

The Custodian Remedy for Deadlocks in Close Corporations

Deadlock in the management of a close corporation can cause serious and irreversible economic losses. The management structure of close corporations make these corporations especially vulnerable to deadlock. The problem can be solved by the appointment of a custodian in certain situations. This article examines the various remedies for deadlocks in close corporations and discusses why the custodian remedy in particular is suitable to overcome deadlocks.

INTRODUCTION

All corporations face the specter of deadlock.¹ Deadlock causes an impasse in management decision-making that can result in severe economic loss to the corporation and threaten its ultimate solvency. There are, however, many remedies for deadlock. These include voluntary dissolution,² involuntary dissolution,³ arbitration,⁴ remedial equitable remedies other than dissolution,⁵ provisional directors⁶ and custodians.⁷ Yet, most deadlock remedies are only appropriate in certain circumstances. Furthermore, most states have adopted only a few of these possible remedies. Therefore, many corporations suffering from deadlock are left with an ineffective remedy for their particular problem.

¹ Deadlock occurs when intracorporate dissension is elevated to such a degree that the operation of the business is substantially impaired. Tinney, *Dissension or Deadlock of Corporate Directors or Shareholders*, 6 AM. JUR. PROOF OF FACTS 2d. 387, 397 (1975). In close corporations, deadlock among either the shareholders or directors inevitably results in the complete paralysis of the corporation. See text accompanying note 15 *infra*.

² See note 16 and accompanying text *infra*.

³ See note 21 and accompanying text *infra*.

⁴ See notes 26-29 and accompanying text *infra*.

⁵ See note 32 and accompanying text *infra*.

⁶ See note 55 and accompanying text *infra*.

⁷ See note 56 and accompanying text *infra*.

In addition, the effectiveness of some remedies in breaking deadlocks may depend to a large degree on the size of the corporation. One of the most frequently occurring situations is deadlock of the small, or close corporation.⁸ Recently, several states including California have adopted special provisions that address the unique problems posed by deadlock in close corporations.⁹ One unique problem is deadlock at both the director and shareholder level. Yet, even states which treat close corporations separately do not offer fully effective statutory remedies to overcome this deadlock. The appointment of a custodian is one such

⁸ A close corporation under California law is a corporation whose articles provide that all of the corporation's issued shares of all classes shall be held by not more than 10 persons and a statement that "This corporation is a close corporation." CAL. CORP. CODE § 158 (West Cum. Supp. 1980). See also F. O'NEAL, *CLOSE CORPORATIONS* § 1.04 (2d ed. 1971)

Section 158 of the California Corporations Code serves as a recognition that shareholders of close corporations rarely adhere to the legal requirements and formalities of the corporations code. For example, many shareholders of close corporations neglect to hold shareholders' and directors' meetings. Therefore, California's close corporations provisions were enacted to meet the needs of such corporations. LEGIS. COMM. COMMENTS TO CORPORATIONS CODE § 158, reprinted in 24 WEST CAL. ANN. CODES 34 (1977).

Close corporations are particularly vulnerable to deadlocks if a shareholder dies and the deceased's heirs want to continue to draw income and become part of the management. Therefore, shareholders normally provide in their by-laws for methods of purchase of a deceased member's beneficial interest. Such provisions are necessary because shareholders of close corporations which are normally family-owned do not have a method of selling shares on the open market. However, heirs who want to continue to draw income from the corporation over a long period of time, may also want to participate in such a corporation's management. Leffler, *Dispute Settlements Within Close Corporations*, 31 ARB. J. 254 (1976). This situation is likely to cause much dissension. The heir very often does not have the same skills or talents of the deceased shareholders. Therefore, tensions which lead to deadlock will develop if the other shareholders resist the heir's desire to participate in management.

⁹ See ARIZ. REV. STAT. §§ 10-201 to 218 (1977); CAL. CORP. CODE § 158 (West Cum. Supp. 1977) (defining close corporation); DEL. CODE ANN. tit. 8, §§ 341-356 (1974); ILL. ANN. STAT. ch. 32, §§ 1201-1216 (Smith-Hurd Cum. Supp. 1979); KAN. STAT. §§ 17-7201 to 7216 (1974 and Cum. Supp. 1977); ME. REV. STAT. ANN. tit. 13A, § 102(5) (1974) (defining close corporation); N.J. STAT. ANN. § 14A:13-7(1)(C) (West Cum. Supp. 1979) (definition for the purposes of involuntary dissolution); N.Y. BUS. CORP. LAW § 620 (McKinney 1963 and Cum. Supp. 1980) (provision in certificate of restricting management control of directors valid); PA. STAT. ANN. tit. 13, §§ 1371-1386 (Purdon Cum. Supp. 1979).

effective remedy.¹⁰ This article examines the deadlock problem in close corporations, the adequacy of existing statutory remedies in California and similar states, and the need for a custodian remedy to solve the problem of deadlocks in close corporations.

I. THE DEADLOCK PROBLEM IN CLOSE CORPORATIONS

Nowhere is deadlock more fatal to a business than in a close corporation. Deadlock is more prevalent in close corporations for several reasons. First, the close contact between members in the operation of the business generally complicates disagreements and prolongs dissension more than in other business forms.¹¹ In addition, most close corporations have supermajority or unanimity voting requirements that serve as a veto power for minority shareholders.¹² These voting requirements increase the number of votes needed to pass corporate proposals and thus enhance the prospect of deadlock.¹³ Finally, close corporation investors

¹⁰ California, Maine and Texas have adopted remedies such as voluntary dissolution, involuntary dissolution and close corporation provisional directors, but have stopped one step short of fully meeting the needs of close corporations paralyzed by deadlock. These states should examine the desirability of a close corporation custodian statute, a deadlock remedy especially suited for small corporations. See CAL. CORP. CODE §§ 1900, 1800, 180 (West 1977 and Cum. Supp. 1980); ME. REV. STAT. ANN. tit. 13A, §§ 1101-1103, 1111, 1115, 1123(3)(E) (1974 and Cum. Supp. 1978); TEX. BUS. CORP. ACT ANN. arts. 6.01, 6.02, 6.03, 7.01, 2.30-4 (Vernon Cum. Supp. 1978).

¹¹ Close contact between members is common in close corporations because such corporations generally function by the labor of most of the shareholders. Furthermore, dissensions intensify because of the relationships among the members. For example, many close corporations are composed of family members or close friends. Note, *Some Experimental Parallels to the Deadlocked Close Corporation*, 13 U. FLA. L. REV. 232, 235 (1960).

¹² Members of close corporations include supermajority voting requirements in their by-laws so that the judgment of each owner may be involved in all corporate decisions. In other words, each wants to protect himself or herself from being outvoted by the other shareholders. *Id.* at 234-35. In reality, shareholders of such corporations are attempting to manage the corporation as a partnership, by avoiding the corporate formality of an independent board of directors. For a criticism of close corporate treatment of what is in effect a partnership, see Fessler, *The Fate of Closely Held Business Associations: The Debatable Wisdom of "Incorporation,"* this issue at 473.

¹³ The presence of supermajority voting requirements in a corporation's by-laws greatly increases the chances of deadlock because they present, as a practical matter, a requirement of unanimity. For example, if the corporation is

often have unreasonably high expectations that disagreements will not occur.¹⁴ Thus, these investors generally do not take precautions to anticipate the deadlock problem at the formation stage of the corporation.

