The Road to Becoming a Close Corporation

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Abstract

The term “close corporation” has been defined in a variety of ways by various authorities and commentators. In close corporations, shareholders have difficulty determining the market value for their shares, and they have even more difficulty finding a willing outside buyer for a minority stake, whether restrictions are detailed in the articles of incorporation or a written shareholders agreement. In dealing with the unique features of a close corporation, the Model Statutory Close Corporation Supplement developed by an American Bar Association (ABA) Committee uses the integrated format. However, Japan’s Company and Taiwan’s Business Mergers and Acquisitions Law do not use the integrated approach; instead, close corporation provisions are spread throughout their general corporation laws.

This article compares the methods for enclosing corporations adopted by the corporation laws of the United States, Japan and Taiwan, and discusses the issue of whether the decision to enclose a corporation could be made by a mere majority, rather than a unanimous shareholders agreement. It is highly probable, however, that such an amendment to the articles of corporation made by majority rule would be unfair to minority shareholders because it could affect the transferability of the minority shareholders’ shares. This article also focuses on potential abuse by majority shareholders when a mere majority is required to enclose a corporation and whether the dissolution right or appraisal right can be the best appropriate remedy to minority shareholders. Although shareholders agreement and the articles of incorporation are the two vehicles of corporate autonomy, the shareholders agreement reached by all of shareholders is more consistent with the reasonable expectation of minority shareholders than is amendment of the articles of incorporation by a majority.

Key words: Close Corporation, Shareholders Agreement, Appraisal Right, Dissolution Right, Buy/Sell Provisions, Right of First Refusal, Private Ordering.
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I. Introduction

Corporate shares are the personal property of shareholders\textsuperscript{1}, easily transferred in
the stock market. Shareholders numbering several dozen to several hundred thousand
are the owners of issued shares that may be subsequently traded person-to-person,
over-the-counter, or through a stock exchange market. But close corporations, the
most common form of business entity in the world, generally have a small number of
shareholders and no ready market for their shares. Furthermore, in close corporations,
there are restrictions on the transfer of shares to those outside the close corporations.

The provisions of Article 163 of the Taiwan’s Company Law, deemed a
mandatory rule by the Supreme Court,\textsuperscript{2} declare shares to be freely transferable.\textsuperscript{3} This
is because one of the fundamental rights of a shareholder is the freedom to dispose of
the shares as the shareholder sees fit. Nevertheless, the Business Merger and
Acquisition Law, promulgated on February 6, 2002, has allowed shareholders
adopting the voting agreement and other shareholder agreements to reach the goals of
the mutual exercise of voting rights,\textsuperscript{4} and to establish reasonable restrictions on the
transfer of shares.\textsuperscript{5}

In contrast, Japan’s new Company Law, promulgated on June 29, 2005, allows
for restrictions on the transfer of all shares to enclose the corporation. All shares must
first be offered to and approved by the corporation before they may be transferred to
outsiders, if the restrictions are included the corporation's articles of incorporation.\textsuperscript{6}
In addition, the corporation can amend the articles of incorporation to restrict the
transferability of all shares upon a resolution made by a supermajority vote
representing two-thirds of the attending shareholders who represent a majority of the
total number of issued shares.\textsuperscript{7} Such restriction is a consent restraint, which prohibits

\begin{itemize}
  \item \textsuperscript{1} See James S. Covington, Jr., The Tennessee Corporation Act and Close Corporations for Profit, 43
  TENN. L. REV. 184, 185 (1976) (declaring stocks are personal property).
  \item \textsuperscript{2} See No.1838, the Civil Decision of Taiwanese Supreme Court (1992).
  \item \textsuperscript{3} See Company Law, Article 163(1) (Taiwan, 2006) (provides that assignment/transfer of shares of a
  company shall not be prohibited or restricted by any provision in the articles of incorporation of the
  issuing company, but shall not be effected until the incorporation registration of the company).
  \item \textsuperscript{4} See Business Merger and Acquisition Law, Article 10(1) (Taiwan, 2002).
  \item \textsuperscript{5} See id. Article 11(1).
  \item \textsuperscript{6} See Company Law, Article 107(1)(a), (2)(a) (Japan, 2005).
  \item \textsuperscript{7} See id. Article 309(3)(a).
\end{itemize}
the transfer of stock without the permission of the other shareholders or the board of directors in the close corporation.

Section 3 of the Model Statutory Close Corporation Supplement provides that any corporation organized under the General Business Corporation Act and having fewer than 50 shareholders may become a statutory close corporation by amending its articles of incorporation to include a statement that the corporation is a "statutory close corporation." Nevertheless, the approach employed by the Revised Model Business Corporation Act and Model Statutory Close Corporation Supplement in the United States expressly allows for reasonable restrictions on the transfer of shares, if the restrictions are conspicuously noted on the stock certificate. Such restrictions may be detailed in the articles of incorporation or bylaws based on a written shareholders' agreement. One such restriction is a consent restraint, which prohibits the transfer of stock without the permission of the other shareholders in the close corporation. Several states have adopted provisions endorsing the effectiveness of specified shareholder agreements.

The basic theory of these statutes is to permit owners of a corporation to control its ownership and management and prevent outsiders from inserting themselves into the operations of the corporation. When shareholders are limited by substantial restrictions on the sale of their shares, the corporations are completely enclosed. In close corporations, the shareholders have difficulty determining the market value for the shares, and they have even more difficulty finding a willing outside buyer for a minority stake, even when the restrictions are not detailed in the articles of incorporation or a written shareholders agreement.

In comparing the methods for enclosing corporations adopted by the corporation laws of Japan, United States and Taiwan, one important issue should be of central concern: whether the corporation could become enclosed by means of a majority vote rather than to a unanimous shareholders agreement. It is highly probable, however, that such an amendment to articles of incorporation made by mere majority rule would be unfair to minority shareholders because of the effective restrictions on transferability. Thus, the stricter the restrictions on the transfer of shares, the greater the need for a unanimous shareholders agreement; this is particularly true when

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9 See Model Bus. Corp. Act Ann. § 7.32 (1996); see also id. 20.
dissatisfied shareholders can demonstrate harm.

