,[140] and annual agreement of the shareholders.[141]

Non-judicial methods of setting the price are often superior to relying on a judicial determination as contemplated by the MCCA.[142] Not only do the parties save the costs of litigation, which include the cost of hiring appraisers as expert witnesses, but

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which and for which the formulas may have been devised. Formulas are frequently inappropriate in valuing shares upon the death of a shareholder because the death may have a substantial impact on formula variables. For example, the death of a key salesperson-owner is sure to have a negative impact on sales of the business. In that case, if a formula bases its valuation on historical sales, the result is likely to be misleading.

139. Extreme care should be used if book value or adjusted book value is adopted as the purchase price. Although one of the easiest ways to establish a purchase price, book value is one of the least reliable ways to establish a purchase price. Book value takes into account the historical price of assets and does not attempt to gauge fair market value. In order to remedy this problem, attorneys frequently provide for purpose of the valuation, the appraised value of land, equipment and investments will be used to determine book value. Use of book value valuations also fails to take into account the value of goodwill because goodwill is not typically valued on the balance sheet. Contingent liabilities are not usually considered when computing book value. Book value, in some businesses, is distorted by arbitrary (but not capricious) accounting concepts such as election of "last in, first out" methods of inventory valuation. Finally, book value is often adjusted to exclude the amount of life insurance proceeds realized by the corporation as a result of the shareholder's death.

When book value is used, there is frequently a dispute whether the parties are bound by their agreement if book value bears little relation to market value. Generally, courts have held that a disparity between the option price and the fair market value at the time of the buyout will not invalidate the restriction. Stech v. Panel Mart, Inc., 434 N.E.2d 97, 103 (Ind. Ct. App. 1982) (purchase price $250, fair market value $1,250); Elson v. Schmidt, 140 Neb. 646, 653, 1 N.W.2d 314, 316-17 (1941); Renberg v. Zarrow, 667 P.2d 465, 470 (Okla. 1983) (purchase price $3,500, fair market value $31,300). *See also* Howeth v. D.A. Davidson & Co., 163 Mont. 355, 370, 517 P.2d 722, 730 (1973). If fraud, overreaching or bad faith exists at the time the agreement is made, however, the purchase provision may be invalid. *Renberg*, 667 P.2d at 470.

140. These non-court-appointed appraisers could be named in the agreement, selected upon mutual agreement of the estate and corporation or selected by a knowledgeable trusted third party such as the corporation's accountant or primary loan officer.

141. Annual agreements of shareholders of the value of the stock in the company are frequently more reliable than a court valuation, because, in many businesses, shareholders are most familiar with the true value of their business. If the annual valuation method is used, care should be taken to provide all shareholders must agree to the valuation. Failure to require unanimous agreement may result in healthy shareholders agreeing to an artificially low price in order to prejudice a shareholder on his or her deathbed. Provisions must also be made for those corporations where the shareholders are not able to reach a unanimous decision or fail to make yearly valuations. These "back-up" methods include use of a formula, adjusted book value, or non-court appraisal.

142. Valuation decisions are difficult for anyone to make:

> The valuation of a company or a business is not an exact science; considering the same relevant facts, experts may differ widely in their appraisals of value. This is understandable because of the many factors generally involved in reaching a decision or overall valuation. The weight given these factors is a matter of judgment . . . .

G. McCarthy & R. Healy, Valuing a Company 4 (1971).

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the parties also retain control over appraisers and the appraisal method. Although the MCCA provides guidance to the courts concerning some of the factors to consider when valuing shares,[143] the statute does not direct the court to use a particular method of valuation (asset valuation, earnings valuation, etc.).[144] Nor does the MCCA give the courts any guidance concerning any discounts that might be applied to the valuation. For example, shareholders may agree in advance whether to discount the value of a minority interest of shares. Discounts for minority shares, because of the lack of marketability, range from 10 percent to 50 percent.[145] The Montana Supreme Court has not used any specific guidelines when determining whether to use a discount for minority interests. In divorce actions, for example, the Montana Supreme Court recently upheld a valuation of a close corporation that did not apply a minority discount[146] because the district court was given broad authority to determine value. Courts, when determining the appropriateness of a discount for a minority interest, should look to the facts and circumstances to determine the expectations of the parties.[147] If the shareholders are able to agree, in advance, whether or not to discount a minority interest, it behooves them to specify the agreement to minimize the risk that a court would fail to follow the parties' wishes.

Shareholders should always make plans for the death of a shareholder. While the scheme set forth in the MCCA[148] provides a method for determining the price and terms of a buyout, shareholders are advised to carefully consider which scheme is the most appropriate based on their own needs. With careful consideration, separate shareholder agreements might better provide for the contingency (and eventuality) of death.

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143. MONT. CODE ANN. §§ 35-9-207, -503(2)(a), (b) (1987).

144. For a good discussion of the methods of valuation and factors to be taken into account *see* Rev. Rul. 59-60, 1959-1 C.B. 237.

145. *See* MCCARTHY & HEALY, *supra* note 142, at 4.

146. *In re* Johnston, ___ Mont. ___, ___ 726 P.2d 322, 325 (1986). *See also* Buxbaum v. Buxbaum, ___ Mont. ___, ___, 692 P.2d 411, 414 (1984); Burleigh v. Burleigh, 200 Mont. 1, 650 P.2d 753 (1982).

147. Factors that might be examined include whether the shareholders intended to be equal managers of the corporation, whether any single shareholder has control, or whether the shareholder bought his or her interest for a price that was discounted as a minority interest.

148. MONT. CODE ANN. §§ 35-9-205 to -208 (1987).

C. *Agreements Permitting the Corporation to Operate Like a Partnership*

One of the most significant provisions of the MCCA allows shareholders to agree to operate the corporation in unconventional ways, even if operation of the corporation resembles a partnership more than a corporation.[149] The MCCA permits, but does not require, shareholder agreements which: (1) eliminate the board of directors; (2) restrict the powers of discretion of the board; (3) authorize director proxies and weighted voting; and (4) allow the partnership to act as a corporation. In a related provision of the MCCA, the articles of incorporation may even authorize any shareholder to dissolve the corporation at will or upon the happening of a specified occurrence.[150] In the absence of the MCCA, these arrangements may constitute an unlawful delegation of the powers usually reserved to the board of directors.[151]

The law requiring shareholders to form a board and to submit to the majority rule of a board[152] has long been criticized by commentators and disregarded by owners of close corporations.[153] As one commentator ably stated:

> Forcing partners who wish to incorporate to submit to majority rule and the formal mechanics of publicly held corporations will not contribute an iota to the protection of creditors or to the progress and stability of the world of business and should not be regarded as the *quid pro quo* for limited liability.[154]

The provisions of the MCCA allowing a corporation to operate as a partnership are not mandatory; rather, shareholders must elect the

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149. MONT. CODE ANN. § 35-9-301 (1987).

150. MONT. CODE ANN. § 35-9-404 (1987).

151. MONT. CODE ANN. § 35-1-401(1) (1987) provides that a corporation, unless the articles of incorporation otherwise provide, "shall be managed under the direction of the board of directors." Courts have held that agreements which have the effect of requiring a corporation to act as a partnership are unenforceable. *See*, F. O'NEAL, *supra* note 3, § 5.05, at 5-16. *See* Sun River Stock & Land Co. v. Mont. Trust & Sav. Bank, 81 Mont. 222, 262 P. 1039 (1928).

152. However, MONT. CODE ANN. § 35-9-306 (1987) specifically provides that the failure to observe the usual corporate formalities is *not* ground for imposing personal liability on shareholders.

153. *See, e.g.*, Shaffer v. Buxbaum, 137 Mont. 397, 399, 352 P.2d 83, 84 (1960) (failure to file annual reports); State *ex. rel.* Foot v. Farmers & Mechanics State Bank, 85 Mont. 256, 259, 278 P. 828, 829 (1929) (failure to issue stock); Scott v. Prescott, 69 Mont. 540, 552-53, 223 P. 490, 494 (1924); Hansen Sheep Co. v. Farmers & Traders State Bank, 53 Mont. 324, 331, 163 P. 1151, 1153 (1917) (failure to hold meetings of the shareholders and/or directors).