A key contributing factor to the frequency of deadlocks in close corporations is the near identity of shareholders and directors. In publicly held corporations, separation of management from ownership serves as a built-in mechanism to resolve deadlocks. These shareholders can, and often do, break deadlocks among the directors. In close corporations, however, this built-in mechanism does not exist. Deadlock among directors will result in a deadlock among shareholders because both groups are composed of the same people.¹⁵

II. DISSOLUTION, ARBITRATION, AND RESIDUAL EQUITABLE REMEDIES OTHER THAN DISSOLUTION

Among the statutory remedies for deadlock are voluntary dissolution, involuntary dissolution, arbitration, and residual equitable remedies other than dissolution. While most states do not provide for all of these remedies, nearly all provide for voluntary dissolution as a remedy for deadlock.¹⁶ Voluntary dissolution

composed of two shareholders or two separate groups of shareholders, a 51% vote requirement is, in effect, a requirement of unanimity. *Olin v. Merle Norman Cosmetics, Inc.*, 200 Cal. App. 2d 260, 268, 19 Cal. Rptr. 387, 391-92 (2d Dist. 1962).

¹⁴ Hetherington & Dooley, *Illiquidity and Exploitation: A Proposed Statutory Solution to the Remaining Close Corporation Problem*, 63 VA. L. REV. 1, 2 (1977).

¹⁵ Deadlock develops because managerial distinctions between stockholder members and director members are dispelled in close corporations. Members of these corporations trust each other because of their close ties and small numbers. Thus, they rarely adhere to the formalities of corporate management. For example, they often fail to call formal meetings of corporate management. See e.g., *Slotsky v. Gellar*, 49 Pa. D. & C. 2d 252 (1969), *remanded* 455 Pa. 148, 314 A. 2d 495 (1974). The corporation, therefore, is managed by the shareholders as much as it is by the directors.

Such a close corporation can operate smoothly as long as trust and agreement remain. However, once dissension occurs, deadlock is certain for two reasons: first, shareholders will not be able to break the deadlock because of the near identity between shareholders and directors; and second, shareholders must contend with supermajority voting requirements that nearly all close corporations include in their by-laws. In *re Sahara Beach Club, Inc. v. Meyers*, 3 A.D. 933, 163 N.Y.S. 2d 315 (1957).

¹⁶ See, e.g., ALA. CODE tit. 10, §§ 21(76), 21(77) (Cum. Supp. 1973); ALASKA

statutes provide that a majority of voting shareholders can elect to dissolve the corporation regardless of its solvency.¹⁷ The rationale for this remedy is that the majority should have the absolute right to dissolve the corporation.¹⁸ In addition, under certain circumstances the board of directors can elect to dissolve

STAT. §§ 10.05.465, .474, .477 (1968); ARIZ. REV. STAT. ANN. § 10-207 (1977); ARK. STAT. ANN. § 64-901 (1966); CAL. CORP. CODE § 1900 (West 1977); COLO. REV. STAT. §§ 7-8-101 to 103 (Cum. Supp. 1978); CONN. GEN. STAT. ANN. § 33-376 (West 1960 and Cum. Supp. 1980); DEL. CODE ANN. tit. 8, § 355 (1974); D.C. CODE ANN. § 29-701 (1968); FLA. STAT. ANN. §§ 607.251, .254, .257 (West 1977); GA. CODE ANN. §§ 22-1301 to 1304 (1977); HAW. REV. STAT. § 416-121 (1976); IDAHO CODE §§ 30-1-82 to 84 (Cum. Supp. 1979); ILL. ANN. STAT. ch. 32, § 1213 (Smith-Hurd Cum. Supp. 1979); IND. CODE ANN. § 23-1-7-1 (Burns 1972); IOWA CODE ANN. §§ 496A.79 - 81 (West 1962); KAN. STAT. §§ 17-6803 to 6804,-7215 (1974); KY. REV. STAT. §§ 271A.410, .415, .420 (Cum. Supp. 1978); LA. REV. STAT. ANN. § 142 (West 1969 and Cum. Supp. 1980); ME. REV. STAT. tit. 13A, §§ 1101, 1103 (1974); MD. CORP. & ASS'NS. CODE ANN. § 76 (1973); MASS. GEN. LAWS ANN. ch. 156B, §§ 99-100 (West 1970 and Cum. Supp. 1979); MICH. STAT. ANN. §§ 21.200 (801), .200 (803) to (805) (1974); MINN. STAT. ANN. §§ 301.46 - .47 (West 1969); MISS. CODE ANN. §§ 79-3-163, -165, -167 (1973); MO. ANN. STAT. §§ 351.460, 351.465 (Vernon 1966); MONT. REV. CODES ANN. §§ 15-2275 to 2277 (1967); NEB. REV. STAT. §§ 21-2081 to 2083 (1977); NEV. REV. STAT. § 78.580 (1973); N.H. REV. STAT. ANN. §§ 294:97, :97-a (1978 and Supp. 1979); N.J. STAT. ANN. §§ 14A:12-1 to 5 (West 1969 and Cum. Supp. 1979); N.M. STAT. ANN. §§ 53-16-1 to 3 (1978); N.Y. BUS. CORP. LAW §§ 1001-1002 (non-judicial voluntary dissolution), §§ 1102-1103 (judicial voluntary dissolution) (McKinney's 1963); N.C. GEN. STAT. §§ 55-116 to 118 (1975); N.D. CENT. CODE §§ 10-21-01 to 03 (1976); OHIO REV. CODE ANN. § 1701.86 (Page Supp. 1979); OKLA. STAT. ANN. tit. 18, §§ 1.177, 1.182 (West 1953 and Cum. Supp. 1979); OR. REV. STAT. §§ 57.526, .531, .536 (1977); PA. STAT. ANN. tit. 15, §§ 2101, 2102 (Purdon 1967); R.I. GEN. LAWS §§ 7-1.1-75 to -77 (1969); S.C. CODE §§ 33-21-10 to 40, -140 (1977); S.D. COMPILED LAWS ANN. §§ 47-7-1 to -4 (1967); TENN. CODE ANN. §§ 48-1001, 1002 (1979); TEX. BUS. CORP. ACT ANN. art. 6.01 to -03 (Vernon 1956 and Cum. Supp. 1980); UTAH CODE ANN. §§ 16-10-77 to 79 (1973); VT. STAT. ANN. tit. 11, §§ 2051-2053 (1973); VA. CODE §§ 13.1-79 to 81 (1978); WASH. REV. CODE ANN. §§ 24.03.250 to 295 (1969 and Supp. 1978); W. VA. CODE §§ 31-1-124 to 126 (1975); WIS. STAT. ANN. § 180.753 (West 1957); WYO. STAT. §§ 17-1-601 to 603 (1977 and Cum. Supp. 1979).

¹⁷ A solvent corporation is one that has sufficient property to pay all of its debts or can afford a reasonable security for its creditors. 16A W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 8016, at 112 (rev. perm. ed. 1979).

For example, California provides that a majority of voting shareholders may dissolve a solvent corporation. "Any corporation may elect voluntarily to wind up and dissolve by a vote of shareholders holding shares representing 50 percent or more of the voting power." CAL. CORP. CODE § 1900(a) (West 1977).

¹⁸ W. FLETCHER, *supra* note 17, § 8022, at 131.

the corporation.¹⁹

Voluntary dissolution does not break the deadlock, but discontinues the business. It represents a recognition by the directors and shareholders that continued management of the corporation is impossible. Since this remedy requires the majority shareholders' acquiescence, the remedy is unjust only when the minority shareholders or the public will suffer irreparable harm from the dissolution.²⁰

Almost as many states provide for involuntary dissolution as provide for voluntary dissolution.²¹ Normally, any close corpora-

¹⁹ In California, the board of directors may dissolve:

- (1) A corporation which has been adjudicated a bankrupt;
- (2) A corporation which has disposed of all of its assets and has not conducted any business for a period of 5 years immediately preceding the adoption of the resolution electing to dissolve the corporation;
- (3) A corporation which has issued no shares.