This article focuses on whether the closing of a corporation should be approved by unanimous shareholder agreement or by majority rule of shareholders. It considers the potential for abuse by majority shareholders, and whether the dissolution right or appraisal right is the most appropriate remedy for minority shareholders. The article is structured as follows. First, it describes the unique nature of close corporations, and the liability risk to their shareholders. Second, this article introduces and compares the alternative models for enclosing corporations that are employed in the United States, Japan and Taiwan. Third, the article analyzes recent corporation law giving more power to private ordering in close corporations, and examines the theoretical limits of self regulation by the shareholders agreement and the articles of incorporation. Fourth, the article explores some of the exit mechanisms that have been adopted for close corporations. Finally, this article concludes that the enactment of Taiwan's Business Merger and Acquisition Law indicates that Taiwan has indeed begun a transition toward a private-order model of corporate governance, although one cannot yet declare that Taiwan has achieved a corporate governance regime that provides optimal protection for minority shareholders.

II. Close Corporation and Limited Liability

A. Legal Characteristics of Close Corporation

The best approach to an analysis of the close corporation may be to contrast it with the alternative corporate model, the public corporation. The public corporation is regulated by government agencies and usually keeps detailed records of its activities. The public corporation gives the appearance of strict conformity to the formalities of corporate governance as dictated by statutes, its articles of incorporation, and its bylaws. In addition, disclosure regime requirements of securities laws facilitate monitoring and incentives generated by market discipline.

By contrast, the close corporation rarely has more than a few dozen shareholders. Its shares are ordinarily not traded, and there may be restrictions on transferability that prohibit the admission of new members to the shareholder group and make it difficult for a shareholder to recover her investment from the company. The close corporation is traditionally typified by a small number of stockholders, the absence of a market for the corporate stock, and substantial majority stockholder participation in the
management, direction and operations of the corporation.” There is no separation of ownership and control in most close corporations, as shareholders often become employees and rely on their salaries as their return on investment. The shareholders are often active in management and may even serve as directors. Minority shareholders often protect themselves through contractual mechanisms, such as shareholder agreements. They may tend to view themselves as partners and may possess management rights and privileges that arise from various agreements among themselves. These agreements may grant unusual powers to a minority or to a single shareholder, including individual veto power, the ability to accomplish organic changes in the business, the power to control employees, or the power to dissolve the company.

The core corporation law is a combination of the corporate governance matrix. In addition to mandatory rules established by law, it is also necessary to model the regulatory impact of markets, private ordering, and self-regulation on corporate behavior. The market for executive services dramatically influences governance, and the merger and acquisition market has become a key component of governance in addition to the product market and the capital market. In close corporations, private ordering is king, and it describes the structuring and maintenance of a relationship among shareholders. Although private ordering commonly is manifested through bargaining among the shareholders, bargaining is not the sole means by which private ordering may be accomplished. A shareholders agreement is a means by which private ordering typically is implemented, but the articles of corporation also constitute a realistic means of structuring the underlying business relationships. In a word, shareholders of close corporation should be given wide discretion to make their own agreements, bargain for appropriate provisions in articles of incorporation, and generally protect their investments through private ordering mechanisms.

B. Unstable Limited Liability for Shareholders in Close Corporation

12 See James S. Covington, Jr., supra note 1, at 188.
13 See Robert B. Thompson and Randall S. Thomas, The Public and Private Faces of Derivative Lawsuits, 57 VAND. L. REV. 1747, 1755 (2004) (stating that the director-centric legal system is only a portion of the corporate governance matrix. In addition to law, it is also necessary to model markets, private ordering, and norms as regulators of corporate behavior.).
Public corporations have a large number of shareholders whose shares are either traded on a national securities exchange or on the over-the-counter market. The corporate shareholders are generally investors who do not manage the day-to-day operations of the corporation. Those shareholders are not personally responsible for the business decisions made by the corporation. A common situation resulting in the formation of a close corporation is the incorporation of the family business. Because of the unity of management and ownership in a close corporation, both decision making and investment risks fall on the shareholders. The shareholders in a close corporation generally feel as if they are in a partnership, especially based on the shareholders agreement. Shareholders of close corporations bear greater overall personal risk than shareholders of public corporations due to the unity of management and ownership. In Robert Thompson’s study of 1600 cases, piercing the corporate veil occurred only in close corporations, not in public corporations. Professor Thompson analyzed the nature of the corporations and reasons given by the courts in deciding to allow or disallow piercing of the corporate veil.  

Most successful piercing cases involve either individuals who serve as both shareholders and managers, or corporate groups in which the parent corporation was the shareholder and could name the individuals who managed the subsidiary. Because piercing of the corporate veil only occurs in close corporations or corporate groups, Professor Thompson suggests that "passivity" is an important factor in piercing the veil. Thus, a mere passive investor should be insulated from piercing, and only those owners who take on a more active role in the business will typically be subject to liability. Thompson also suggests that the activity required to pierce the veil goes beyond the usual shareholder role as a relatively passive provider of capital.

Unfortunately, there is much disagreement as to which factors from the corporate piercing doctrine should apply to limited liability entities. As a general matter, a shareholder acting as a shareholder was entitled to vote her shares selfishly, even acting against the interests of other shareholders. To the creditors, the ability to

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16 See id.
17 Id.
18 Id.
pierce a close corporation’s veil, a generally accepted principle in corporation law, is still an open question. However, since close corporations are more like partnerships, there are certain instances when shareholders should be treated like partners. The limited liability of shareholders may be penetrated de facto as a matter of fraud, absence of formalities, inadequate capitalization, commingling of assets, and excess control. It is worth noting that shareholders of close corporations may adopt specific provisions governing the corporate formation and exercise strong control of the corporation via the shareholders agreement or the articles of incorporation. Therefore, the equitable doctrine of piercing the corporate veil will more possibly apply to the close corporation, and shareholders may be liable to creditors stemming from the absence of formalities and excessively strong control of the corporation.

III. The Methods to Enclose the Corporation

To maintain the corporation's close status, each shareholder must exercise two sets of powers: the power to exclude new members from the shareholder group and the power to prevent changes in agreed managerial and financial schemes. Technically, a more common method is to impose limitations on the transferability of shares in order to accomplish guaranteed maintenance of the status.