154. Powers, *Cross Fire on the Close Corporation: Norms Versus Needs*, 11 U. FLA. L. REV. 433, 470 (1958).

individual provisions.[155]

1. *Elimination of the Board of Directors*

At first blush, it may appear desirable to eliminate the board of directors of a close corporation. Small corporations frequently operate without formal boards. If formal boards are used, they usually rubber stamp the decisions of the officers or, in some cases, the dominant shareholder(s). When all the shareholders are directors, it might seem duplicative to require a board of directors.

Incorporators should exercise caution, however, before doing away with the board of directors in situations where more than one shareholder desires to participate in management. The board of directors, and the associated required meetings, provide a time-tested manner in which to operate the corporation.[156] If the board is eliminated, it becomes incumbent on the attorney to devise a surefire method for the shareholders to share control. Failure to do so will result in the corporate ship operating without the direction of a helm.[157]

If the corporation is a "one person" corporation, a subsidiary or a family corporation exclusively managed by one person, there is no concern about creating an alternative mechanism to share powers because power is already centralized. As a result, the formality of the board of directors is probably unnecessary and the incorporators may wish to operate without a board. A corporation without a board, however, may encounter some resistance from banks, customers, suppliers or governmental entities who are accustomed to requesting board approval of certain corporate actions. The MCCA, in recognizing this problem, allows the close corporation to authorize a "designated director" to sign contracts on behalf of the corporation.[158]

2. *Restrictions on the Power of the Board of Directors*

The Montana Business Corporation Act takes virtually all management away from the shareholders[159] and centralizes the

155. MONT. CODE ANN. § 35-9-301(1), (2)(c) (1987).

156. MONT. CODE ANN. § 35-1-401 (1987).

157. The MCCA does, in part, address this concern by providing that actions requiring director vote require a similar shareholder vote if the board is eliminated. MONT. CODE ANN. § 35-9-302 (1987). These provisions, however, do not provide the same structure as exists for calling board meetings and determining quorum.

158. MONT. CODE ANN. § 35-9-302(3)(e) (1987).

159. There are six exceptions to the general rule that shareholders have no voice in management. Shareholders:

(1) elect directors (MONT. CODE ANN. § 35-1-402 (1987));

management in the board.[160] The law governing partnerships, on the other hand, reserves all powers to the owners.[161] Non-management shareholders in close corporations frequently desire compromise of the two types of approaches. While shareholders are content to allow the board of directors to make the management decisions, they usually desire a vote in decisions other than day-to-day decisions. These shareholders, of course, become frustrated by the general rule that the board, and the board alone, manages the corporation.

Accordingly, MCCA allows corporations to reserve certain decisions to the shareholders. These decisions might include decisions such as whether to:

> a. make expenditures in excess of a stated dollar amount;
> b. hire or fire employees;
> c. enter contracts where performance (by one or both parties to the contract) is expected to last more than one year;
> d. approve loans (other than extension of trade credit in the ordinary course of business) or guarantee loans;
> e. approve changes in product line, location or focus of business; or
> f. approve sale of assets in excess of a stated amount.

Incorporators might seriously consider restricting the power of the board of directors when not all shareholders are active in the business or members of the board of directors. The inactive shareholders might appropriately desire a veto over major decisions such as those listed above. Likewise, even if all shareholders are members of the board of directors, restricting the power of the board of directors and providing for a supermajority of unanimous approval of the shareholders for certain transactions provides protections against a squeeze-out of minority shareholders.

3. *Director Proxies and Weighted Voting*

Director proxies and weighted voting[162] afford the board of di-

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(2) must approve amendments to the articles of incorporation (Mont. Code Ann. § 35-1-207(1)(c) (1987));
(3) must approve loans to directors (Mont. Code Ann. § 35-1-415 (1987));
(4) must approve sales of assets (Mont. Code Ann. § 35-1-809 (1987));
(5) must approve of consolidations and mergers (Mont. Code Ann. § 35-1-803 (1987)); and
(6) must approve of granting of stock rights or options (Mont. Code. Ann. § 35-1-607(2) (1987)).

160. Mont. Code Ann. § 35-1-401 (1987).
161. Mont. Code Ann. § 35-10-401(5) (1987).
162. Mont. Code Ann. § 35-9-301(2)(b) (1987).

rectors additional flexibility. Director proxies allow directors to convene a quorum even without the required number of directors present in person at the meeting. The convenience of director proxies allows one member of a family to grant his or her vote to another member of the family. Weighted voting eliminates the necessity to appoint a large board in order to allow each shareholder to control his or her proportionate share of directors. For example, if a corporation has a shareholder owning ⅔ of the stock, it is no longer necessary to have a three-person board in order that the director may control ⅔ of the vote. Under the MCCA,[163] two directors could be elected, with the shareholder owning ⅔ of the stock holding twice as many votes on the board as the other shareholder.

4. *Other Provisions Authorizing the Corporation to Act as a Partnership*

The MCCA provides that shareholder agreements may also have the "effect [of] treat[ing] the corporation as a partnership"[164] or "creat[ing] a relationship among the shareholders . . . that would otherwise be appropriate only among partners."[165] Neither the MCCA nor the Comments to the ABA Supplement clearly states what types of agreements the drafters contemplated. Conceivably, the close corporation could draft a shareholder agreement to provide for the operation of the corporation under the rules governing partnerships. These provisions must contain sufficient specificity to define exactly the management of the business since different partnerships are managed in different ways. A better approach may be to modify the traditional corporate structure (e.g. abolishing the board or limiting the power of the board) in order that the owners clearly understand where their rights and responsibilities differ from the traditional rights and responsibilities of shareholders and directors.

5. *Dissolution at Will Upon Occurrence of Specified Events*

One important trapping of a partnership allows any partner to dissolve the partnership at will.[166] In order for "incorporated partnerships" to more closely resemble a true partnership, the MCCA allows the shareholders (individually or as a group) to dissolve the

163. *Id.*
164. MONT. CODE ANN. § 35-9-301(2)(c) (1987).
165. MONT. CODE ANN. § 35-9-301(2)(d) (1987).
166. MONT. CODE ANN. § 35-10-603(1)(b), (c) (1987).

corporation at will or upon the occurrence of a specified event.[167] Although the law always makes dissolution at will available to a partnership, it has long been regarded as an undesirable attribute of operating as a partnership. The persistent threat of dissolution makes management and operation of the business difficult at best. Likewise, these provisions grant a disgruntled shareholder the extraordinary leverage of threat of dissolution to use against other shareholders to coerce them into the dissident shareholders' desired action.[168] Unwanted dissolution not only risks a potential fire sale of the assets, but also risks triggering undesired tax consequences.[169]

In some circumstances, however, the owners of the business may desire to provide a shareholder with the opportunity to dissolve the corporation.[170] Such circumstances might include the start up phase of a personal services close corporation without substantial assets. Conceivably, shareholders may agree to operate under the threat of dissolution at will until they feel comfortable with each other. Usually, however, better ways exist to protect the interests of the shareholders. The incorporator might prepare agreements to provide the apprehensive shareholders with an option to require the corporation to purchase their stock for a fair market value in lieu of dissolution.[171] These types of agreements allow the corporation to continue the business, while providing a fair return to the unhappy shareholders.

6. *Provisions Concerning By-Laws*

A Montana close corporation operating under the MCCA may also dispense with by-laws, if the shareholder agreement or articles of incorporation contain the provisions required in by-laws. In Montana, few provisions are required by statute to be included in the by-laws.[172] As a general matter, the Montana Business Corpo-

167. ABA Supplement § 33 (corresponding to MONT. CODE ANN. § 35-9-404(1) (1987)). *See* ABA SUPPLEMENT COMMENTS, *supra* note 30, § 33, at 1824. Any provision must be present in the articles of incorporation.

168. These actions might include increases in salary, increased draws, etc. *See* Kessler, *The ABA Close Corporation Statute*, 36 MERCER L. REV. 661, 690 (1985).

169. For a good discussion of the income tax aspects of corporate dissolution after the Tax Reform Act of 1986, *see* Brade, *General Utilities Repeal: A Transactional Analysis*, 66 J. TAX'N 322-28 (1987).