CAL. CORP. CODE § 1900(b) (West 1977).

²⁰ Minority shareholders often lose the fair value of their stock because they cannot forestall the dissolution and cannot afford to buy the liquidated assets. *Theis v. Spokane Falls Gas Light Co.*, 34 Wash. 23, 31, 74 P. 1004 (1904).

A member of the public may suffer irreparable harm from dissolution of a corporation if he or she was engaged in substantial business transactions with the dissolved corporation. For example, dissolution has been denied when it would have seriously injured a bank that was financing a joint venture corporation. *Louis Adelman Assocs., Inc. v. Goldsten*, 209 Va. 731, 167 S.E.2d 104 (1969), noted in O'Neal & Magill, *California's New Close Corporation Legislation*, 23 U.C.L.A. L. REV. 1155, 1166 n.61 (1976).

²¹ See, e.g., ALA. CODE tit. 10, § 21 (78) (Cum. Supp. 1973); ALASKA STAT. § 10.05.540 (1968); ARIZ. REV. STAT. ANN. § 10-215 (1977); ARK. STAT. ANN. §§ 64-907, -1103 (1966); CAL. CORP. CODE § 1800 (West 1977); COLO. REV. STAT. § 7-8-113 (Cum. Supp. 1978); CONN. GEN. STAT. ANN. § 33-383 (1960 and Cum. Supp. 1980); DEL. CODE ANN. tit. 8, § 283 (1974); D.C. CODE §§ 29-719, -726 (1968); FLA. STAT. ANN. § 607.271 (West 1977); GA. CODE ANN. § 22-1317 (1977); HAW. REV. STAT. § 416-122 (1976); IDAHO CODE § 30-1-94 (Cum. Supp. 1979); ILL. ANN. STAT. ch. 32, § 1214 (Smith-Hurd Cum. Supp. 1979); IND. CODE ANN. § 23-1-73 (Burns 1972); IOWA CODE ANN. § 496A.91 (West 1962 and Cum. Supp. 1979); KAN. STAT. § 17-6812 (1974); KY. REV. STAT. §§ 271A.470, .475 (Cum. Supp. 1978); LA. REV. STAT. ANN. § 143 (West 1969 and Cum. Supp. 1980); ME. REV. STAT. tit. 13A, §§ 1111, 1115 (1974 and Cum. Supp. 1978); MD. CORP. & ASS'NS. § 79A (1973); MASS. GEN. LAWS ANN. ch. 156B, § 99 (West 1970); MICH. STAT. ANN. §§ 21.200(823), 21.200 (825) (1974); MINN. STAT. ANN. §§ 301.46, 301.49 (West 1969); MISS. CODE ANN. §§ 79-3-187, -193, -203 (1973); MO. ANN. STAT. §§ 351.485, .550 (Vernon 1966); MONT. REV. CODES ANN. § 15-2701 (Cum. Supp. 1977); NEB. REV. STAT. § 21-2096 (1977); NEV. REV. STAT. § 78.650 (1973); N.H. REV. STAT. ANN. § 294-80-a, -b (1978); N.J. STAT. ANN. § 14A.12-7

tion shareholder can bring an action for involuntary dissolution.²² Courts will order involuntary dissolution where insolvency, deadlock, fraud or minority oppression is shown.²³ Involuntary dissolution allows a shareholder to petition for dissolution even if such a shareholder is unable to obtain a majority vote. This remedy flows from a recognition of the parties' inability to work together; thus, the state should allow them to discontinue their relationship.²⁴ As in the case of voluntary dissolution,

(West Cum. Supp. 1979); N.M. STAT. ANN. § 53-16-16 (1978); N.Y. BUS. CORP. LAW §§ 1104, 1104(a)(judicial involuntary dissolution)(McKinney's 1963 and Cum. Supp. 1980); N.C. GEN. STAT. § 55-125 (1975); N.D. CENT. CODE § 10-21-16 (1976); OHIO REV. CODE ANN. § 1701.91 (Page 1978); OKLA. STAT. ANN. tit. 18, §§ 1.195 - 197 (West 1953 and Cum. Supp. 1979); OR. REV. STAT. § 57.595 (1977); PA. STAT. ANN. tit. 15, § 2107 (Purdon 1967); R.I. GEN. LAWS § 7-1.1-87 (Cum. Supp. 1979); S.C. CODE § 33-21-150 (1977); S.D. COMPILED LAWS ANN. § 47-7-26 (1967); TENN. CODE ANN. § 48-1008 (1979); TEX. BUS. CORP. ACT ANN. art. 7.01 (Vernon 1956 and Cum. Supp. 1980); UTAH CODE ANN. §§ 16-10-89 to 92 (1973 and Cum. Supp. 1979); VT. STAT. ANN. tit. 11, § 2067 (1973); VA. CODE § 13.1-94 (1978); WASH. REV. CODE ANN. §§ 24.03.250 - 295 (1969 and Supp. 1978); W. VA. CODE § 31-1-134 (1975); WIS. STAT. ANN. § 180.769 (West 1957); WYO. STAT. § 17-1-614 (1977 and Cum. Supp. 1979).

²² CAL. CORP. CODE § 1800(a)(2) (West 1977) provides that any shareholder of a close corporation has automatic standing to bring a cause of action for involuntary dissolution. *See also*, ILL. ANN. STAT. ch. 32, § 1214 (Smith-Hurd Cum. Supp. 1979); MD. CORP. & ASS'NS CODE ANN. § 79A (1973).

²³ Minority oppression occurs when obstruction to a shareholder's right to participate in the management of a close corporation exists. W. FLETCHER, *supra* note 17, § 8016.1, at 116. It is a relatively new ground for involuntary dissolution.

California and New Jersey have added provisions giving minority shareholders of small corporations additional grounds for dissolution. For example, California allows any shareholder or shareholders of close corporations to bring a cause of action for dissolution on grounds of "pervasive fraud, mismanagement, or abuse of authority or persistent unfairness toward any shareholders" by those shareholders who control the corporation. CAL. CORP. CODE § 1800(b)(4) (West 1977). Similarly, in New Jersey, a shareholder of a close corporation may bring an action for involuntary dissolution if the directors or controlling shareholders have committed illegal or fraudulent acts, have mismanaged the corporation, abused their authority or "have acted oppressively or unfairly toward one or more minority shareholders" in their capacities as officers or shareholders. N.J. STAT. ANN. § 14A:12-7 (1) (c) (West Cum. Supp. 1979). *See also* note 52 and accompanying text *infra*. These kinds of provisions ease the burden of proof which a cause of action for fraud imposes on minority shareholders.

²⁴ A similar rationale underlies partnership law. According to an English rule of partnership dissolution, once mutual confidence is destroyed, neither partner will cooperate with each other. J. TINGLE, *THE STOCKHOLDER'S REMEDY*

involuntary dissolution is inequitable only if it unduly harms shareholders or the public.²⁵

Arbitration is also used as a remedy for deadlock in close corporations. Arbitration may be provided by shareholder agreements or by a provision in the corporation's by-laws or articles of incorporation.²⁶ In addition, Arizona²⁷ and Illinois²⁸ have spe-

OF CORPORATE DISSOLUTION 70-71 (1959).