A. The American Model: Shareholders Agreement + The Articles of Incorporation

1. Statutory Accommodation

(1) The Model Statutory Close Corporation Supplement

Section 3 of the Model Statutory Close Corporation Supplement provides that any corporation having fewer than 50 shareholders may become a statutory close corporation by amending its articles of incorporation. The amendment must be approved by the holders of two-thirds of the shares of each class of the corporation’s stock, whether they are normally voting shares or not. Section 3 further provides that any shareholder voting against the formation of a close corporation shall be entitled to receive the fair value of her shares. In short, if a corporation’s articles of

22 See James S. Covington, Jr., supra note 1, at 206.
incorporation state in their heading that it is a close corporation and provide that all issued stock is not to be held by more than 50 persons, that all issued stock is subject to one or more restrictions on transfer permitted by Section 11 of the Model Statutory Close Corporation Supplement, and that corporation may not offer any stock at public offering within meaning of Securities Act of 1933, then corporation may be organized as a close corporation. An existing corporation may become a close corporation by amending its certificate of incorporation to comply with Section 3 and 11.

Notably, Section 20 of the Model Statutory Close Corporation Supplement authorizes the shareholders agreement to regulate the exercise of corporate powers, the management of business, and the relations among shareholders. Such agreements must be in writing and require the unanimous consent of the shareholders. Thus, Section 20 recognizes that shareholders may elect to operate the corporation as if it were a partnership, and specifically authorizes such an approach to doing business. In addition, this Section recognizes that shareholders may either eliminate the board of directors pursuant to Section 21 or restrict the discretion or powers of the board. Section 20 also allows the board of directors to prohibiting any election in the articles of incorporation. Section 20(f) further states that any amendment to a shareholder agreement authorized by this section must be made by unanimous consent of the shareholders, just as unanimous consent is necessary to reach such an agreement.

(2) The Model Business Corporation Act

When forming a close corporation, a shareholders agreement is usually adopted to govern internal matters between the shareholders, and it should provide, at the very least, a restriction on the transferability of shares. The provision must be included in the articles of incorporation or by an amendment that has been unanimously approved by the shareholders. Such a provision prevents one shareholder from selling her shares to a third party without first giving the remaining shareholder the right to buy them (commonly referred to as a "right of first refusal" provision). This also gives shareholders the right to choose with whom they do business.

24 See id. § 20(a).
25 See id. § 20(b)(3).
26 See id. § 20(c) (providing that the procedure in abolishing the board of directors pursuant to § 21).
27 See id. § 20(d).
28 See id. § 20(f).
29 See Darian M. Ibrahim, Solving The Everyday Problem of Client Identity in the Context of Closely
Although the Model Business Corporation Act does not generally distinguish between public and close corporations, one provision is specifically designed for and limited to corporations without publicly traded shares, offering them the maximum ability to establish a customized private order to meet the needs of close corporations. Section 7.32 of the Revised Model Business Corporation Act provides that an agreement among shareholders is effective even if it is inconsistent with one or more provisions of the corporate statute. The provision thus effectively endorses a broad array of shareholder agreements ranging from agreements affecting or eliminating the powers of the board of directors to agreements concerning deadlock or dissolution. Sometimes, close corporations operate as partnerships or limited liability companies in the United States.\(^\text{30}\) If a close corporation has adopted a specific amendment to its articles of incorporation based on the shareholders agreement declaring the corporation to be subject to the statutory close corporation rules, it is referred to as a statutory close corporation. Such agreements must be approved unanimously by all shareholders and are valid for ten years, unless provided otherwise.\(^\text{31}\)

It is important to note that several states have adopted provisions endorsing the effectiveness of specified shareholder agreements.\(^\text{32}\) Although states may vary in the scope of the types of shareholders agreements that will be endorsed, the majority of states allow shareholders agreements that depart from statutory norms on fundamental matters such as the election of directors, appointment of officers, and guarantee of compensation for close corporations. Shareholder agreements are contracts that define arrangements among shareholders not covered by the conventional corporation rules. Shareholder agreements can be used to protect minority shareholders, avoid deadlock, protect ownership interests, create a valuation formula for shares, and provide an exit strategy for shareholders.\(^\text{33}\)

Although statutory close corporations are a subset of closely held corporations, the Delaware Supreme Court explicitly rejected the suggestion that closely held corporations and statutory close corporations should be deemed legal equivalents.\(^\text{34}\)

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\(^{30}\) See id. at 189 (indicating that closely held businesses can operate as corporations, partnerships, or limited liability companies).


\(^{34}\) See Nixon v. Blackwell, 626 A.2d 1366, 1380 (stating that court will not treat a corporation as a

(1) Buy/Sell Provisions

An effective shareholder agreement should provide for the involuntary transfer of shares and should include an option to sell, referred to as “buy/sell provisions”. An option to sell clause requires that a corporation or its shareholders purchase all shares that an exiting shareholder seeks to transfer. An involuntary transfer clause requires that a shareholder allow the corporation or its shareholders to purchase shares if her shares become subject to any encumbrances or liens.35

In practice, there are five basic types of buy/sell provisions, including Texas Showdown, Russian Roulette, Armenian Handshake, Right of First Refusal, and Appraisal Rights.36 The most common type of transfer restriction, the right of first refusal, reserves for the corporation or the shareholders the option to purchase shares of the corporation in preference to outsiders. Under first refusal option restrictions, the shares must first be offered to the corporation or remaining shareholders before they may be sold or transferred to outsiders.37 If the corporation or the other shareholders decide not to exercise the option by purchasing the shares, the shareholder is then free to transfer the shares to another party.

The first refusal option may be triggered by such events as a proposed sale of the stock; the death, divorce, retirement, termination of employment, or bankruptcy of a shareholder; or a pledge or gift of the stock. However, a clear and unambiguously drafted right of first refusal can list any number of possible events as the triggering mechanism for the option. Share transfer restrictions, especially the right of first refusal, are extremely important to close corporations, which comprise the vast majority of corporations in the business world.