170. MONT. CODE ANN. §§ 35-9-301(5), -404 (1987).

171. MONT. CODE ANN. § 35-9-301(8) (1987) permits these types of agreement between the shareholders.

172. *See* MONT. CODE ANN. § 35-1-404(2) (1987) (notice and agenda of directors meetings); MONT. CODE ANN. § 35-1-410 (1987) (election of officers); MONT. CODE. ANN. § 35-1-501(1) (1987) (place of shareholders meetings and date of annual meeting).

ration Act mandates that the by-laws provide for the "regulation and management of a corporation."[173] According to the Montana Business Corporation Act, most of the regulations governing the corporations may also be included in the articles of incorporation.[174]

If the optional shareholder agreement which effectively converts the corporation to an "incorporated partnership" contains all of the terms usually required in by-laws, it becomes superfluous to use by-laws. However, if the corporation does not operate as a partnership pursuant to a shareholder agreement, then by-laws are usually an efficient and effective way to prescribe the management of the corporation.

In the event that the close corporation dispenses with the by-laws, the shareholders should make certain the following problems (typically covered by by-laws, but whose coverage is not mandated) are addressed in a shareholder agreement or in the articles of incorporation:

- How certain owners of stock (other corporations, legal representatives, minors, joint tenants and incompetents) vote their shares;
- Whether deadlocks on the board may be submitted to arbitration;
- Who has the authority to enter into contracts, borrow money, sign checks;
- What procedure controls the transfer of shares; and
- What procedure governs replacement of lost or stolen stock certificates.

If the corporation elects to operate without by-laws and under a shareholder agreement, it should be aware that while by-laws are usually amended by a majority vote of the directors,[175] most shareholder agreements may only be amended, like any other agreement, by unanimous vote of the shareholders as parties to the agreement. Therefore, if a shareholder agreement takes the place of the by-laws, one obstreperous shareholder may block desirable changes in the shareholder agreement.

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173. MONT. CODE ANN. § 35-1-214 (1987).

174. MONT. CODE ANN. § 35-1-401 (1987) (qualifications of directors); MONT. CODE ANN. § 35-1-401 (1987) (number of directors); MONT. CODE ANN. § 35-1-403 (1987) (classification of directors); MONT. CODE ANN. § 35-1-404(3) (1987) (conference call board meetings); MONT. CODE ANN. § 35-1-405 (1987) (board of director voting requirement); MONT. CODE ANN. § 35-1-406 (1987) (board action without a meeting); MONT. CODE ANN. § 35-1-407 (1987) (board committees); MONT. CODE ANN. § 35-1-408 (1987) (removal of directors); MONT. CODE ANN. § 35-1-501(3) (1987) (who may call special shareholders' meeting); MONT. CODE ANN. § 35-1-505(1) (1987) (quorum requirements for shareholders' meetings).

175. MONT. CODE ANN. §§ 35-1-214, -405(2) (1987).

D. *Limitation on Courts' Power to Pierce Corporate Veil*

Virtually all cases where courts have pierced the corporate veil involve corporations with one, two or three shareholders or corporations where shareholders are members of a single family.[176] The Montana Supreme Court has considered the failure to observe corporate formalities as one factor indicating that the corporation has become the alter ego of the shareholder(s).[177] However, merely because the court has determined that the corporation is an alter ego of its shareholders does not justify piercing the corporate veil. The courts must also determine that disregarding the corporate veil is necessary to prevent fraud or avoid inequity.[178] When, for example, the corporation is undercapitalized, courts have pierced the corporate veil to prevent inequity.[179] Undercapitalized close corporations are as common as corporations which ignore corporate formalities. As a result, many Montana corporations and their shareholders face the potential of loss of limited liability if an aggressive plaintiff has the inclination to pursue the issue.[180]

The MCCA effectively minimizes the risk that the court will pierce the corporate veil not only when a corporation acts like a partnership, but also when a corporation with a board of directors does not comply with customary management formalities.[181] Minimization of this risk is one of the most significant benefits conferred by the MCCA on close corporations. The MCCA, however, provides only limited protection.[182] It will not shield a corpora-

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176. F. O'NEAL, *supra* note 3, § 1.10, at 1-44.

177. *See, e.g.*, Hansen Sheep Co. v. Farmers & Traders State Bank, 53 Mont. 324, 335, 163 P. 1151, 1154 (1917) (failure to properly utilize board of directors).

178. Comment, *Piercing the Corporate Veil in Montana*, 44 MONT. L. REV. 91, 97-105 (1983) (authored by Jody S. Brewster).

179. "If the capital is illusory or trifling compared with the business to be done and the risk of loss, this is ground for denying the separate entity privilege." H. BALLANTINE, CORPORATIONS § 129 at 302-03 (rev. ed. 1946). *See* Shaffer v. Buxbaum, 137 Mont. 397, 401, 352 P.2d 83, 85 (1960) (where corporate capital was $300 and existing debts were $5,948.77); Commercial Credit Co. v. O'Brien, 115 Mont. 199, 203, 146 P.2d 637, 639 (1943) (where corporate capital was $11,174.17 as compared to total assigned receivables being $183,481,689.92). *See also* Cataldo, *Limited Liability with One-Man Companies and Subsidiary Corporations*, 18 LAW & CONTEMP. PROBS. 473, 482-83 (1953). *But see* Walkovszky v. Carlton, 18 N.Y.2d 414, 223 N.E.2d 6, 276 N.Y.S.2d 585 (1966).

180. According to Professor F. Hodge O'Neal, the issue of piercing the corporate veil is one of the most frequently litigated of all issues in corporate law. 1 F. O'NEAL, *supra* note 3, § 1.10, at 1-39 to 1-40.

181. MONT. CODE ANN. § 35-9-306 (1987).

182. ABA SUPPLEMENT COMMENTS, *supra* note 30, § 30, at 1843, states that section 1843 of the ABA Supplement (corresponding to MONT. CODE ANN. § 35-9-401 (1987)) merely prevents a court from "piercing the corporate veil" because it is a statutory close corporation. However, the language of the ABA Supplement (and MCCA) does more. The MCCA provides protection from liability for failure to follow corporate formalities relating to man-

tion's shareholders from loss of limited liability for ignoring statutory requirements or formalities other than management. For example, a court might find that the corporation is the alter ego or a "mere instrumentality" of its owners if (1) personal funds are commingled with corporate funds; (2) corporate credit is used to fund personal expenses; or (3) profits of the corporation are distributed through means other than dividends.

E. *Judicial Supervision*

Until passage of the MCCA, the Montana Business Corporation Act provided the courts with very little flexibility in devising solutions to problems created by shareholder deadlock or oppression by shareholders.[183] Courts were usually forced to order a dissolution of the corporation[184] or, in a few cases, to compel the corporation to purchase an interest of a disgruntled shareholder.[185] Borrowing provisions from the 1948 English Companies Act, the MCCA enumerates an additional menu of remedies available when the court finds fraud, oppression, unfairly prejudicial conduct or deadlock. Remedies include appointment of provisional directors, removal of officers or directors, alteration of corporate by-laws or corporate actions, and payment of dividends.[186] The court, however, does not have jurisdiction to intervene if the parties have agreed in writing to a non-judicial alternative.[187] The advantage of providing the court with a clear listing of equitable remedies is that it will not feel compelled to use its draconian remedies of dissolution or compelled purchase of shares.[188]

Pursuant to the Montana Business Corporation Act, any shareholder may petition the court to apply the equitable remedy of dissolution when the conduct of the majority is illegal, oppressive or fraudulent.[189] The MCCA adds "unfairly prejudicial conduct" to that list. While it may be difficult to determine exactly

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agement for any corporation electing coverage under the Supplement, even if it elects not to adopt any of the ABA Supplement provisions altering the traditional management scheme. Hence, even those shareholders in corporations electing to retain a board of directors and related trappings will be protected from personal liability merely because of the corporation's failure to follow corporate formalities regarding management.

183. *See supra* text accompanying notes 92-102.

