The C & D Newsletter

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A LAW CORPORATION

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STATUTORY CLOSE CORPORATIONS

Any corporation may elect to be treated as a "close corporation" under California law. This Newsletter shall discuss the formation of a close corporation, and the advantages and disadvantages of being a close corporation.

Formation of a Close Corporation. In order to be a close corporation, the name of the corporation must contain the word "corporation," "incorporated," "limited," or some abbreviation of these words. The articles of incorporation must contain an express provision that the corporation's stock may not be held by more than 35 shareholders, and the statement "This corporation is a close corporation." If an existing corporation desires to become a close corporation after the issuance of stock, the amendment to the articles of incorporation must be approved by all of the shareholders.

Advantages of a Close Corporation. The primary advantage of a close corporation is the flexibility it gives to the shareholders in corporate matters. For example, the shareholders may, through a shareholder agreement, provide that (a) shares of stock must be voted in a certain manner, (b) only certain shares have voting rights, (c) certain matters require a supermajority vote of shares, (d) certain shareholders have the authority to manage the business of the corporation, (e) only certain types of business may be conducted by the corporation, (f) the shareholders can determine the consideration for which shares may be issued, (g) profits are to be distributed in a specified manner, (h) there are preferential distribution rights upon liquidation of the corporation, and (i) the corporation must dissolve after a certain term of years. The second main advantage of a close corporation is that it allows the corporation to reduce strict compliance with corporate formalities, such as directors' and shareholders' meetings, without risking personal liability for corporate obligations on a "piercing the corporate veil" theory.

Disadvantages of a Close Corporation. The primary disadvantage of a close corporation is the expense of preparing the shareholder agreement setting forth the relationship of the shareholders and the manner of operating the corporation. Frequently, the shareholder agreement involves extensive negotiation and detailed drafting, with its attendant legal fees. Secondly, if the shareholder agreement provides for supermajority or unanimous voting on important matters, the possibility of a deadlock increases, which can impair the operation of the business. Additionally, to the extent the shareholders have the responsibility of managing the business of the corporation, they may have liability for their actions that would normally belong to the directors. If the shareholder agreement provides that the shares have different rights, privileges, preferences and limitations, there is a potential problem that the Internal Revenue Service may claim that the corporation has two classes of stock, which would prevent the corporation from being treated as an S corporation for tax purposes. Similarly, if the shareholder agreement substantially alters the relationship of the shareholders so that the shareholders resemble partners, there is a chance that the Internal Revenue Service may treat the corporation as a partnership for tax purposes.

The decision to elect to be a close corporation is one that should be made only after careful consideration of the benefits and drawbacks of a close corporation, the differences between a close corporation and a regular corporation, and the needs and desires of the shareholders of the corporation.

This complimentary newsletter is intended to provide general information. Because of the complexities and constant changes in the law, it is important to seek professional advice before acting on any of the matters covered herein.