(2) Control Provision

statutory close corporation if the entity did not elect that status); see also Mary Siegel, Fiduciary Duty Myths in Close Corporate Law, 29 Del. J. Corp. L. 377, 412-413 (2004) (discussing whether closely-held corporations should be treated as equivalent to statutory close corporations).
In many shareholders agreements, the primary objective is to protect the minority shareholder against the power vested in the majority and to permit the minority shareholder to gain a position on the board of directors or attain some other voice in corporate management. The minority shareholders could be entitled to appoint some directors by means of a shareholders agreement with: (a) supermajority requirements, (b) voting agreements; (c) a clause in the articles of incorporation or bylaws designating directors or specifying that a shareholder has the right to designate a specific number of directors; and (d) class voting for directors, effectively a blocking position on matters not to their liking. Shareholders agreements may be divided into those that regulate shareholder actions and those that control director functions. Included in the former category are pooling agreements, proxy agreements, and voting trusts, among others.

(3) Governance Provision

The shareholders agreement should modify the traditional norms of corporate law that reflect the needs of large, publicly held corporations. For example, the shareholders agreement can restrict the discretion of the directors, allow for exclusive shareholder governance, and even arrange the suitable governance mechanism. Although in most states corporation laws permit corporations to limit or restrict the power of the board of directors and to thereby place power in the hands of shareholders, those changes to the corporate governance norms usually must be made by provisions in the articles of incorporation. In summary, minority and majority shareholders can use a shareholders agreement and/or amend the articles of incorporation to modify the corporate governance norms of centralized control.

B. The Japanese Model: The Articles of Incorporation

1. Statutory Accommodation

(1) Commercial Code

The Japanese government reviewed the Commercial Code in 1966 and

39 See, e.g., DEL. CODE ANN. tit. 8 § 141 (2003) (stating that except as otherwise provided in the certificate of incorporation); Revised Model Bus. Corp. Act § 8.01 (2002) (stating that subject to any limitation set forth in the articles of incorporation or in an agreement authorized under § 7.32).
40 In 1966, two factors led to change; one international, one domestic. Internationally, many Japanese
expanded the spaces of corporate autonomy to meet the needs of close corporations. The Commercial Code provides that the articles of incorporation of Japanese corporations may require all transfers of shares to be approved by the board of directors of the company. The purpose of such transfer restrictions may be divided into two categories: (a) flat prohibitions on transfers designed to maintain certain current shareholders as shareholders of the corporation, and (b) transfer restrictions which exclude unknown or undesirable third parties from becoming shareholders.

Share certificates in Japan may bear a legend stating that transfers are subject to the approval of the board of directors, provided that such a restriction is also included in the articles of incorporation and that such articles are registered with the Ministry of Justice. In addition, in cases where a board of directors does not approve a proposed transfer, the Commercial Code requires the company to find an alternative purchaser. In the event that the board of directors does not approve a proposed transfer of shares by a shareholder, the board must designate an alternative purchaser of such shares or, if the board is unable to designate an alternative purchaser (which may include the corporation), the shareholder may transfer the shares to the originally proposed purchaser.

(2) New Company Law

Notably, the Diet enacted Japan’s new Company Law on June 29, 2005, which expressly allows for restrictions on the transfer of all shares to enclose the corporation. The corporation can issue three types of restrictions on shares, if the restrictions are included in the corporation's articles of incorporation: (a) the shares must first be offered to and approved by the corporation before they may be transferred to outsiders,

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41 See Commercial Code, Article 204 (Shoho, Japan) (provides that the articles of incorporation may stipulate that the transfer of shares requires the approval of the board of directors).
42 See id. Articles 188(II)(3), 204, 225-8.
43 See id. Article 204-2.
44 See id. Article 204-2(3).
the shareholders may request the corporation to acquire the shares, or (c) the corporation may acquire the shares on the fulfillment of condition upon the occurrence of a specified event.\footnote{See Company Law, Article 107(1), (2) (Japan, 2005).}

In addition, as in the United States, class stock in Japan may also be designated as containing the previous transfer restriction.\footnote{See id. Article 108(1)(d)(e)(f).} Such provisions in the articles of incorporation may state that a shareholder or the holders of a specified proportion of class shares may require recognition of the corporation at will or upon the occurrence of a certain event. In particular, the transfer restriction of shares prescribed in the articles of incorporation is a consent restraint, which prohibits the transfer of stock without the permission of the other shareholders or the board of directors in the close corporation. A technique commonly used in the United States to put potential transferees of such shares on notice of such restrictions is adopted in Japan’s Company Law.\footnote{See id. Article 216(3).} Legends on share certificates indicate that the shares are subject to transfer restrictions set forth in the articles of incorporation.

Furthermore, the provision must be included in the articles of incorporation by the incorporators or by an amendment that has been approved by the shareholders’ meeting. The corporation can amend the articles of incorporation ex post to restrict the transferability of all shares by means of a resolution approved by a supermajority vote representing two-thirds of the attending shareholders who represent a majority of the total number of issued shares.\footnote{See id. Article 309(3)(a).} In contrast, the amendment or change (except abolishment) of the articles of incorporation must be approved unanimously by all shareholders when it prescribes that the corporation may acquire the shares on the fulfillment of condition upon the occurrence of a specified event.\footnote{See id. Article 110.}

In the United States, such a provision to restrict the transferability of all shares usually is achieved by written shareholders agreements and requires the unanimous consent of the shareholders. Unlike the American model adopted by the Model Business Corporation Act, the Japanese model permits the corporation to ex post amend the articles of incorporation to restrict the transferability of all shares by supermajority vote. For the adoption of an amendment to the articles of incorporation that alters the corporation’s essential nature as well as the fundamental relationships of the shareholders both among themselves and to the corporation, especially by
restricting the transferability of all shares to enclose the corporation, the consent of
the shareholders should be required. Nevertheless, the Japanese Company Law provides that majority shareholders can amend the corporation’s charter documents to
enclose the corporation, ignoring the potential facts that the minority shareholders
might be squeezed out and unfairly oppressed.

2. Corporate Practice

In United States, minority shareholders often use shareholder agreements to
secure management rights in a close corporation by modifying traditional statutory
management and shareholder matters. Such a shareholder agreement often includes
restrictions concerning the transfer of shares. In contrast, Japan has no similar
statutory provision blessing the use of contractual arrangements among shareholders
to govern the exercise of voting rights and alter the corporate governance norms. The
absence of statutory guidance on this issue in Japan leads to several notable
differences from United States with respect to the effectiveness of including
management rights in shareholders agreements.