184. Fox v. 7L Bar Ranch, Inc., 198 Mont. 201, 645 P.2d 929 (1982).

185. Maddox v. Norman, ___ Mont. ___, 669 P.2d 230 (1983).

186. MONT. CODE ANN. §§ 35-9-501, -504 (1987).

187. MONT. CODE ANN. § 35-9-501(3) (1987).

188. For example, the court in *Skierka*, ___ Mont. ___, 629 P.2d 214 (1981) could have simply created a new board position for the minority shareholder, instead of liquidating the corporation.

189. MONT. CODE ANN. § 35-1-921(1)(a)(ii) (1987).

what effect the addition of the term "unfairly prejudicial"[190] may add, the term probably refers to conduct less egregious than fraudulent conduct.[191] The authors of the MCCA properly refrained from attempting a precise formulation of the term. According to the Official Comment "[t]hese are elastic terms whose meaning varies with the circumstances presented in a particular case."[192]

Although the MCCA provides a list of remedies,[193] these remedies do not necessarily tip the scales in favor of the minority shareholder. The MCCA simply allows (and encourages) the court to use more creativity and presumably greater equity in fashioning a solution to the problems of the paralyzed corporation.[194] The MCCA also mandates that the two solutions heretofore used by the Montana Supreme Court and other courts—dissolution[195] and mandatory purchase of a disgruntled shareholder's interest[196]—are to be applied only in extraordinary circumstances.[197]

There are minor disadvantages to encouraging the court to use remedies in addition to dissolution and compelled purchase in resolving corporate disputes. One fear is that courts may become unduly entangled in corporate decision-making. No detailed standards describe when a court should provide each remedy.[198] The

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190. MONT. CODE ANN. § 35-9-501(1)(a) (1987).

191. *See* Bradley, *supra* note 118, at 836. Some might express concern that the addition of the term "unfairly prejudicial" might allow unhappy minority shareholders more access to the courts because unfairly prejudicial conduct is less egregious than fraudulent or oppressive conduct found in MONT. CODE ANN. § 35-1-921(1)(a)(ii) (1987). This concern is probably misplaced in Montana because the courts already define oppressive conduct as conduct which violates the reasonable expectations of minority shareholders. *Fox*, 198 Mont. at 209-10, 645 P.2d at 933. Likewise, majority shareholders have a fiduciary duty to minority shareholders. *Id.* Conduct should not be considered as unfairly prejudicial if there has been no breach of the majority's fiduciary duty and the reasonable expectation of shareholders has not been violated.

192. ABA SUPPLEMENT COMMENTS, *supra* note 30, § 40, at 1852-1955. The ABA SUPPLEMENT § 40 corresponds with MONT. CODE ANN. § 35-9-501 (1987).

193. MONT. CODE ANN. § 35-9-502(l) (1987).

194. Some commentators have concluded that adoption of provisions such as the MCCA might imply that the flexible remedies for deadlock and other special provisions may not be available to non-statutory close corporations. *See* Karjala, *supra* note 16, at 1259; Jordan, *The Close Corporation Provisions of the New California General Corporation Law*, 23 U.C.L.A. L. REV. 1094, 1151 (1976). The problem, commonly known as negative implication problem, is not a problem under the MCCA. MONT. CODE ANN. § 35-9-102(3) (1987) states that the MCCA "does not repeal or modify any . . . rule of law that applies to a corporation . . . that does not elect to become a statutory corporation . . . ." It is clear that the enactment did not modify any of the rules of equity heretofore applying to corporations.

195. *See supra* text accompanying notes 51-67.

196. *See supra* text accompanying notes 68-69.

197. MONT. CODE ANN. § 35-9-503(1) (1987).

198. Those drafting the ABA Statutory Supplement purposely omitted detailed standards of when and how a court should resolve a dispute. A Comment states: "A court should have broad discretion to fashion the most appropriate remedy to resolve the dispute. What

concern, however, that a court will become unduly entangled in management is probably misplaced. Courts have historically hesitated to become overly involved in supervision of corporate management because courts lack the time and the expertise to manage a corporation.[199] Courts may properly decline to exercise the powers described in section 35-9-502 of the Montana Code Annotated if exercising such powers effectively requires them to manage the corporation. In most cases, the mere threat of court intervention will encourage parties to resolve their disputes. In the few cases when a court determines that the operation of the corporation will require substantial court supervision, court time or business expertise, the court should not become entangled in management but should take the extraordinary step of resolving the dispute by ordering a buyout or liquidation.

IV. Tax Consequences of Election to Operate as Statutory Close Corporation

When corporations are operated as partnerships there are two primary tax concerns; whether the corporations are partnerships or associations taxable as corporations and whether an S corporation will lose its status as an S corporation.

A. *Status as a Corporation or a Partnership*

When structuring a corporation with attributes of a partnership, the incorporators must consider the possibility of changing the tax status of the corporation to a partnership. The regulations promulgated under the Internal Revenue Code describe four primary attributes of associations taxable as corporations: (1) continuity of life, (2) centralization of management, (3) limited liability and (4) free transferability of interest.[200] If the organization lacks two of the four characteristics described above, then the Internal Revenue Code classifies the business as a partnership.[201]

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works in one case may not work in another. Detailed standards are not provided since they might encourage litigation and also unduly restrict the court's discretion." ABA Supplement Comments, *supra* note 30, § 41, at 1856. The ABA Supplement Comments § 41 corresponds with Mont. Code Ann. § 35-9-502 (1987).

199. Courts are reluctant to make business judgments because, as the Court of Chancery of Delaware stated in Puma v. Marriott, ___ Del. Ch. ___, 283 A.2d 693, 696 (1971) "[a] court is precluded from substituting its uninformed opinion for that of the experienced, independent board members . . . ." *See also* Financial Indus. Fund, Inc. v. McDonnell Douglas Corp., 474 F.2d 514 (10th Cir. 1973).

200. Treas. Reg. § 301. 7701-1 to -3 (1961). *See also* Morrissey v. Commissioner, 296 U.S. 344 (1935).

201. Treas. Reg. § 301.7701-2(a)(3) (1961). The regulations note, however, that "other

The regulations also provide that local law is not determinative.[202]

Close corporations might lack the attribute of centralized management because ownership and management are vested in the same individuals. The Treasury Regulations provide that "an organization has centralized management if any person (or any group of persons *which does not include all the members*) has continuing exclusive authority to make the management decisions . . . ."[203] Several cases, however, have held that the relevant question is whether there is an opportunity for centralized management, not whether centralized management actually exists.[204] As a result, it is an open question as to whether close corporations have the characteristics of centralized management if the board is composed of all of the shareholders.[205]

The concern is compounded when a close corporation agrees on restrictions which impinge on a shareholder's free transferability of interest because the corporation retains the right of first refusal. According to the Internal Revenue Code Regulations, "[a]n organization has the corporate characteristics of free transferability of interest if each of its members . . . have the power, without the consent of other members, to substitute for themselves in the same organization a person who is not a member of the organization."[206] A shareholder agreement with a right of first refusal certainly limits the ability of shareholders to transfer shares to the transferee of his or her choice. As a result, the regulations recognize that a right of first refusal creates a "modified form of free transferability."[207] The Internal Revenue Service, in determining whether the organization qualifies as a partnership or a corporation, has stated: "the presence of this modified corporate characteristic will be accorded less significance than if the characteristic [free transferability of interest] were present in the unmodified form."[208] In effect, the regulation counts corporations which use the right of first refusal as having one half of a corporate attribute

factors . . . may be significant in classifying an organization as an association, a partnership or a trust." *Id.* at 301.7701-2(a)(1).

202. *Id.* at § 301.7701-1(c). ("[T]he term "partnership" is not limited to the commonlaw meaning of partnership, but is broader in its scope and includes groups not commonly called partnerships.")

203. *Id.* at § 301.7702(c) (emphasis added).

204. *See* Morrissey v. Commissioner, 296 U.S. 344, 359 (1935); Kurzner v. United States, 413 F.2d 97, 103, 106 (5th Cir. 1969).

205. *See* Note, *Close Corporations and the Federal Income Tax Laws — Should the State Label Control?* 59 IOWA L. REV. 552, 574 (1974).

206. *Id.* at § 301.7701-2(c)(1).