The court in *In Re Weiss*, 32 A.D. 2d 279, 301 N.Y.S.2d 839 (1969), viewed the relationship between members of close corporations as approximating the relationship between partners. Hence, the court ordered dissolution. Furthermore, the court stated "when a point is reached where the shareholders who are actively conducting the business of the corporation cannot agree, it becomes in the best interests of those shareholders to order a dissolution." *Id.* at 299, 301 N.Y.S.2d at 842.

Many states treat close corporations as "incorporated partnerships" which should be dissolved upon deadlock. Israel, *The Sacred Cow of Corporate Existence: Problems of Deadlock and Dissolution*, 19 U. CHI. L. REV. 778 (1952); Comment, *Deadlock and Dissolution in the Close Corporation: Has the Sacred Cow Been Butchered?* 58 NEB. L. REV. 791 (1979). Adherents to the incorporated partnership theory believe that remedies to continue a deadlocked business are more suitable to a public corporation. Unlike close corporations, public corporations can survive death, incapacity, and conflicts among their members. Public corporations can survive these setbacks because, in contrast to close corporations, they will replace the incapacitated members with people from outside the corporation. Alternatively, the corporation may choose another of their many shareholders as a replacement. In other words, public corporations have a large pool of people who can qualify to replace the incapacitated member. Close corporations, however, cannot survive such traumas because their success depends on the contribution of each shareholder and they will not seek replacements from outside the corporation. Comment, *The Close Corporation - Comparing the Separate Statutory Treatments of Florida, Delaware and Maryland with Virginia's Version of the Model Act*, 7 U. RICH. L. REV. 511, 524 (1973).

²⁵ In *Roach v. Margulies*, 42 N.J. Super. 243, 126 A.2d 45 (App. Div. 1956), the court acknowledged that it had the discretionary power to dissolve a close corporation. However, dissolution was denied to avoid injuring the public due to its relations with the corporation and due to the large number of subscribers to the corporation. The court stated further that dissolution should be avoided where possible if relief can be accomplished by a less onerous remedy.

See also note 20 and accompanying text *supra*.

²⁶ Leffler, *supra* note 8, at 257.

²⁷ Arizona and Illinois, however, specifically provide for enforcement of arbitration decrees of issues as to which shareholders or directors of a close corporation are deadlocked. ARIZ. REV. STAT. § 10-206 (1976); ILL. ANN. STAT. ch. 32, § 1211 (a) (7) (Smith-Hurd Cum. Supp. 1979). In addition, such enforcement can be implied from a close corporation statute in Maryland which provides that a court of equity may enforce a unanimous shareholders' agreement. MD.

cifically provided for arbitration in the close corporation context.

Arbitration is especially valuable because it is an expedient way of resolving disputes. In arbitrated disputes, the arbiter acts as a neutral director to break the deadlock.²⁹ The arbiter's disinterested decision is generally binding upon the parties. Arbitration is an appropriate remedy if the deadlock centers only on one or two issues. Arbitration does not, however, resolve deadlock if the conflict is deep and covers a succession of stalemates over management policy.³⁰ In such instances, dissension will arise after arbitration if all potential issues in dispute are not submitted to the arbiters.³¹

Statutes of five states give their courts wide discretion to grant other types of relief.³² Among the remedies available are injunctions to bar dissolution, injunctions prohibiting an act of the corporation, the shareholders, the directors or the officers and cancellation or alteration of any provision of the corporation's articles or by-laws. Maine also provides for the appoint-

CORP. & ASS'NS. CODE ANN. § 4-401(d) (1975).

²⁹ ILL. ANN. STAT. ch. 32, § 1211 (a) (7) (Smith-Hurd Cum. Supp. 1979).

²⁹ Leffler, *supra* note 8, at 258. See also O'Neal, *Resolving Disputes in Closely Held Corporations: Intra-Institutional Arbitration*, 67 HARV. L. REV. 786 (1954).

³⁰ Arbitration is valuable only if the arbiter may vote to break the deadlock and the parties have a desire to continue to work together. Leffler, *supra* note 8, at 259.

³¹ *E.g.*, in the Matter of Colletti v. Mesh. 23 A.D. 2d 245, 260 N.Y.S. 2d 130 (1965), disputes between five shareholders of a close corporation were submitted for arbitration. The arbiters decided the disputed conflict of interest issues. However, the dispute continued after the arbitration hearing. The matter was then taken to court where the arbitration award was confirmed.

³² Arizona's, North Carolina's and South Carolina's statutes simply state that the courts have the discretionary power to provide for remedies other than dissolution. ARIZ. REV. STAT. § 10-216 (1977); N.C. GEN. STAT. § 55-125.1 (1975); S.C. CODE § 33-21-230 (1976).

Maine's statute also states that the courts have discretion to grant appropriate relief other than dissolution. In addition, this statute lists some available remedies such as cancelling or altering any act of the corporation. ME. REV. STAT. ANN. tit. 13A, § 1123(3)(F) (1974).

New Hampshire has a remedy exclusively for shareholders of a closely held corporation with two shareholders who each hold 50% of the voting stock. The New Hampshire statute gives the shareholders of these corporations six months to resolve the deadlock. During that period, the powers of the board of directors will be suspended and exercised by the shareholders. If the deadlock is not broken within six months, the corporation must be dissolved. N.H. REV. STAT. ANN. § 294:80-a (1977).

ment of an additional director whose powers are defined by the court.³³ These statutes allow courts some flexibility to combat deadlock without dissolving the corporation. Such flexibility is necessary in cases where dissolution would irreparably harm the shareholders or the public.³⁴ Also, a remedy other than dissolution is appropriate when the majority shareholders intend to continue the corporation under another name while excluding minority shareholders.³⁵

III. ANALYSIS OF THE PROVISIONAL DIRECTOR AND THE CUSTODIAN REMEDY

In addition to dissolution, arbitration, and residual equitable remedies, some statutes provide for the appointment of judicial officers to serve on the corporation's board of directors. These judicial officers are the provisional director and the custodian.³⁶

³³ ME. REV. STAT. ANN. tit. 13A, § 1123(3)(E) (1974).

³⁴ Courts will not strip a corporation of its right to dissolve but rather will order an injunction against voluntary dissolution until steps are taken to protect third persons. *E.g.*, in *U.S. Industrial Alcohol v. Distilling Co. of America*, 89 N.J. Eq. 177, 104 A. 216 (1918), the corporation to be dissolved entered into a contract guaranteeing payment of dividends on the stock of another corporation and providing that no voluntary dissolution should affect the guarantee. The court granted an injunction to bar dissolution of the corporation until reasonable protection could be given the shareholders of the other corporation.

³⁵ These situations, termed "freeze-outs" of minority shareholders, have been defined as a statutory dissolution for the purpose of enabling majority shareholders to acquire corporate property to the exclusion of minority shareholders. *W. FLETCHER, supra* note 8, § 8022, at 131.

³⁶ CAL. CORP. CODE § 1802 (West Cum. Supp. 1980); GA. CODE ANN. § 22-703 (1977); ME. REV. STAT. ANN. tit. 13A, § 1123 (3) (C) (1974); MO. ANN. STAT. § 351.323 (Vernon 1966); OHIO REV. CODE ANN. [§ 1701.91.1] § 1701.911 (Page 1978); TEX. BUS. CORP. ACT ANN. art. 2.30-4 (Vernon Cum. Supp. 1980).