In Japan, if a corporation's articles of incorporation contain such a transfer
restriction, any transfer would be subject to the approval of shareholders’ meeting or
board of directors.50 In addition to the right of first refusal, the most common type of
buy/sell provision in the United States, a Japanese corporation may have an additional
method of controlling who becomes a shareholder. As discussed above, a Japanese
corporation may specify in its articles of incorporation that all transfers of shares must,
as a condition of their transfer, be approved by the shareholders’ meeting or the board
of directors. As a result, the unconditional prohibitions on transfer and rights of first
refusal are treated similarly under the Japanese Company Law, but take different
forms from American corporation norms.

The problem is that if the prohibitions on transfer and rights of first refusal are
merely included in a shareholders agreement, rather than prescribed in the articles of
incorporation, it is unclear whether parties should be bound up in the contract.
Generally speaking, such transfer restrictions, when included in a shareholders
agreement to which a transferring shareholder is a party, are valid. However, if a
transferring shareholder transfers her shares in breach of a shareholders agreement
and the transferee legally acquires such shares, the transfer would be valid.
Accordingly, while a shareholder who transfers her shares in violation of transfer

50 See id. Article 139(1).
restrictions in a shareholders agreement would be liable to the other shareholders for monetary damages (which could be extremely difficult to calculate and collect), such shareholder's transfer of its shares would not be unwound.\footnote{See Kenneth J. Lebrun, \textit{Making a Private Equity/Venture Capital Investment in Japan: Implementing Techniques Commonly Used in U.S. Transactions}, 23 U. PA. J. INT'L. ECON. L. 213, 238 (2002).}

C. The Myths of the Taiwanese Model

1. Statutory Accommodation

In 2002, the Business Mergers and Acquisitions Law amended and modified some stipulations of Taiwan’s Company Law relating to the transfer of shares, and introduced the validity of voting agreements and other shareholders agreements. According to Article 11(1) of Business Mergers and Acquisitions Law, in the process of merger/consolidation and acquisition by a company, the written agreement among shareholders may reasonably regulate the following issues: (a) the corporation, other shareholder or a designated third party shall have the priority to purchase the shares transferred by the shareholder; (b) the corporation, shareholder or a designated third party may have the priority to subscribe for shares held by other the shareholder; (c) the shareholder may request other shareholders to jointly transfer their shares; (d) any transfer of shares or offering of shares as a security in pledge to a given person by a shareholder shall require approval from the board of directors or the shareholders’ meeting; (e) the transferee or pledgee of shares owned by shareholders; and (f) restraining shares from being transferred or offered to a third person as a security in pledge within a specific period of time.\footnote{See Business Mergers and Acquisitions Law, Article 11(1) (Taiwan, 2002).} The so-called reasonable restrictions provided in Article 11(1) shall comply with the following principles: (a) such restrictions are prescribed for compliance with the Securities and Exchange Law, the tax law or any other applicable laws and ordinances; and (b) such restrictions are prescribed by virtue of being a shareholder, or as required by business competition or operation development.\footnote{See \textit{id.} Article 11(3).} Furthermore, when issuing new shares due to merger/consolidation and acquisition by a corporation that has its share certificates publicly issued (and thus subject to restrictions of transfer or pledge of shares as provided in Article 11(1)), such restrictions shall be explicitly entered into the prospectus as specified in the Securities and Exchange Law or in the document to be delivered to the investors as specified by the authority in charge of securities.\footnote{See \textit{id.} Article 11(4).} Pursuant the meaning of the previously-mentioned Article 11(1), this provision may

\footnotesize{\begin{itemize}
\item See Business Mergers and Acquisitions Law, Article 11(1) (Taiwan, 2002).
\item See \textit{id.} Article 11(3).
\item See \textit{id.} Article 11(4).
\end{itemize}}
be applied only in the procedures of merger and acquisition, and the shareholders agreement should be approved unanimously by all shareholders.

In contrast, according to Article 11(2) of the Business Mergers and Acquisitions Law, a corporation not having its share certificates publicly issued may stipulate the aforesaid issues in the articles of incorporation, and so become a close corporation. The provision of restriction on the transfer or pledging of shares must be included in the articles of incorporation by the incorporators or by an amendment to the articles of incorporation after the resolution is made by a supermajority vote. In summary, the corporation can amend or alter the articles of incorporation to restrain the transferability and alienability of all shares, and there is a direct analogue in the American model adopted by the Model Statutory Close Corporation Supplement.

In addition, the provisions in Article 163(1) and 163(2) of the Company Law, stating that the transfer of shares shall not be prohibited or restricted by any provision in the articles of incorporation, and the transfer of shares owned by incorporators shall not be affected until the passage of one year after the incorporation registration, are not applicable to Article 11(1) and 11(2) hereof. Notably, the sum of the purchased quantity of shares by a company pursuant to Article 11(1) (a) and (b) and those redeemed and purchased under other laws and ordinances shall not be greater than twenty percent of the total outstanding shares issued by that company, and the total amount of redemption and buyback shall not be greater than the sum of retained earnings plus premiums on outstanding shares issued above their par value and realized capital surplus.

Although Article 11(1) of the Business Mergers and Acquisitions Law introduces

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56 See Business Mergers and Acquisitions Law, Article 11(2) (Taiwan, 2002).
57 See Company Law, Article 277 (Taiwan, 2006) (provides that: (1) A company shall not modify or alter its Articles of Incorporation without a resolution adopted at a meeting of shareholders. (2) The aforesaid resolution at the meeting of shareholders shall be adopted by a majority of the shareholders present who represent two-thirds or more of the total number of its outstanding shares. (3) For a company that has had its share certificates publicly issued, if the total number of shares represented by shareholders present at a shareholders' meeting is not sufficient to meet the criteria specified in the preceding paragraph, the resolution may be adopted by two-thirds of the votes of the shareholders present at a shareholders' meeting who represent a majority of the total number of issued shares. (4) Where stricter criteria for the total number of shares represented by shareholders present at a shareholders' meeting and the number of votes required to pass a resolution as referred to in the preceding two paragraphs are specified in the Articles of Incorporation, such stricter criteria shall govern.).
the provisions regarding the rights of first refusal, co-sale rights and transfer restriction, there are two myths and lacks to consider when explaining such provisions.