207. *Id.* at § 301.7702-2(e)(2).

208. *Id.*

in the first transferability of shares category. As a result, prior to the enactment of the MCCA, most close corporations possessed at least two and one-half corporate characteristics.[209]

1. *Statutory Corporations Not Electing Optional Partnership Provisions*

There should be no doubt that, by itself, the election of treatment under the MCCA does not jeopardize Internal Revenue Service tax treatment as a corporation. The provisions of section 35-9-203 of the Montana Code Annotated which provide a statutory right of first refusal are no different from a shareholder agreement containing a right of first refusal. Likewise, simple election of treatment under the MCCA does not abolish the board. As a result, the corporation will still have at least two and one-half corporate characteristics: continuity of life, limited liability and "one half" of transferability of interest.[210] Only when the incorporators elect to operate the corporation without a board and as a partnership, will the significant possibility of treatment as a partnership arise under the Internal Revenue Code.[211]

2. *Statutory Corporations Electing Optional Partnership Provisions*

Those statutory close corporations electing to operate as a partnership abolish the board of directors, prohibit the transfer of shares, and often allow shareholders to dissolve the corporation at will. As a result these corporations are likely to lack the features of centralization of management, continuity of life and free transferability of interest. Because these corporations lack at least two of the four corporate attributes,[212] they are likely to be classified as partnerships. Given the potential for treatment as a partnership for tax purposes, traditional partnerships might also consider

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209. The characteristics include limited liability, continuity of life and "one half" of free transferability of interest. As described, it is an open question as to whether close corporations whose shareholders comprise the board are considered to have centralized management. *See supra* text accompanying notes 203-05.

210. The corporation, even if it retains the board of directors, may not have centralized management if all shareholders are directors. *See supra* text accompanying notes 203-05. If a close corporation uses a board of directors made up of a group other than all the shareholders, the corporation will possess three and one-half corporate characteristics.

211. There may, in fact, be an advantage to partnership status after the Tax Reform Act of 1986. If the MCCA is fully implemented the maximum tax rate for individual partners will be 28 percent and the maximum tax rate for corporations will be 34 percent. I.R.C. §§ 1, 11 (Law. Co-op. 1986).

212. *See supra* text accompanying note 201.

electing the provisions of the MCCA. To the extent the MCCA allows corporations to act as partnerships, but with the benefits of limited liability, there may be good reason for partnerships to consider incorporating under the MCCA. These partnerships would incorporate and adopt a shareholder agreement that provides that the corporation will act like a partnership. Presumably, if the statutory close corporation operates as a partnership, it is taxed as a partnership because it will lack at least two of the four attributes of a corporation. The option of incorporating a partnership is particularly attractive because many commentators believe that the Tax Reform Act of 1986 has diminished the advantages of taxation as a C corporation.[213] Likewise, those partnerships organized as partnerships instead of S corporations because they do not qualify as S corporations[214] or are unable to pass through all of their losses to shareholders because of a limited basis in corporate assets, should consider incorporating under the MCCA and electing to act as a partnership.[215] By doing so, these businesses may derive the advantage of being taxed as partnerships, while at the same time receive the benefits of limited liability under state law.[216]

Although corporations acting as partnerships are likely to trig-

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213. The problems with operating as a C corporation include generally higher tax rates than individuals and taxation of liquidating distributions. *See, e.g.*, Friedrich, *The Unincorporation of America*, 14 J. CORP. TAX. 3 (1987).

214. A corporation might not qualify as an S corporation because it is a member of an affiliated group, has more than thirty-five shareholders (there is no limit on the number of shareholders for purpose of electing under the MCCA if the corporation is to be newly incorporated) or has ineligible shareholders (nonresident alien, corporate shareholders). I.R.C. § 1361(b)(1), (2) (Law. Co-op. 1986).

215. The amount of loss which may be deducted by an S corporation shareholder may not exceed the sum of the adjusted basis of the shareholder's stock and the adjusted basis of the corporation's indebtedness to the shareholder. I.R.C. §§ 704(d), 705(a) (Law. Co-op. 1986). No such limitation exists with respect to partnership. As a result, many organizations may prefer to operate as a partnership rather than as an S corporation where substantial losses are expected. Partnerships are, like all taxpayers, limited in the amount of loss that may be passed through to owners by the "at risk rules." *See* I.R.C. § 465(b) (Law. Co-op. 1986).

216. What if a sole proprietor incorporates pursuant to the MCCA, abolishes the board, adopts articles providing that shares are not transferable and that the owner may dissolve the business at will. Will the business be considered a corporation or a sole proprietorship by the IRS? While the answer to that issue is beyond the scope of this article, it is not unprecedented for a corporation, owned by a single owner, to be considered a sole proprietorship if the corporation does not have the attributes of an association. In Knoxville Trust Sales & Serv., Inc. v. Commissioner, 10 T.C. 616 (1948), the United States Tax Court considered the case of a corporation owned, managed and controlled by one individual. The corporate charter was revoked, but the court noted that "[n]either before nor after that time did it have the essential characteristics of an association." *Id.* at 622. *See also* B. BITTKER AND J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS, § 2.07 (3d ed. 1971).

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ger an audit when a corporation files a partnership return, under existing Internal Revenue Code regulations, it appears that those business organizations would have a good chance of prevailing.[217] Although the Internal Revenue Code seems to provide that a partnership is an unincorporated organization,[218] the Internal Revenue Code Regulations[219] and the courts[220] adopt a functional analysis to determine whether a business organization is taxed as partnership or corporation. Since most incorporated partnerships do not have at least three of the four corporate attributes, the Internal Revenue Service, under existing regulations, should find that these organizations are not corporations.[221]

Although some statutory close corporations might benefit from classification as a partnership for tax purposes, the Internal Revenue Service treats the conversion from an association taxable as a corporation to partnership status as a liquidation.[222] The deemed liquidation will result in recognition, at the corporate level, of a gain or loss as if the corporation sold its assets for their fair market value.[223] Likewise, shareholders will recognize a gain or loss equal to the difference between the net fair value of their shares minus

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217. The Internal Revenue Service may argue that under the definitions of partnership, state law labels should be important. *See* O'Neill v. United States, 410 F.2d 888 (6th Cir. 1967). This argument, however, is inconsistent with the "functional" test used by the courts and described in the Regulations. Treasury Regulations state, for example, "the term 'partnership' is not limited to the common-law meaning of partnership, but is broader in its scope and includes groups not commonly called partnerships." Treas. Reg. § 30, 7701-1(c), 2 T.O. 6503 1960-2 C.B. 413. Several commentators have also concluded that the state label of a "corporation" does not control the classification of the organization. *See* Wang, *California Statutory Close Corporation: Gateway to Flexibility or Trap for the Unwary?* 15 San Diego L. Rev. 587 (1978); Note, *Close Corporation and the Federal Income Tax Laws—Should the State Label Control?*, 59 Iowa L. Rev. 552 (1974); Note, *The Pennsylvania Technical Close Corporation v. Commission of Internal Revenue: A Hypothetical*, 31 U. Pitt. L. Rev. 275, 282 (1969) (authored by Roger E. Wright). *See also* B. Bittker & J. Eustice, Federal Income Taxation of Corporations and Shareholders § 2.01, at 2-2 n.4 (4th ed. 1979 & 1987 Supp.).

218. I.R.C. § 7701(a)(2) (Law. Co-op. 1986) provides a partnership is a "syndicate, group, pool, joint venture, or other *unincorporated* organization" (emphasis supplied).

219. Treas. Reg. § 301.7701-2, 2 T.D. 6503, 1960-2 C.B. 413.

220. Morrissey v. Commissioner, 296 U.S. 344 (1935).

221. As discussed at notes 200-02, *supra*, Treas. Reg. § 301. 7701-2, 2 T.D. 6503, 1960-2 requires that a corporation have more corporate attributes than non-corporate attributes. Incorporated partnerships are likely to have only one of the four corporate attributes (limited liability) and lack the other three attributes (continuity of life, centralization of management, and free transferability of interest).

222. Rev. Rul. 63-107, 1963-1 C.B. 71 states: "In those cases where an organization properly classified as an association taxable as a corporation amends its operating agreement so that thereafter it is properly classified as a partnership, the change in status is treated as the liquidation of a corporation." *Id.* at 72.