A total of nine states have a provisional director remedy: CAL. CORP. CODE §§ 308, 1802 (West Cum. Supp. 1980); DEL. CODE ANN. tit. 8 § 353 (1975); GA. CODE ANN. § 22-703 (1977); KAN. STAT. ANN. § 17-7213 (1973); ME. REV. STAT. ANN. tit. 13A, § 1123(3)(E) (1974) (called an "additional director"); MO. ANN. STAT. § 351 (Vernon 1959); OHIO REV. CODE ANN. [§ 1701.91.1] § 1701.911 (Page 1978); PA. STAT. ANN. tit. 15, § 1384 (Purdon Cum. Supp. 1979); TEX. BUS. CORP. ACT ANN. art. 2:30-4 (Vernon Cum. Supp. 1980).

Of these nine states, five states have provisional director statutes specifically for close corporations. CAL. CORP. CODE § 1802 (West 1977); DEL. CODE ANN. tit. 8, § 353 (1974); KAN. STAT. ANN. § 17-7213 (1973); PA. STAT. ANN. tit. 15, § 1384 (Purdon Cum. Supp. 1979); TEX. BUS. CORP. ACT ANN. art. 2.30-4 (Vernon Cum. Supp. 1980).

In addition, Arizona has a section that provides for a conservator or interim

The purpose of both judicial officers is to break corporate deadlocks and continue operation of the business. The provisional director breaks deadlocks at the director level by voting as an additional director if deadlock occurs among the members of the board. The custodian, like the provisional director, can function as an additional director. Also, a custodian may exercise discretionary powers to supersede the board of directors.

The remedies differ, however, in the degree that each may interfere with existing corporate management. This difference results in many ramifications, including the availability of the remedies to minority shareholders and the availability of credit to the corporation during the deadlock crisis. The suitability of each remedy for a particular close corporation depends on the cause of the deadlock and the effectiveness of the remedies in ultimately continuing the business.

A. *Benefits of the Custodian Remedy*

The benefits of the custodian remedy lie in the strong power and control that the custodial director can exert in a close corporation. They are more effective than provisional directors in breaking deadlocks and continuing the operation of the deadlocked close corporation until management can be returned to the directors and shareholders.

The custodian's broad discretionary powers may be the only effective way to break deadlocks where the disagreements over management develop into deep personal conflicts. In close corporations, relations between directors or shareholders can deteriorate to a point where virtually any management question is certain to result in deadlock.³⁷ A custodian would be able to prevent economic loss due to deadlock by taking full control of the corporation and managing the business until the conflicts are re-

manager in the event of deadlock. It is not clear from the statute whether the remedy is for a provisional director or a custodian. This officer is appointed to "preserve the business or continue operation of the business during pending of arbitration." According to the statute, a superior court will define the powers of such an officer. Hence, the officer may be just a tie-breaker like a provisional director, or the officer could conceivably take control of corporate management as custodians do. ARIZ. REV. STAT. ANN. § 10-214 (1976).

³⁷ The deadlock problem in close corporations is magnified due to the small number of shareholders, close ties between them, and supermajority vote requirements. See notes 11-15 and accompanying text *supra*.

solved. In addition, the custodian would be the best person to determine when the differences between shareholders are irreconcilable and the corporation should be dissolved.³⁸ If differences do not appear to be irreconcilable, a custodian could effect long range policies during the impasse and guide the corporation toward a path of continued operation. In contrast, a provisional director's power as a tie-breaker may only result in postponing final resolution of the issue.³⁹ If a provisional director votes negatively on an issue that is dividing the corporation, the issue may simply arise again at the next meeting.⁴⁰

Courts that have appointed custodial directors have not delineated their reasons for choosing the custodial director instead of a provisional director.⁴¹ However, custodians have been appointed where evidence of extreme acts of intentional wrongdoing, self-dealing, and mismanagement were found.⁴² For example, in *Slotsky v. Gellar*,⁴³ the Pennsylvania court found evidence of one shareholder's unilateral raises, failure to follow safety rules, and failure to fire an employee that had assaulted another shareholder. This evidence constituted sufficient illegal and oppressive conduct to support the appointment of a custodian.⁴⁴ Since the corporation was prospering despite deadlocks,

³⁸ Custodians are not given the power to liquidate the corporation according to most custodian statutes. See note 56 and accompanying text *infra*. Yet, custodians would be an extremely useful source of information to the courts should a petition for dissolution arise.

³⁹ See, e.g., *In re O'Brien Mach., Inc.*, 224 Cal. App. 2d 563, 36 Cal. Rptr. 782 (2d Dist. 1964), where the close corporation had been deadlocked for over two years as to a plan of voluntary dissolution. The provisional director that served for one year on the board of directors of a deadlocked corporation asked permission of the court to be relieved, because he felt that under the circumstances a provisional director was not an adequate remedy "and that something more drastic than merely breaking a deadlock on the board of directors is required, such as the appointment of a receiver or the voluntary or involuntary dissolution of the corporation." *Id.* at 566, 36 Cal. Rptr. at 784.

⁴⁰ Comment, *Corporations-The Incorporated Partnership and the Problem of the Deadlocked Board*, 3 VILL. L. REV. 196, 198-99 (1958).

⁴¹ *Slotsky v. Gellar*, 49 Pa. D. & C. 2d 252 (1969), *remanded*, 455 Pa. 148, 314 A. 2d 495 (1974); *O'Malley v. Desmond, Inc.*, 62 Pa. D. & C. 2d (1973); *Wilderman v. Wilderman*, 315 A.2d 610 (Del. Ch. 1974).

⁴² *Slotsky v. Gellar*, 49 Pa. D. & C. 2d 252 (1969), *remanded* 455 Pa. 148, 314 A.2d 495 (1974). See note 44 and accompanying text *infra*.

⁴³ 49 Pa. D. & C. 2d 252 (1969), *remanded*, 455 Pa. 148, 314 A. 2d 495 (1974).

⁴⁴ *Slotsky v. Gellar*, 49 Pa. D. & C. 2d 252 (1969), *remanded*, 455 Pa. 148,

the court decided that a custodian was necessary to save the corporation.⁴⁵

It appears from *Slotsky v. Gellar* that a custodian is a better remedy than the provisional director where extreme fraudulent and illegal acts have been committed.⁴⁶ The custodian can protect minority shareholders by taking management powers from the shareholders who are acting fraudulently.⁴⁷ Also, the custodian can prevent economic loss of the corporation until such fraudulent action is stopped. In contrast, the provisional director is an ineffective remedy for fraud because the provisional director has only the power to vote at meetings. This power is insufficient to stop fraud.

Hopefully, the effectiveness of the custodian in breaking deadlocks will prevent courts from dissolving deadlocked corporations. Continued operation of a close corporation that suffers

314 A.2d 495 (1974). Similar conduct led the court in *O'Malley v. Desmond, Inc.*, 62 Pa. D. & C. 2d (1973), to appoint a custodian. In *O'Malley*, the court stated that if "illegal, oppressive or fraudulent" acts were found, a custodian would be appointed. 62 Pa. D. & C. 2d at 647. As in *Slotsky*, the court in *O'Malley* did not explain why a provisional director was not an appropriate remedy for the close corporation in question. The Pennsylvania court interpreted the plaintiff's complaint as a request for a custodian despite the plaintiff's designation of the court appointed officer as a "receiver." The court held that if the plaintiff's allegations of improper payments to officers, destruction of records, failure to protect assets, and unauthorized withdrawal of corporate funds were found by a jury to be true, a custodian should be appointed. 62 Pa. D. & C. 2d at 647.