First, Article 11(1), (3) and (4) of the Business Mergers and Acquisitions Law seem to indicate that the shareholders in public corporation might reach a buy/sell provision included in the shareholders agreement. If a corporation has its share certificates publicly issued, the shares should be freely traded in the capital market. Even though such a shareholders agreement was explicitly entered into the prospectus as specified in the Securities and Exchange Law, such a restriction on the transfer or pledging of shares cannot be set up as a defense against any third party after the articles of incorporation have been registered.58

Second, a corporation not having its share certificates publicly issued can amend the articles of incorporation to restrict the transferability of all shares. Unlike the American model, the Taiwanese model permits the private corporation to amend the articles of incorporation to enclose the corporation by supermajority vote, and to prescribe the provisions of restriction on the transfer and pledge of shares.

2. Corporate Practice

Although Article 163 of Taiwan’s Company Law has announced that its policy is to disfavor restraints on the transferability of shares, such restraints commonly vary among different shareholders agreements in corporate practice, and transfer restrictions typically require the approval of the issuing corporation or remaining shareholders. The first refusal option may be triggered by such events as a proposed sale of the shares, death, retirement, termination of employment and many other possible events.

Regardless of the Business Mergers and Acquisitions Law, controlling shareholders often adopt special contractual arrangements designed to deter undesirable third parties from becoming shareholders of the corporation, rather than to protect minority shareholders. Such transfer restrictions used in Taiwan commonly take the form of rights of first refusal. Such a provision provides that in case a shareholder desires to sell its shares to a third party, the other shareholders will have

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58 See id. Article 12 (provides that: If a company, after its incorporation, fails to register any particular that should have been registered or fails to register any changes in particulars already registered, such particulars or changes in particulars cannot be set up as a defense against any third party.).
the right to purchase such shares first.

The Supreme Court and Taiwanese High Court have addressed the right of first refusal, a reservation by a corporation of the option to gratuitously acquire the shares as a result of such events as a proposed transfer of the stock or the termination of employment, and have held the right to be valid.\(^{59}\) According to the holdings of these courts, such agreements concerning the right of first refusal do not infringe the capital maintenance rules stipulated in Article 167(1) of Company Law.\(^{60}\) The Supreme Court also recognized transfer restrictions, when included in a shareholders agreement and to which a transferring shareholder is a party, but not when they purport to affect a third party.\(^{61}\)

IV. The Limits of Shareholders Agreement

Corporation law always embraces two core principles of corporate governance: a board of directors that oversees the management of the corporation, and shareholder decisions decided by majority rule.\(^{62}\) Over time, some legislatures have amended corporate statutes to enable shareholders to contract among themselves to dispense with corporate formalities, to alter corporate core principles, and to establish new private ordering suitable to the corporation. Through private ordering, a corporation can effectively signal to potential investors that it will not expropriate the interests of minority shareholders. This private ordering may take the form of amending the articles of incorporation to provide better protections for minority shareholders, listing on a domestic securities exchange that has rules protecting minority shareholders, or cross listing on a foreign exchange (e.g., the New York Stock Exchange). This serves as a way for the firm to bond itself to stricter corporate governance rules. It also

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\(^{59}\) See No.296, the Civil Decision of Taiwanese Supreme Court (1981); No.236, the Civil Decision of Taiwanese High Court (2004).

\(^{60}\) See Company Law, Article 167(1) (Taiwan, 2006) (provides that: Subject to the provisions otherwise set out in Article 158, Article 167-1, Article 186 and Article 317 of this Law, a company may not, at its own discretion, redeem or buy back any of its outstanding shares, nor may it accept any of its outstanding shares as a security in pledge, unless a shareholder is in liquidation or adjudged bankrupt, in which case, the shares being held by the said shareholder may be bought back by the issuing company at the market price, with the buy-back price payable to the said shareholder to be withheld for off-setting the debt owed to the company by said shareholder prior to the process of the foregoing liquidation or bankruptcy pronouncement.).

\(^{61}\) See No.1025, the Civil Decision of Taiwanese Supreme Court (1981).

\(^{62}\) See Michael P. Dooley, FUNDAMENTALS OF CORPORATION LAW 1011 (Foundation Press 1995); see also Mary Siegel, supra note 34, at 384.
signals to investors that the firm will protect shareholders’ interests.63

Although the trend of corporation law affords much greater flexibility to close corporations to use shareholder agreements to meet their needs, the greater the freedom to tailor the rules of their business, the greater the risk as to whether such private ordering will be upheld by the courts.

The shareholders agreement might address the composition of the board of directors, the identity of or a procedure for determining officers of the corporation, compensation, dividend policies, any special procedures or requirements for issuing additional shares, policies for the transfer of shares, admission of additional shareholders, problems arising from death, disability, or termination of employment, and similar matters.64 Despite the substantial protections shareholders agreements afford, there are limits to the use of shareholders agreements because shareholders cannot use such agreements to permit certain acts of wrongful or oppressive conduct or corporate waste.65 Under a shareholders agreement, contractual freedom still cannot supplant the public policy concerns arising from corporation law. Even though the public policy language is neither definite nor unlimited in its scope, shareholders should proceed with caution as it is likely that the courts will determine the enforceability of shareholders agreements. In the close corporation context, commentators who favor expansive minority shareholder protections contend that minority shareholders generally fail to enter into shareholder contracts due to ignorance or overly trusting behavior.66 Therefore, they contend that courts should adopt rules to protect the reasonable expectations of minority shareholders, such as expectations to be employed by the corporation, and to have a voice in its management.67

In addition, the Model Business Corporation Act explicitly prohibits public

companies from providing shareholders with intervention power. Section 7.32 of the Revised Model Business Corporation Act authorizes shareholder agreements that are set forth in the articles of incorporation or bylaws to shift managerial power to shareholders. Section 7.32(d), however, provides that such agreements "cease to be effective when shares of corporation are listed on a national securities exchange. Moreover, once a company becomes public, if the agreement is contained or referred to in the corporate charter, the board is authorized to amend the charter without shareholder approval to delete from the charter the agreement as well as any references to the agreement." As a close look at the Japan’s Company Law reveals, the public corporation cannot provide restrictions in its articles of incorporation that require all or part of a shareholder’s shares to be first offered to and approved by the corporation before they may be transferred to outsiders. Therefore, the public corporation shall not issue shares or class shares with transfer restrictions. It is interesting to note that the model adopted by Taiwan's Business Mergers and Acquisitions Law obviously is inconsistent with the public corporation core norms as they exist in the United States and Japan.