223. I.R.C. § 336(a) (Law. Co-op. 1986).

the basis of their shares.[224] The disadvantage of the taxes associated with the deemed liquidation may well outweigh any advantages of the subsequent tax classification as a partnership.

As stated by Professors Bittker and Eustice, "the area has long been marked by fluidity, confusion and controversy . . . . Until Congress responds with more elaborate guidelines . . . life in this area will continue to be difficult for taxpayers, the Treasury and the courts."[225] States such as Montana, which allow business organizations to operate as partnerships, but still enjoy the benefits of limited liability, may cause the Internal Revenue Service, or Congress, to rethink and clarify the regulations and Code in this area.

B. *S Corporation Status*

Certain shareholder agreements allowed under the MCCA might create another tax problem if the Act or the shareholder agreements effectively create more than one class of stock by defining different rights among shareholders. If a corporation has more than one class of stock, it will lose the benefit of its S corporation tax election.[226]

The critical issue when determining if there is more than one class of stock is whether the "outstanding shares of the corporation [are] identical as to the rights of the holders in the profits and in the assets of the corporations."[227] Those restrictions contained in the nonelective provisions of the MCCA do not modify the rights to profits or assets and thus do not jeopardize the S election. Simple agreements creating a right of first refusal do not create a second class of stock because they do not modify individual shareholder's rights to the profits and assets of the corporation.[228] The same reasoning holds true, according to the Internal Revenue Service, if the corporation or other shareholders have the right to buy a shareholder's stock in the event of death, disability or termina-

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224. I.R.C. § 331(a) (Law. Co-op. 1986).

225. Bittker & Eustice, *supra* note 217, § 2.01, at 2-4.

226. I.R.C. § 1361(b)(1)(D) (Law Co-op. 1986). The result, of course, is that the corporation's income and losses would no longer be passed through to the shareholders and the corporation would not be treated similar to a partnership.

227. Committee Report, Senate Explanation (b) 1982 Subchapter S Revision Act as reprinted in 8 P.H. Federal Taxes ¶ 33, 317.21 (1987).

228. Rev. Rul. 85-161, 1985-2 C.B. 191. *See also* Priv. Ltr. Rul. 8,129,116 (Apr. 27, 1981); 8,407,082 (Nov. 17, 1983); 8,405,077 (Nov. 2, 1983); 8,432,024 (May 3, 1984); 8,506,114 (Nov. 19, 1984); 8,528,049 (Apr. 17, 1985). The Internal Revenue Service has also ruled that agreements requiring payment of dividends to all shareholders as well as restricting transfer of stock do not create a second class of stock. Priv. Ltr. Rul. 8,540,062 (July 9, 1985); 8,432,024 (May 3, 1984); 8,411,057 (Dec. 13, 1983).

tion of employment.[229] Provisions reallocating management powers within the corporation should not create two classes of stock because they are similar to provisions depriving shareholders of a vote. The Internal Revenue Code provides that depriving the shareholders of a vote does not create a separate class of stock.[230] Likewise, abolition of the board of directors and management of the business like a partnership does not modify the rights to profit or assets. Only in the unusual case when the attorney drafts a shareholder agreement that creates two classes of shareholder rights to profits or assets does the attorney need to be concerned about jeopardizing the S corporation election.

V. CONCLUSION

Close corporations should seriously consider incorporating as a statutory close corporation pursuant to the MCCA.[231] There are several advantages of electing to incorporate under the MCCA, irrespective of the optional elective provisions. The disadvantages associated with the MCCA for many businesses are inconsequential as compared to the advantages to a Montana close corporation.[232]

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229. Rev. Rul. 85-161, 1985-2 C.B. 191.

230. I.R.C. § 1361(c)(4) (Law. Co-op. 1986) provides that a corporation will not be considered to have more than one class of stock solely because of differences in voting rights.

231. The authors of this article do not, however, wish to create a presumption for attorneys and clients to automatically elect coverage under the optional provisions of the MCCA. For example, whether a corporation should elect the compulsory purchase provisions upon death or the partnership provisions is best decided on a case-by-case basis. Corporations which qualify for the benefits of the MCCA but are not true close corporations may not desire to elect coverage of the MCCA. Corporations that are not true close corporations are those corporations where the ownership and management of the corporation actually are separate. *See supra* text accompanying note 4. These corporations may desire the formality of the Model Business Corporation Act and may not desire to limit the transferability of shares.

232. There have been a number of commentators who have criticized the provisions of close corporation supplements. *See* 1 F. O'NEAL, *supra* note 3, § 1.19, at 1-95 to 1-103; Bradley, *supra* note 118, at 845-47. These criticisms include arguments that the ABA Supplement is not mandatory for close corporations, do not provide more protection for minority shareholders than the Model Business Corporation Act, fail to provide standardized forms for use by shareholders and do not modify the business judgment rule. Although all of these criticisms are subject to debate, it is important to note these criticisms focus on problems of close corporations with which the ABA Supplement might have dealt with but did not. The thrust of these criticisms is the ABA Supplement did not go far enough, but these authors would most likely concede the ABA Supplement is a step in the right direction.

In states allowing corporations to be treated as statutory close corporations, a minority of eligible corporations have so elected. *See* 1 F. O'NEAL *supra* note 3, § 1.18. The reasons for the relatively small number of elections are difficult to ascertain. Based on one of the author's experience in the private practice of law in Wisconsin, which has adopted the varia-

Clearly, the MCCA is appropriate for those corporations which desire the added flexibility of operating without a board of directors. In fact, without the provisions of the MCCA, the court might not enforce shareholder agreements altering the statutory scheme of board of directors' control of a corporation.[233]

Most corporations, however, will desire to continue using traditional forms of corporate management, including the board of directors. The MCCA benefits these corporations, even though shareholder agreements may confer several of the same advantages conferred by the MCCA.[234] The following benefits, not available with the Montana Business Corporation Act, are usually sufficient to justify election of the MCCA, even by those corporations which have an attorney able to draft the appropriate shareholder agreement.

> (1) *Increased Protection from Piercing the Corporate Veil.* The degree of protection from the threat of the court disregarding the corporate veil is modest, but significant.[235] At the least, the enactment of section 35-9-306 of the Montana Code Annotated is a legislative indication that if the corporation's primary sin is disregard of corporate formalities, the court should not pierce the corporate veil.
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> (2) *Legislative Mandate to Use Less Severe Remedies in Shareholder Disputes.* Because the Montana Supreme Court has been quick to find oppression when the reasonable expectations of the minority shareholders are not met, it is important that the court have the power to apply remedies other than the drastic remedies of compelled purchase or dissolution. The MCCA directs the courts to apply less severe remedies such as payment of dividends or modification of a corporate action when these less severe remedies are appropriate.

The disadvantages of electing the provisions of the MCCA are few. A majority shareholder may find the MCCA's attempt to provide the minority shareholder with additional remedies undesirable when majority shareholder's conduct is unfairly prejudicial. In reality, the degree to which the scales are tipped toward additional

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tion of the ABA Supplement, attorneys in that state did not use the ABA Supplement until they had the time to become familiar with it. This article and the forms in the Appendix are an effort to make it easier for Montana practitioners to learn about and use the ABA Supplement.

233. *See* Sensabaugh v. Polson Plywood Co., 135 Mont. 562, 342 P.2d 1064 (1959).

234. Examples include the right of first refusal and certain restrictions on the power of the board.

235. *See supra* text accompanying notes 177-82.

shareholders' rights have been properly described as "modest."[236] It may be considered another disadvantage that the MCCA requires the incorporator to tailor the incorporation documents to the individual needs of each corporation. "Custom tailoring," however, is usually required on any close corporation and always pays off in the end. To minimize this possible disadvantage, suggested articles of incorporation and a checklist are found in the Appendices to this article.

The benefits of the MCCA for corporations owned by one person, one family or a small number of individual owners are evident. Less obvious, but equally significant, are the advantages for subsidiary corporations. Under the MCCA, the parent corporation is no longer required to provide separate management for a subsidiary.[237] Like any other corporation incorporating under the MCCA, the parent corporation shareholder may elect to manage the subsidiary corporation.