⁴⁵ The opinion in *Slotsky v. Gellar*, 49 Pa. D. & C. 2d 252 (1969), *remanded*, 455 Pa. 148, 314 A.2d 495 (1974) implies that if the corporation is profiting, there is more need for a custodian to continue the business and less justification for dissolution.

⁴⁶ 49 Pa. D. & C. 2d 252 (1969), *remanded*, 455 Pa. 148, 314 A.2d 495 (1974). See also *O'Malley v. Desmond*, 62 Pa. D. & C. 2d 645 (1973).

⁴⁷ In *Holi-Rest Inc., v. Treolar*, 217 N.W.2d 517 (Iowa 1974), the Iowa Supreme Court appointed a special fiscal agent similar to a custodian. The minority shareholder in this case had very little business sense. She was unaware of the majority shareholder's flagrant self-dealing and fraud. Therefore, the court felt that extra protection was required. Iowa does not have a custodian statute; however, the judicial officer was appointed as a discretionary equitable remedy. The agent's power was as extensive as the power of a custodian. He had exclusive control of the corporation and its operation. Furthermore, the court made it clear that the corporation was not to be dissolved because the shareholder had a right to petition for dissolution but did not seek such remedy. Hence, the fiscal agent was a *de facto* custodian.

from deadlock is highly debated.⁴⁸ Many states provide for dissolution upon deadlock.⁴⁹ However, dissolution may not be equitable under certain circumstances.⁵⁰ For example, in some cases, minority shareholders may suffer heavy economic losses from the dissolution.⁵¹ Also, a minority shareholder may depend on the corporation as his or her only source of income.⁵²

Furthermore, it is sometimes unwise to remove a fraudulent shareholder from the board of directors. Such a shareholder is often indispensable to the success of the business.⁵³ Hence, a custodian would be beneficial to the corporation to protect the minority shareholder's interests and yet utilize the skills and knowledge of the other shareholders.

In sum, the custodian remedy is excellent because it results in protection of minority shareholders who were victims of fraud or illegal conduct of other shareholders. The appointment of a custodian does not ensure that the deadlocked corporation will continue. However, its availability in addition to voluntary dissolution, involuntary dissolution, arbitration, residual equitable remedies and provisional director remedies will aid courts in fashioning appropriate remedies for deadlocks as they arise.

B. Criticisms of the Custodian Remedy

State legislatures must consider both the defects and the ben-

⁴⁸ See note 24 and accompanying text *supra*.

⁴⁹ See note 21 and accompanying text *supra*.

⁵⁰ See note 20 and accompanying text *supra*.

⁵¹ *Id.*

⁵² In *In re Reidom v. Neidorff*, 307 N.Y. 1, 119 N.E.2d 563 (1954), a provisional director was appointed and dissolution was denied by the court because it would deprive a widow of her only source of income.

⁵³ In *Wilderman v. Wilderman*, 315 A.2d 610 (Del. Ch. 1974), a shareholder was found to have made excessive compensation to himself after his separation from the other shareholder, his ex-wife. He was considered by the court as indispensable to the corporation. The court found that the defendant had gained a thorough knowledge of the business from the original owner, his former father-in-law. The court also found that the defendant had done most of the estimating, supervising and promotion of the business for many years. Prior to the cause of action for excessive compensation, a custodian was appointed and was still involved in the corporation's management while the litigation was taking place. The Delaware Court did not state the reasons for the initial appointment for the custodian. However, the court must have felt that it was a proper remedy because the custodian continued after the resolution of the litigated case.

efits of statutory proposals. There are two major drawbacks to the custodian remedy: first, the custodian's power over the corporation can result in excessive judicial interference into private business and second, the strict requirements placed on obtaining the appointment of a custodian pose a heavy burden on minority shareholders.⁵⁴ Hence, as in California, six states include the provisional director but omit the custodian remedy.⁵⁵ Nevertheless, seven states have provided for the custodian as a remedy to corporate deadlock.⁵⁶

The custodian statutes in these states set forth the powers of the custodian in very broad terms. Five of the state statutes provide that the custodian has all the powers of a receiver; however, the custodian has the authority only to continue, not liquidate, the business.⁵⁷ In addition, custodians often have discretionary

⁵⁴ TEX. BUS. CORP. ACT ANN. art. 2.30-4 (comment) (Vernon Cum. Supp. 1980).

⁵⁵ See note 36 and accompanying text *supra*.

⁵⁶ A total of seven states have provisions for custodians: DEL. CODE ANN. tit. 8, § 352 (1974); KAN. STAT. § 17-7212 (1974); LA. STAT. ANN. § 12:151 (West 1969) (custodian called administrator or overseer); NEV. REV. STAT. § 78-650 (1975) (custodian called a receiver); N.J. STAT. ANN. § 14A:12-7 (Cum. Supp. 1977); PA. STAT. ANN. tit. 15, § 1383 (Purdon Cum. Supp. 1979); VA. CODE ANN. § 13.1-94 (1950).

Of these seven states, four states specifically provide for custodians for close corporations: DEL. CODE ANN. tit. 8, § 352 (1974); KAN. STAT. § 17-7212; N.J. STAT. ANN. § 14A:12-7 (West Cum. Supp. 1979); PA. STAT. ANN. tit. 15, § 1383 (Purdon Cum. Supp. 1979).

⁵⁷ The custodian provisions for close corporations in Delaware, Kansas, and Pennsylvania do not set out the powers of the custodian. DEL. CODE ANN. tit. 8, § 352 (1974); KAN. STAT. § 17-7212 (1974); PA. STAT. ANN. tit. 15, § 1383 (Purdon Cum. Supp. 1979). The custodian provisions for corporations in general, however, state that the custodian may not liquidate the business unless authorized by the court or unless a petitioning shareholder has the right to dissolution by the corporation's certificate of incorporation. DEL. CODE ANN. tit. 8, §§ 226(b), 221 (1974); KAN. STAT. §§ 17-6516(b), -6901 (1974); PA. STAT. ANN. tit. 15, §§ 1513.1, 2101 (Purdon 1967 and Cum. Supp. 1979).

The equivalent of a custodian in Nevada is called a receiver. NEV. REV. STAT. § 78.650 (1975). Louisiana, however, authorizes the appointment of an administrator and overseer. LA. REV. STAT. ANN. § 12:151 (West 1969). Except for the difference in designations, Louisiana's statute closely parallels those of Delaware, Kansas, and Pennsylvania. For example, except for the power to liquidate, a custodian in Delaware, Kansas, and Pennsylvania has the same powers as a liquidating receiver. Likewise, Louisiana's custodian (referred to as a receiver) has the same power as a "judicial liquidator." LA. REV. STAT. ANN. § 12:152 (West 1969). Under Nevada's statute, holders of one-tenth of the out-

powers to do all acts which may be necessary and proper for the corporation.⁵⁸ Therefore, custodians have the power to take charge of all corporate affairs and to do all acts which might be done by the corporation.

Courts are hesitant to use custodians because the power that they exert in the corporation removes ultimate management power from the owners.⁵⁹ There is very little case law that sets forth the exact scope of the custodian's power. However, the discretionary power that is granted to the custodian in the statutes usually includes the power to override decisions of the board of directors should a deadlock occur.⁶⁰ For example, in *Wilderman v. Wilderman*,⁶¹ the Delaware Chancery Court held that a custodian has the broad power to declare dividends, and by implication, to fix salaries. These are important powers normally possessed by the board.