V. The Door to Exit the Close Corporation

Generally speaking, a corporation may terminate its status as close corporation by amending its articles of incorporation to delete certain provisions. Amendment must be approved by supermajority vote of outstanding shares of each class of stock the articles of incorporation require a greater vote to terminate.

The conventional corporate law concepts of majority rule and centralized control can lead to serious problems for the close corporation minority shareholder. Traditionally, most corporate power is centralized in the hands of a board of directors. In a close corporation, the board is ordinarily controlled by the shareholder or shareholders holding a majority of the voting power. Through this control of the board, the majority shareholder has the ability to take oppressive actions against the minority shareholder's interests. In a public corporation, the minority shareholder can escape these abuses of power by simply selling her shares on the market. However, there is no ready market for the stock of a close corporation. Thus, when a close corporation shareholder is treated unfairly through oppression or otherwise, the investor cannot

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69 See Company Law, Article 2(5) (Japan, 2005).
escape the unfairness simply by selling out at a fair price; therefore, statutory relief for minority shareholders should be adopted by legislatures.

A. Dissolution Right

All jurisdictions have established voting requirements for the voluntary dissolution of the corporation and, in particular, have required supermajority votes. Apparently, the strong control rights these rules gave to minority shareholders were offset by the oppressive problems they created. Pursuant to Section 20(e) of the Model Statutory Close Corporation Supplement, a shareholder's right to compel dissolution of the corporation (as authorized in section 15) must also be set forth in the articles of incorporation. Most states' judicial dissolution provisions are derived from or are similar to these model statutory codes.

Statutory relief for minority shareholders who are treated unfairly in the close corporations setting is also provided in Section 14.30 of the Revised Model Business Corporation Act, which is really a kind of quasi appraisal remedy. The Model Business Corporation Act provides for both voluntary and judicial dissolution. According to the statutory comparison, virtually all states have adopted provisions for involuntary dissolution. Section 14.30(2) of the Revised Model Business Corporation Act provides for judicial dissolution in four major circumstances: (a) the directors are deadlocked in the management of the corporate affairs, the shareholders are unable to break the deadlock, and irreparable injury to the corporation is threatened or being suffered, or the business and affairs of the corporation can no longer be conducted to the advantage of the shareholders generally, because of the deadlock; (b) the directors or those in control of the corporation have acted, are acting, or will act in a manner that is illegal, oppressive, or fraudulent; (c) the shareholders are deadlocked in voting power and have failed, for a period that includes at least two consecutive annual meeting dates, to elect successors to directors whose terms have expired; or (d) the corporate assets are being misapplied or wasted. In theory,

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74 See Douglas K. Moll, supra note 70, at 792.
76 See id. § 14.01, § 14.30.
77 See Sandra K. Miller, supra note 32, at 590.
involuntary judicial dissolution requires the break-up of the corporation, but in practice, its effects are much milder. Special statutory and judicial remedies have evolved to protect minority shareholders from oppressive conduct by majority shareholders. Many states have adopted liberalizing remedies, which include the remedy of a judicial corporate dissolution, or, in other cases, less drastic remedies.

Where a dissolution action has been instituted, Section 14.30 of the Revised Model Business Corporation Act provides that the corporation, or one or more shareholders, may elect to purchase all of the shares owned by the petitioning shareholder. The election to purchase must be filed within ninety days after the filing of the petition for dissolution, or at a later time in the discretion of the court. After an election to purchase has been filed, the election for dissolution may not be discontinued or settled. This statute applies to publicly-owned as well as privately-owned corporations. If the parties cannot reach an agreement as to the "fair value" of the shares, the court must make its own determination. Both the Revised Model Business Corporation Act and the Model Statutory Close Corporation Supplement instruct that "fair value" should be paid. The majority of states follow this rule.

Unlike public corporations, whose shares' value is set by the market, there is no market for shares of close corporations. The shareholder of a public corporation invests money with the expectation of receiving money in return. That is, the investor expects only to receive a proportion of the earnings of the company, either in the form of dividends or appreciation in value of the stock. The close corporation investor, however, typically invests her capital with the expectation that her return will be comprised of a combination of employment benefits, management participation, and a share of the company's earnings. Generally, courts have defined fair value in the

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83 See id.
context of a buyout as "the pro rata share of the corporation as a going concern." In the context of valuation of shares in dissenters' rights cases, the American Law Institute (ALI) has defined fair value as "the value of the eligible holder's proportionate interest in the corporation, without any discount for minority status or, absent extraordinary circumstances, lack of marketability." 

The idea of using involuntary judicial dissolution to protect minority shareholders has been adopted in the corporation laws of both Japan and Taiwan. As in the United States, judicial dissolution may be permitted if the directors are deadlocked in the execution of corporate affairs, and irreparable injury has occurred or is threatened. Judicial dissolution may also be granted if the management or discretion of the assets is apparently inappropriate and poses a serious danger to the existence of the corporation. Typically, the intent of the statutes that provide relief is to give increased discretion to the judiciary to fashion a remedy if the conduct of the directors or those in control of the corporation is illegal, oppressive, or fraudulent. Furthermore, the dissolution application should be filed by shareholders who have been holding more than 10% of the total number of outstanding shares or voting shares issued by the corporation.

In Taiwan, although judicial dissolution may be permitted because of apparent difficulty in the operation of a corporation or when serious damage is threatened, it may not be permitted merely because the directors or shareholders are deadlocked in the execution of corporate affairs. In a close corporation (except unlimited companies, limited companies, and unlimited companies with limited liability shareholders), the dissolution application should be filed by shareholders who have been continuously holding more than 10% of the total number of outstanding shares issued by the corporation for a period over six months. Nevertheless, judicial

“earnings of a close corporation often are distributed in major part in salaries, bonuses and retirement benefits”).