The MCCA gives a corporation the tools with which to tailor the charter documents and shareholder agreement of a close corporation to the desires of its owners. Adopting the appropriate provisions of the MCCA will provide benefits to the great majority of Montana close corporations.[238] The flexibility provided by the MCCA is, however, one of its greatest pitfalls. Those close corporations seduced by the temptation to elect, without analysis, coverage of the MCCA and its optional provisions may have done themselves a disservice. Not all provisions of the MCCA are appropriate for all corporations. In order to maximize the benefits of the MCCA, the incorporators carefully should analyze the MCCA. The MCCA does not eliminate the need for preincorporation planning, but rather underscores that need.

236. Bradley, *supra* note 118, at 836. *See also supra* note 191.

237. Wilson v. Milner Hotels, Inc., 116 Mont. 424, 427, 154 P.2d 265, 267 (1944); Commercial Credit Co. v. O'Brien, 115 Mont. 199, 203, 146 P.2d 637, 639 (1943).

238. One commentator has even suggested that failure to consider the benefits of the ABA Supplement borders on violation of the attorney's duty to evaluate all forms of business organizations when analyzing an entity selection question. *See* Comment, *Assessing the Utility of Wisconsin's Close Corporation Statute: An Empirical Study*, 1986 WIS. L. REV. 811, 830 (1986) (authored by Mike Harris).

APPENDIX I

Montana Close Corporation Incorporation Checklist

A. 1. Corporate Name

First Choice: ______________________________

Second Choice: ______________________________

Third Choice: ______________________________

Fourth Choice: ______________________________

<u>Business Corporations</u>

Must contain one of the following:]] 35-1-301

Incorporated or Inc.
Corporation or Corp.
Limited or Ltd.
Company or Co.

<u>Professional Corporations</u>

Must contain one of these:

Professional Corporation or P.C.

2. Name of any predecessor partnership or other organization:

____

B. Registration of Other Names

1. Registration of farm or ranch name: ____________________
]] 30-13-112

2. Assumed business name: ____________________
]] 30-13-202

3. Trademark registration: ____________________
]] 30-13-302

4. Livestock mark or brand: ____________________
]] 81-3-101

C. Principal Montana Office: ____________________

____

____

D. Articles of Incorporation]] 35-1-202

1. Date To Be Filed: Not Before: ____________________

After: ____________________

2. Election of Corporation

_____ Close Corporation]] 35-9-103 (available for 25 or fewer shareholders for existing corps., no limit for new corps.)
_____ Business Corporation
_____ Professional Corporation

3. Period of Existence]] 35-1-202(1)(b)

_____ Perpetual
_____ Other: ____________

4. Purpose]] 35-1-202(1)(c)

_____ "any and all lawful business for which corporations may be incorporated under Title 35, Chapter 1, of the Montana Code Annotated."

_____ Professional corporation for the practice of ____________________

_____ Other ____________________

5. Powers]] 35-1-202(2)

_____ unlimited

_____ limited]] 35-1-202(2) -- list limitations ____________________

____

6. Stock]] 35-1-601

Class	Series	Number of Shares	No Par or Par Value
_____	_____	_____	_____
_____	_____	_____	_____
_____	_____	_____	_____

7. Share transfer restrictions]] 35-9-201, 202 through 204

_____ restriction should also apply to these transfers (must so state in articles)

- _____ transfers between shareholders
- _____ transfers between family members
- _____ others: list ____________________ ____________________

_____ other modifications

- _____ payment terms (e.g. 5 years or term in proposed offer whichever is longest)
- _____ other: ____________________ ____________________ ____________________ ____________________

8. Optional right of shareholder's estate to compel buy-out

_____ Use MCCA scheme (provide statement of election in articles of incorporation)]] 35-9-205

_____ Use Shareholders Agreement (provide details in shareholders agreement section)

_____ No optional right of shareholder's estate to compel buy-out

9. Preemptive Rights]] 35-1-511

_____ Grant rights (must include statement in articles)

_____ Deny rights

10. Optional Provisions (check those desired)

_____ Elimination of Board of Directors (MCA]] 35-9-301(4))

If the board of directors is eliminated, specify:

- _____ Terms of shareholders agreement specifying how corporation is to be managed: ____________________ ____________________ ____________________
- _____ Names of Designated Directors, MCA]] 35-9-302(3)(e) ____________________ ____________________ ____________________

_____ Limitation on mandatory indemnification]] 35-1-414

_____ Requirement that shareholder must amend bylaws]] 35-1-214

(otherwise directors may amend the bylaws)

11. Registered Agent]] 35-1-305: ____________

12. Registered Office]] 35-1-305: ____________

13. Directors:

_____ Number of Initial Directors: _____
Name Directors:
Name Address
____________ ____________
____________ ____________
____________ ____________
_____ Board is abolished - Designated Director:
____

14. Incorporators (Need one or more)

____

15. Method of Amendment of Articles]] 35-1-507

(a) Generally
_____ Majority vote of shareholders
_____ 2/3 vote
_____ 80% vote

(b) Supermajority required for
_____ amendment of preemptive provisions - specify
_____ other actions requiring supermajority

16. Computation of fees:

Filing fee	$20.00
License fee	_____*
Total fee to Secretary of State	_____

* Minimum fee is $50.00. The minimum fee of $50.00 authorizes 50,000 shares of no par stock or $50,000 shares of stock of $1.00 par value.

E. Bylaws]] 35-9-303

_____ No By-laws (requires detailed shareholder agreements)]] 35-9-303(1)
_____ Adopt By-laws
1. Annual Meeting]] 35-9-304(1)
_____ First Business Day after May 31st]] 35-9-304(1).
_____ Other: Specify: -- day of week _____
-- week of month _____
-- month of year _____
_____ No Annual Meeting]] 35-9-304(2)

2. Board of Directors Deadlock Resolution Provision.
_____ Yes -- specify provisions: ____________
____
____

3. Board of Directors Meetings Permitted by Phone?
_____ Yes. See MCA]] 35-1-404.
_____ No.

4. Quorum Requirements ()]]] 35-1-405, -505) for Directors
_____ majority (standard)
_____ other (higher than majority)

5. Quorum Requirements for Shareholders
_____ majority (standard)
_____ 1/3 (minimum for shareholders)
_____ other

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6. Removal of Directors]] 35-1-408
   (a) Shareholders vote needed to remove entire board
   _____ 2/3 vote of corporation with 100 or more shareholders or majority with fewer than 100 shareholders
   _____ other (may increase vote specified above, must note in Articles)
   (b) Removal of individual member of board
   _____ 2/3 of vote of shareholders
   _____ other (may increase vote specified above, must note in Articles)

7. Required notice of meetings
   (a) Directors]] 35-1-401
   _____ not less than 48 hours if by telegram and 5 days by mail
   _____ other
   (b) Shareholders
   _____ not less than 10 days nor more than 50 days before the meeting,]] 35-1-502 (may not be modified)

8. Committees]] 35-1-407.
   _____ Board of Director's committees not authorized (no bylaws needed)
   _____ Board of Director's committees authorized with limits set forth in the statute
   _____ Board of Director's committees authorized with limits in addition to those set forth in statute. Specify (e.g. must be approved of by shareholders).
   ____

9. Amendment of Bylaws.]] 35-1-214.
   _____ 2/3 vote of shareholders (must be provided for in Articles)
   _____ majority vote of shareholders (must be provided for in Articles)
   _____ majority of directors may amend subject to shareholder reversal

F. Special Shareholders Agreements Authorized by Title 35, Chapter 9,]] 35-9-301

_____ elimination of board of directors]] 35-9-301(2)(a)
_____ limit/restrict powers of the board of directors]] 35-9-301(2)(b). Explain how: ______________________________
____
_____ authorize director proxies]] 35-9-301(2)(b)
_____ weighted voting rights]] 35-9-301(2)(b)
_____ treat corporation like partnership]] 35-9-301(2)(c)&(d). Explain how.
_____ provision allowing one or more shareholders to dissolve corporation. Explain how: ______________________________
____
____
____
____
_____ modification of statutory right of first refusal contained in]] 35-9-202 (statement required in articles of incorporation). Explain modification: ______________________________
____
____
_____ Modification of mandatory purchase on death in]] 35-9-205 (statement required in articles of incorporation.)
____
____
_____ Additional Agreements. Explain: ______________________________
____
____