Due to this unrestrained discretion, courts favor the more limited provisional director remedy.⁶² Provisional directors have all the rights and powers of a regularly elected director.⁶³ They

standing stock may petition for the appointment of a receiver without applying for a dissolution. NEV. REV. STAT. § 78.650 (2) (1975). Except for the power to liquidate, the power of a nonliquidating receiver in Nevada is the same as that of a liquidating receiver. NEV. REV. STAT. §§ 78.650(5), 78.635 (1975).

⁵⁸ DEL. CODE ANN. tit. 8, § 226 (1974); KAN. STAT. § 17-6516 (1973); PA. STAT. ANN. tit. 15, § 1513.1 (Purdon Cum. Supp. 1979).

⁵⁹ Hetherington & Dooley, *supra* note 14, at 23.

⁶⁰ The New Jersey statute states a custodian may exercise the power of the board and officers, "directly, or through, or in conjunction with the corporation's board or officers in the custodian's discretion or as the court may order." N.J. STAT. ANN. § 14A:12-7(4) (West Cum. Supp. 1979).

The custodian statutes of Delaware, Kansas, Pennsylvania also do not expressly state whether custodians can override a board's decision. However, such a power can be implied from the custodian's power in these states to "do all acts which might be done by the corporation." DEL. CODE ANN. tit. 8, § 221 (1974); KAN. STAT. § 17-6516 (1974); PA. STAT. ANN. tit. 15, § 1513.1 (Purdon Cum. Supp. 1979).

⁶¹ 315 A.2d 610 (Del. Ch. 1974).

⁶² *In re Jamison Steel*, 158 Cal. App. 2d 27, 35, 322 P.2d 246, 260 (1st Dist. 1958).

In addition, Texas has not adopted a custodian statute for the same reason. TEX. BUS. CORP. ACT ANN. art. 2.30-4 (comment) (Vernon Cum. Supp. 1980).

⁶³ CAL. CORP. CODE § 308(c) (1977) states that:

A provisional director shall be an impartial person, who is neither a shareholder nor a creditor of the corporation, nor related by consanguinity or affinity within the third degree according to the common law to any of the other directors of the corporation or to any

serve as court appointed tie-breakers when there is a split between an even number of directors. However, they do not have discretionary powers to override a decision by the board of directors.⁶⁴ Hence, provisional directors do not take ultimate management from the owners.

In addition, courts are partial to provisional directors because their appointment is not likely to cause debtors to cease paying their bills or cause creditors to withhold credit. The provisional director does not appear to debtors or creditors as a major change in management, but merely as an additional director who votes only upon deadlock. In contrast, the appointment of a custodian who has powers similar to a liquidating receiver may appear to debtors and creditors as a sign of actual or potential insolvency.⁶⁵

The above concerns of the courts are reflected in some of the custodian statutes. For example, some statutes provide courts with the discretion to choose between appointing a provisional

judge of the court by which such provisional director is appointed. A provisional director shall have all the rights and powers of a director until the deadlock in the board or among shareholders is broken or until such provisional director is removed by order of the court or by approval of the outstanding shares (Section 152).

⁶⁴ The California court in *In re Jamison Steel* preferred the provisional director remedy over any kind of receiver, non-liquidating or liquidating, because the provisional director does not take property out of the hands of owners as receivers do. *In re Jamison Steel*, 158 Cal. App. 2d 27, 36, 322 P.2d 246, 251 (1st Dist. 1958).

⁶⁵ Because a custodian is probably more effective in breaking deadlocks and continuing the business than a provisional director, this situation is ironic. Most custodian statutes provide that the custodian does not have the power to liquidate unless given authority by the court or unless a shareholder has the right to dissolve the corporation under the articles of incorporation. See note 57 *supra* and accompanying text. Some of this confusion may be due to the fact that some states refer to custodians as receivers to rehabilitate, TEX. BUS. CORP. ACT ANN. art. 2.30-4 note (Vernon Cum. Supp. 1980), or receivers. LA. STAT. ANN. § 12:151 (West 1969); NEV. REV. STAT. §§ 78-650, -651 (1975). In *In re Jamison Steel*, 158 Cal. App. 2d 27, 35, 322 P.2d 346, 350 (1st Dist. 1958), the court noted that:

The idea of insolvency, actual or threatened, is so thoroughly associated in the minds of the public with the appointment of a receiver, that it is readily seen that many of the debtors of the concern would feel themselves absolved from any further obligation to pay. Then, also, we must consider the effect upon the general credit of the corporation of the appointment of a receiver, and I cannot but think it will seriously injure, if not destroy, its credit.

director or a custodian.⁶⁶ These statutes show recognition by state legislators that the provisional director remedy results in less judicial interference into private business. The advantage of such statutes is that they provide courts with the flexibility to grant the milder provisional director remedy first, and resort to the stronger custodian remedy only if necessary.⁶⁷

In addition, Professor F. Hodge O'Neal, an authority on close corporations, contends that courts should not interfere in the management of a business by appointing a custodian where members of the close corporation have specifically agreed on how the business would be operated.⁶⁸ The circumstances in *Slotsky v. Gellar* supports this contention. The shareholders of the corporation in *Slotsky* failed to provide in the shareholder agreement for terms relating to the duration of the agreement, terms relating to officers and directors, terms relating to buying and selling of shares, and remedies in the event of deadlock. The *Slotsky* court stated that these omissions in the shareholder agreement strengthened the decision to appoint a custodian.⁶⁹

The other major criticism of the custodian remedy is that the requirements for petitioners seeking to obtain relief are too burdensome on minority shareholders.⁷⁰ These requirements are said to prevent relief from deadlock for a substantial number of minority shareholders. In the past, statutes for custodian-type directors required that all remedies at law or equity be shown to be inadequate.⁷¹ Recent statutes, however, do not include this

⁶⁶ See, e.g., DEL. CODE ANN. tit. 8, § 352(b) (1974); KAN. STAT. ANN. § 17-7212(2)(b) (1974); PA. STAT. ANN. tit. 15, § 1383(b) (Purdon Cum. Supp. 1979).

⁶⁷ Professor F. Hodge O'Neal has suggested a way of preventing excessive judicial interference by using the provisional director first and then subsequently appointing a custodian if the provisional director proves ineffective. F. O'NEAL, *supra* note 8, § 9.31, at 124.

⁶⁸ F. O'NEAL, *supra* note 8, § 9.31 (Cum. Supp. 1979).

⁶⁹ 49 Pa. D. & C. 2d 252 (1969), *remanded*, 455 Pa. 148, 314 A.2d 495 (1974).

⁷⁰ TEX. BUS. CORP. ACT ANN. art. 2.30-4 (comment) (Vernon Cum. Supp. 1980).

⁷¹ *Id.* Historically, if all remedies at law or equity were shown to be inadequate, equity courts would appoint custodian-type agents but their term would be limited to the period pending the outcome of litigation. The time limitation served as a guarantee against excessive judicial supervision in a close corporation. COMMISSIONER'S COMMENTS TO 1972 AMENDMENTS TO § 14A:12-7, *reprinted in* WEST NEW JERSEY STATUTES ANNOTATED. In *Friedus v. Kaufman*, 35 N.J. Super. 601, 114 A.2d 751 (Ch. Div. 1955), the New Jersey court appointed a custodial receiver pending the outcome of a petition for dissolution.

requirement, and thus are less onerous toward minority shareholders.⁷²

In addition, some of the more recent statutes make the custodian and the provisional director remedies equally obtainable for minority shareholders by establishing identical requirements for both remedies.⁷³ For example, in New Jersey, the requirements for the appointment of a custodian, appointment of a provisional director, or an order for involuntary dissolution are identical.⁷⁴ New Jersey's statute is excellent because it provides

⁷² In construing Pennsylvania's custodian statute, the court in *O'Malley v. Desmond, Inc.*, 62 Pa. D. & C. 2d 645, 647 (1973), stated that the defendant's objection to the appointment of a custodian on the grounds that an adequate remedy at law exists was inappropriate. It was inappropriate because the statute specifically provided for a custodian if conditions such as the illegal conduct present in that corporation existed.