91 See Company Law, Article 833(1)(a) (Japan, 2005).
92 See id. Article 833(1)(b).
93 See id. Article 833(1).
94 See Company Law, Article 11(1) (Taiwan, 2006) (provides that: In the event of an apparent difficulty in the operation of a corporation or serious damage, the court may, upon an application from its shareholders and after having solicited the opinions of the competent authority and the central authority in charge of the relevant end enterprises and having received a defense from the corporation, make a ruling for the dissolution of the corporation.).
95 See No.942, the Civil Decision of Taiwanese High Court, Taichung Division (2004).
96 See Company Law, Article 11(2) (Taiwan, 2006) (provides that: The dissolution application to be
dissolution may not be granted even though the conduct of the directors or those in control of the corporation is illegal, oppressive, or fraudulent. In addition, Taiwan’s Company Law does not include a provision allowing the corporation, or one or more shareholders, to elect to purchase all of the shares owned by the petitioning shareholder.

B. Appraisal Right

One major type of protection includes state provisions requiring that fundamental corporate changes such as mergers, division, and asset sales receive approval not only of the directors, but also of the shareholders. Another critical remedy for minority shareholders lies in statutory appraisal right. The appraisal right is another principal remedy available to the dissatisfied shareholder of a corporation, permitting the shareholder to dissent from a given transaction and obtain a fair market value for stock.

In United States, Section 3 of the Model Statutory Close Corporation Supplement provides that any corporation may become a statutory close corporation by amending its articles of incorporation, with the amendment approved by supermajority vote, and further allows a dissenting shareholder relief if the certificate of incorporation provides for an appraisal right. However, Section 20 further provides that the shareholders agreement to treat the corporation as a partnership must be in writing and requires the unanimous consent of the shareholders. Delaware General Corporation law, like the Model Statutory Close Corporation Supplement, requires that any election of an existing corporation to become a close corporation be approved by the holders of two-thirds of the shares of each class of stock of the corporation which are outstanding. The Delaware statute allows a dissenting shareholder relief if the certificate of incorporation provides for an appraisal right or if an amendment to the certificate of incorporation provided for such right is adopted. In theory, since the transferability of shares restricted by shareholders agreement must be approved unanimously by all shareholders, the appraisal right relief is no longer

filed by the company under the preceding paragraph shall be filed by shareholders who have been continuously holding more than 10% of the total number of outstanding shares issued by the company for a period over six months.).

97 See Sandra K. Miller, supra note 32, at 587.
99 See id. § 20(b)(3).
100 See DEL. CODE ANN. tit. 8, § 342 (2003). But see § 349 (restrictions on transfer of securities are subject to the § 202 requirement of unanimity, otherwise appraisal rights are affected).
101 See id. § 262.
necessary.

In Japan and Taiwan, although an amendment to the articles of incorporation for restriction the transfer of shares requires a higher majority vote, there also exists an important protection of appraisal right for minority shareholders. A typical effect of the appraisal right is to force a compromise between the majority who desire a fundamental change in the corporation, and the dissenters who refuse to be forced into a position different from that bargained for when the stock was purchased.

The Japan’s Company Law allows the corporation to amend the articles of incorporation to restrict the transferability of all shares by supermajority vote, and further provides a dissenting shareholder relief for appraisal right.\(^{102}\) However, since the amendment or change (except abolishment) of the articles of incorporation to prescribe that the corporation may acquire the shares on the fulfillment of a condition or upon the occurrence of a specified event must be approved unanimously by all shareholders,\(^{103}\) the appraisal right relief is no longer necessary.

Taiwan’s regulation is essentially similar to its counterpart in Japan. If a corporation attempts to amend its articles of incorporation to prescribe restrictions on the transfer or pledging of shares, the dissenting shareholder may request the corporation to buy back all of her shares at the prevailing fair price.\(^{104}\) Furthermore, the request and proceeding of the appraisal right is provided in the Articles 187 and 188 of the Company Law.\(^{105}\)

VI. Implications and Conclusion

As evidenced by the differences between United States, Japanese and Taiwanese close corporation law, different corporate settings generate different sorts of minority

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\(^{102}\) See Company law, Article 116(1)(a), 309(3)(a) (Japan, 2005).

\(^{103}\) See id. Article 110.

\(^{104}\) See Business Mergers and Acquisitions Law, Article 12(1)(a) (Taiwan, 2002) (provides that: If any (all?) of the following events occurs in the course of merger/consolidation and acquisitions by a company, the shareholder may request the company to buy back her shares held at then prevailing fair price: If a company attempts to amend its articles of incorporation to prescribe restrictions on transfer or pledge of shares, the shareholder has expressed her objection, in writing or verbally with a record before or during the meeting and waived her voting right).

\(^{105}\) See id. Article 12(2) (provides that: Articles 187 and 188 of the Company Law shall apply mutatis mutandis provided, however, that for any summary merger/consolidation proceeded under Article 18(6) or Article 19, the date as resolved by the board of directors shall be the reference date for any transaction.).
protections. It is important to note that some convergence of corporate laws and policy has occurred through the comparison of different mechanisms. Academic work involves different uses of the comparative method, and each of these uses requires different levels of accuracy in the translation and interpretation of foreign legal rules. This article concludes that investors should not put all their trust in provisions of company law, but rather should pay attention to the private ordering created by the shareholders agreement and the articles of incorporation.

In dealing with the unique features of a close corporation, corporation laws and policy of the United States, Japan and Taiwan appear in two distinct models. The Model Statutory Close Corporation Supplement developed by an American Bar Association (ABA) Committee uses the integrated format. Japan’s Company Law and Taiwan's Business Mergers and Acquisitions Law, however, do not use the integrated approach; instead, close corporation provisions are spread throughout their general corporation laws. Although an existing corporation may become a close corporation by an amendment to its articles of incorporation approved by a supermajority vote or shareholders agreement consented to by all shareholders, the latter is usually adopted. The shareholders agreement and the articles of incorporation are the two wheels of corporate autonomy; however, the shareholders agreement reached by all of shareholders is more consistent with the reasonable expectations of minority shareholders than is the amendment to the articles of incorporation made by majority rule. The shareholders agreement or the articles of incorporation could enclose the corporation and even build up private ordering to arrange a suitable governance mechanism and avoid unnecessary power struggles between the shareholders, but still must not infringe upon the public policy arising from corporation law. Because the stricter restriction on the transfer of shares results in greater need for a unanimous shareholders agreement, the author expects the legal constraints on majority rule to reflect the protections against the potential oppression to the minority shareholders.

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