G. Initial Minutes

1. Call of meetings
   _____ written call
   _____ waiver of notice

2. Form of stock certificate
   _____ blank forms filled in by attorney
   _____ commercial printed forms

3. Subscription agreements:

Name	No. of Shares	Class of Shares	Purchase Price/Share	Total Purchase Price Paid

4. Description of assets (other than cash) to be transferred:
   ____
   ____

5. Description of liabilities to be assumed:
   ____
   ____

H. Miscellaneous Items

1. Primary banking facilities:
   _____ for purpose of checking account: (name & address of bank)
   ____
   Who may withdraw: _______________
   Number of signatures required: _______________
   _____ for purpose of borrowing: (name & address of bank)
   ____
   Amount borrowed: _______________
   Who may sign note: _______________
   _____ Safe Deposit Box
   _____ No
   _____ Yes -- Location: _______________
   Who has access: _______________

2. Taxable year
   _____ Calendar
   _____ Fiscal year ending _______________

3. Initial Officers -- any officer may hold more than one office]] 35-9-305
   President: _______________
   Vice-President: _______________
   Secretary: _______________
   Tresurer: _______________

4. S Corporation election (IRS Form 2553)
   _____ No
   _____ Yes

   (a)

Shareholder Name	SSN	Tax Year

   (b) Effective date of election: _______________

   (c) Earliest of following dates: 1) Date corporation first had shareholders; 2) date corporation first had assets; 3) date corporation first did business: _______________

   _____ Election for state purposes to be filed. MCA]] 15-31-202.

5. Applications for
   _____ Federal employer I.D. No. SS-4
   _____ _______________

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6. Employment Agreement
   For: ____
   ____
   ____

7. Change and/or review lease agreements
   For: ____
   ____
   ____

8. Change and review contracts with outside clients/business
   ____
   ____

9. Discuss insurance (initial to indicate discussion)
   _____ unemployment compensation
   _____ worker's compensation
   _____ public liability carrier
   _____ products liability
   _____ director and officers errors and omissions
   _____ bonding of employee
   _____ medical and accident carrier
   _____ property/casualty insurance

10. Other discussions (initial to indicate discussion)
   _____ need to capitalize
   _____ need to recognize corporate formalities
   _____ attorney acting as intermediary
   _____ termination of close corporation]] 35-9-403
   _____ limitation on extent of limited liability]] 35-9-306 (e.g. problems with undercapitalization)
   _____ share transfer restrictions (inherent limitation to right of refusal)]] 35-9-202
   _____ share compulsory purchase right upon death]] 35-9-206

11. Attorney to:
   _____ provide and compile minute book
   _____ provide and prepare stock certificates
   _____ order corporate seal
   _____ send out reminders (to corporate president) of annual meetings
   _____ add to firm mailing list for updates

12. Agreed upon fee: ______________________________

   Frequency of billing: ______________________________

   Retainer Agreement _____ sent _____ on file

APPENDIX II

ARTICLES OF INCORPORATION[240]

Executed by the undersigned person(s) of legal age, for the purpose of forming a Montana corporation under the "Montana Close Corporation Act," Title 35, Chapter 9 of the Montana Code Annotated.

ARTICLE I

Name. The name of the corporation is ___________.

ARTICLE II

Period of Existence. The period of existence shall be _________.

ARTICLE III

Election of Statutory Close Corporation. Corporation is organized as a statutory close corporation under Title 35, Chapter 9 of the Montana Code Annotated.

ARTICLE IV

Purpose. The purposes shall be to engage in the business of _______ and the transaction of any or all lawful business for which corporations may be incorporated under Title 35, Chapter 1 of the Montana Code Annotated.

ARTICLE V

Stock. (a) The corporation shall have the authority to issue one class of Stock with no par value. The aggregate number of shares of such Stock which the corporation has the authority to issue shall be ______ shares.

(b) The following statement shall appear conspicuously on each stock certificate issued by the Corporation:

> "THE RIGHTS OF SHAREHOLDERS IN A STATUTORY CLOSE CORPORATION MAY DIFFER MATERIALLY FROM THE RIGHTS OF SHAREHOLDERS IN OTHER CORPORATIONS. COPIES OF THE ARTICLES OF INCORPORATION AND BYLAWS, SHAREHOLDERS' AGREEMENT, AND OTHER DOCUMENTS, ANY OF WHICH MAY RESTRICT TRANSFERS AND AFFECT VOTING AND OTHER RIGHTS, MAY BE OBTAINED BY A SHAREHOLDER ON WRITTEN REQUEST TO THE CORPORATION."

(c) The transfer of the shares of Stock in the corporation are restricted in accordance with the share transfer provisions of Sections 35-9-202 through 204 of the Montana Code Annotated. Notwithstanding the provisions of Section 35-9-202(2)(a) of the Montana Code Annotated, the restrictions on transfer shall apply to transfers to other shareholders.[241]

ARTICLE VI

Preemptive Rights. Should additional Stock be issued at any time, the shareholders at the time of such issue shall be entitled to a pro-rata share of such issue upon payment of an amount for each share of capital stock to be established by the Board of Directors.[242]

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239. The author wishes to thank the Corporation Bureau of the Montana Secretary of State for reviewing these Articles as to form.

240. The last sentence of Article V(c) should be omitted if shareholders desire to transfer shares to each other with restrictions. The effect of permitting such transfers is to risk altering the relative percentages of shareholders. For example, if A, B and C each own one-third of the stock of ABC Corporation, the MCCA, unless modified, allows A to transfer its shares to B, making B the majority shareholder. If this scenario is regarded as undesirable, then intra-shareholder transfers should be subjected to the transfer restrictions by adopting language similar to the last sentence of Article V(c).

241. Shareholders owning stock in Montana corporations do not have preemptive rights to newly issued stock unless preemptive rights are mandated in the articles of incorporation. **Mont. Code Ann.**]] 35-1-511 (1987). It is the sense of the authors that preemptive rights are appropriate for most close corporations to assure that shareholders will have the option of maintaining their prorata interest in the corporation. Usually shareholders expect to have the right to retain their relative ownership percentages in the corporation.

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ARTICLE VII

Registered Agent and Office. The address of the initial registered office of the corporation is ___ ____________________, and the name of the initial registered agent at such office is ____________ ____.

ARTICLE VIII

Directors. The number of the directors shall initially be ___ and may, from time to time, be changed by an amendment of the By-laws. The names and addresses of the persons who are to serve as directors until the first annual meeting of shareholders or until their successors are elected and shall qualify are:

Name Address

ARTICLE IX

Incorporator(s). The name and address of the incorporator is

Name Address

ARTICLE X

Other Provisions.[243]

ARTICLE XI

Amendment. Article VI of these Articles of Incorporation may not be amended except by an affirmative vote of the shareholders owning __% of the shares entitled to vote upon the amendment.[244] This Article of the Articles of Incorporation may not be amended except by the affirmative vote of shareholders owning __% of the shares entitled to vote upon the amendment. Article III, Article V(b) and Article V(c) of these Articles of Incorporation may not be amended except by an affirmative vote of the shareholders owning two-thirds of the shares entitled to vote on the amendment.[245] All other Articles contained here may be amended by an affirmative vote of the shareholders owning a majority of the shares entitled to vote on the amendment.

DATED: ______________, 19__.

____

243. The elective provisions of the MCCA (abolition of the Board, dissolution at will of shareholders, etc.) should be adopted here. Introductory language might state
"The option provisions of the Montana Close Corporation Act, elected by the corporation are."

244. Article VI (Preemptive Rights) is designed to provide protection to minority shareholders. The provisions should not be amended except by a supermajority vote.

245. The election of the Montana Close Corporation status may not be revoked except by vote of two-thirds of the shareholders. **Mont. Code Ann.**]] 35-9-402 (1987). Likewise, Article V(b) and V(c) also relates to close corporation status.