⁷³ N.J. STAT. ANN. § 14A:12-7 (West Cum. Supp. 1979).

Furthermore, New Jersey's and Virginia's custodian statutes specifically provide minority oppression as a grounds for the appointment of a custodian. N.J. STAT. ANN. § 14A:12-7 (1)(C) (West Cum. Supp. 1979); VA. CODE § 13.1-94 (a)(2) (1978).

Minority oppression in close corporations has been defined as a shareholder's right to participate in the management of the corporation. W. FLETCHER, *supra* note 17, § 8016.1, at 116. See note 22 and accompanying text *supra*.

In 1974, New Jersey added new grounds of mismanagement and minority oppression for provisional directors, custodians, and involuntary dissolution. These two additions make it easier for shareholders to invoke the remedies and address a wider range of problems. More specifically, these additions address problems that are short of fraud or intentional wrongdoing but which nonetheless substantially damage the interests of minority shareholders. For example, proper grounds include the freezing out of minority shareholders by their removal from office or the substantial diminishing of their compensation. These problems are quite common in close corporations, yet the minority shareholders were without recourse under the previous statute.

Furthermore, New Jersey deleted the requirement that deadlock must be to such a degree that the corporation is unable to function normally. This is consistent with the theory of appointing a custodian to continue and save the business before it becomes paralyzed to the degree that dissolution is necessary. Also, these additions to the statute leave the courts free to look beyond direct harm to the shareholders, which might be difficult to prove and look to other pertinent information of the corporation. COMMISSIONER'S COMMENTS TO 1972 AMENDMENTS TO § 14A:12-7, reprinted in WEST NEW JERSEY STATUTES ANNOTATED.

⁷⁴ Under N.J. STAT. ANN. § 14A:12-7(1) (West Cum. Supp. 1979), the Superior Court may appoint a custodian, appoint a provisional director, order a sale of the corporation's stock, or order dissolution if one of three conditions is shown: (1) if the shareholders have failed, for a period when two consecutive

courts with flexibility to order the remedy that is in the best interests of the corporation.

In practice, even statutes that do not list identical requirements for both the provisional director and the custodian do not result in deprivation of a custodian remedy to most minority shareholders. These statutes have very general standards that give courts room to choose the remedy that would be most effective in breaking the deadlock. For example, most provisional director statutes provide that such a director can be appointed if the directors are equally divided over management so that the business "can no longer be conducted to the advantages of the shareholders."⁷⁵ Custodian statutes provide that custodians can be appointed only if the corporation "is suffering or threatened with irreparable harm."⁷⁶ Judicial interpretations of these statutes, however, have shown that the difference between these two standards of harm is minimal. For example, conditions appropriate for the appointment of a provisional director in *In re Jamison Steel*⁷⁷ were as harmful to the corporation as the conditions appropriate for the appointment of a custodian in *Slotsky v. Gellar*.⁷⁸ The California court in *In re Jamison Steel* appointed a provisional director because it concluded that the corporation was in danger of loss of property. Evidence was shown that unless a \$10,000 dividend was declared, the corporation would suffer severe penalties under federal tax laws. In addition, the court stated that the corporate deadlock over excessive rent charges

annual meetings were or should have been held, to elect successors to directors whose terms have expired; or (2) if a provision as to control of directors is included in the articles of incorporation, and the directors or other managers are unable to effect action on one or more substantial matters respecting management or (3) if controlling shareholders in a close corporation have acted fraudulently or illegally, mismanaged the corporation or abused their authority as officers or directors or acted unfairly or oppressively toward minority shareholders.

⁷⁵ CAL. CORP. CODE §§ 1802, 1800 (b) (2) (West 1977 and Cum. Supp. 1980); DEL. CORP. CODE tit. 8, § 353 (a) (1974); KAN. STAT. ANN. § 17-7213 (1974); PA. STAT. ANN. tit. 15, § 1384 (a) (Purdon Cum. Supp. 1979); TEX. BUS. CORP. ACT. ANN. art. 2.30-4 (A) (Vernon Cum. Supp. 1980).

⁷⁶ DEL. CODE ANN. tit. 8, §§ 226 (a) (2), 352 (1974); KAN. STAT. § 7212 (1974); PA. STAT. ANN. tit. 15, § 1381 (a)(1) (Purdon Cum. Supp. 1979); VA. CODE § 13.1-94 (a)(1) (1978).

⁷⁷ 158 Cal. App. 2d 27, 322 P.2d 246 (1st Dist. 1958).

⁷⁸ 49 Pa. D. & C. 2d 252, 267 (1969), *remanded*, 455 Pa. 148, 314 A.2d 495 (1974).

and employment of a shareholder's son without consultation of the board might lead to heavy monetary losses.⁷⁹

Potential economic loss of similar magnitude was also grounds for the appointment of a custodian in *Slotsky v. Gellar*.⁸⁰ In *Slotsky*, the Pennsylvania court found the corporation and both of its shareholders threatened with three lawsuits as a result of a deadlock between the two shareholders.⁸¹ Although the court in *Slotsky* appointed a custodian, the quantum of potential damage was similar to the damage alleged in the *Jamison Steel* case. Hence, even those statutes that do not establish identical requirements for a provisional director or a custodian do not prevent relief to minority shareholders. Courts have freedom to construe the general requirements of provisional and custodian director statutes liberally in responding to the needs of the corporation.

In sum, the disadvantages of the custodian remedy have been mitigated by recent, well-drafted custodian statutes. For example, judicial interference has been reduced by custodian statutes which provide courts with discretion to first appoint a provisional director. In addition, recent custodian statutes relax the requirements for obtaining a custodian.

CONCLUSION

States which have only a few of the many possible deadlock remedies do not provide adequate protection for shareholders. These states, which include California, need the custodian as a remedy for close corporation deadlock. Provisional directors cannot effectively continue the operation of a deeply deadlocked but profitable business. They are not given the authority to override the unanimity or supermajority voting requirements that are commonly found in close corporations. Custodians, on

⁷⁹ In re *Jamison Steel*, 158 Cal. App. 2d 27, 322 P.2d 246 (1st Dist. 1958). The California court did not appoint a custodial-type director because the court felt that the custodian (receiver) is a drastic remedy and "is one which should not be involved unless there is an actual or threatened cessation or diminution of business." *Id.* at 35, 322 P.2d at 250.

⁸⁰ 49 Pa. D. & C. 2d 252 (1969), *remanded*, 455 Pa. 148, 314 A.2d 495 (1974).

⁸¹ One suit was between the two shareholders; a second suit was threatened by the corporation's landlord against the corporation for failure to comply with repurchase terms of the lease; and a third suit was filed by neighbors of the corporation against the corporation for violation of a deed restriction. *Id.* at 257-58.

the other hand, have certain discretionary powers which make them sufficiently independent of the board to effectively continue the business. Thus, all concerned with the corporation continue to receive its benefits. If, however, the business is not given an opportunity to continue, shareholders may lose, creditors may lose, and employees may lose. The resulting loss could be avoided by proper judicial management in the form of a custodian. Thus, a provision for a custodian would be a beneficial addition to California's close corporation deadlock remedies.

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